Options for Improving the Safety of Superannuation

Draft Recommendations

of the

Superannuation Working Group

4 March 2002

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NOTES

ADI	Authorised Deposit-taking Institution
AFSL	Australian Financial Services Licence
ALRC	Australian Law Reform Commission
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
Banking Act	*Banking Act 1959*
Corporations Act	*Corporations Act 2001*
Data Act	*Financial Sector (Collection of Data) Act 2001*
EPSSS	Exempt Public Sector Superannuation Scheme
FSI	Financial System Inquiry (Wallis)
FSRA	*Financial Services Reform Act 2001*
GIRA	*General Insurance Reform Act 2001*
Insurance Act	*Insurance Act 1973*
Life Insurance Act	*Life Insurance Act 1995*
MIA	*Managed Investments Act 1998*
NTA	Net Tangible Assets
OECD	Organisation for Economic Cooperation and Development
PDS	Product Disclosure Statement
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SMSF	Self managed superannuation fund
SWG	Superannuation Working Group

SUMMARY OF DRAFT RECOMMENDATIONS

Universal licensing regime

APRA licence

Draft Recommendation 1

The SWG recommends that the SIS Act be amended to require that trustees of superannuation entities (other than SMSFs or EPSSSs) be licensed by APRA. The SWG recommends that the APRA licence include certain conditions. These would include that the trustee be required to:

- comply with conditions on a licence, with other legislative requirements and with the covenants in the trust deed;
- have adequate systems in place to supervise functions which have been outsourced;
- have adequate resources in place (financial resources, either through capital or insurance (see discussion on capital under 3.2), technological and human resources);
- meet certain minimum standards of competency;
- have adequate risk management systems in place;
- have a compliance plan in place, and have adequate arrangements in place for ensuring compliance with the plan;
- have adequate levels of professional indemnity insurance and material damage/consequential loss insurance in place; and
- meet any other conditions as prescribed in regulations or as required by APRA.

Licensees would also need to meet the licensing criteria on an on-going basis.

The SWG recommends that the Government give consideration to the appropriate enforcement powers to be given to APRA to suspend or remove trustees where the trustee breaches the conditions of its licence or the conditions on an on-going basis, or where existing trustees fail to obtain a licence from APRA.

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The SWG recommends that the licence apply to either the trustee corporation as a whole, or where the trustee is comprised of individuals and no corporate trustee structure exists, to a notional entity comprising those individuals. Thus, individual trustees would not each be required to meet the licence criteria in their own right.

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The SWG recommends that all superannuation funds be registered by APRA prior to commencement of operations. As a component of this registration process, trustees would be required to lodge the trust deed and a compliance plan, and certification that the trust deed and compliance plan comply with relevant laws.

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The SWG recommends that existing trustees be given up to two years from the date of commencement of legislative amendments to apply to APRA for a licence and to register existing funds. New trustees would be required to be licensed from the date of commencement of the licensing regime. Consideration will need to be given to how the licensing process can be smoothed administratively during the transitional period to ensure that all applications are not received at the end of the two years.

ASIC licence

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The SWG recommends that the requirement for an APRA licence be in addition to the FSRA requirements to have an AFSL to advise or to deal in interests of the fund. However, a trustee should not be required to gain an ASIC licence to operate the fund.

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The SWG also recommends that the Government review the exemption from the AFSL requirements for dealing by non-public offer superannuation funds. If the AFSL is not so extended, the SWG recommends that, as part of their APRA licence, trustees of such funds be required to have compensation arrangements to cover their dealing activity. ASIC would be responsible for such compensation arrangements.

Single entry point

Draft Recommendation 7

The SWG recommends that the Government consider the development of a single entry point where trustees are required to hold both an APRA licence and an AFSL, so that the trustee need only lodge one application with APRA to cover both licences. The application would need to contain sufficient information to meet the requirements for each licence. In considering this recommendation, the SWG suggests that the Government examine the following matters:

- the matters which ASIC should consider when licensing an entity which has already been licensed by APRA;

- the matters in relation to which ASIC should be required to consult APRA:

    : before ASIC imposes, varies or revokes a condition on a licence that would result in an APRA-regulated body being unable to carry on its usual activities (being activities in relation to which APRA has regulatory responsibilities); and

    : before ASIC takes action to suspend or cancel a licence of such a body;

- the matters of which APRA should inform ASIC if it has taken action that would impact on the conditions of an ASIC licence; and

- the memoranda of understanding which establish information-sharing arrangements between APRA and ASIC.

Implementation issues

Draft Recommendation 8

The SWG recommends that the Government consider the current threshold for SMSFs to determine whether it is an appropriate test for determining which funds require prudential regulation.

Prudential standards-making power

Power for APRA to make prudential standards

Draft Recommendation 9

The SWG accepts in-principle that APRA should be given a prudential standards-making power similar to the one it has in relation to general insurance. The SWG acknowledges, however, that there are a number of practical implementation issues that will need to be addressed and consulted on in relation to such a power.

Prudential standard: Investment rules

Draft Recommendation 10

The SWG recommends that trustees be required:

- to ensure that the fund's objectives are clearly articulated; and

- to identify in their compliance plan the measures that they are adopting to ensure that the fund's investment strategies match the fund's objectives, and are in compliance with the sole purpose test contained in section 62 of the SIS Act.

The SWG also recommends that an independent auditor be required to certify whether the fund's investment strategy is in compliance with the fund's objectives, as a part of the fund's annual compliance audit.

Draft Recommendation 11

The SWG recommends that APRA, in consultation with all interested parties, updates its current investment circular and consider the extent to which it should be reflected in a prudential standard.

Prudential standard: Capital adequacy

Draft Recommendation 12

For superannuation funds without a trustee approved pursuant to section 26 of the SIS Act, the SWG does not consider that capital is necessary. However, the SWG recommends:

- that the Government explore whether it is viable to require these trustees to gain insurance to cover losses arising from operational risk, and to enter into

discussions with the insurance industry about the availability, costs and restrictions of such insurance;

- if it becomes apparent that a market is not available or that the costs of insurance are prohibitive, the SWG believes that the Government should consider alternative arrangements in order to address identified concerns.

Draft Recommendation 13

For trustees approved pursuant to section 26 of the SIS Act, the SWG recommends that:

- section 26 of the SIS Act be amended to require Approved Trustees to have a minimum of $100,000 NTA or, where the value of the assets under management is greater than $10 million, NTA must equal 0.5 per cent of the assets under management up to a maximum of $5 million;

- Approved Trustees which use an external custodian should be required to have NTA in accordance with requirements specified in the previous paragraph, and that the requirements in the SIS Act be amended to prevent Approved Trustees from relying on custodians to hold NTA or an approved guarantee or combination thereof;

- a two year transitional period be provided from the date of commencement of the legislative amendments, to enable those Approved Trustees relying upon custodians to cover capital arrangements to make appropriate arrangements for the holding of capital;

- the legislation be amended to provide for the suspension or removal by APRA of trustees who are unable to meet the capital requirements after the end of the two year transitional period; and

- the Government consider, in the longer term, how capital requirements for Approved Trustees could be assessed against the risks of the fund.

Prudential standard: Outsourcing

Draft Recommendation 14

The SWG recommends that, as a condition of the APRA licence, trustees be required to include a term in any contracts with third party service providers that provides APRA with a right of access to the third party, in the event that APRA has concerns about the impact of the activities of the third party on the APRA-regulated entity.

Draft Recommendation 15

The SWG also recommends that APRA consider, in consultation with all interested parties, the development of a prudential standard in this area.

Prudential standard: Governance and operational risks

Draft Recommendation 16

The SWG recommends that, as a component of the licensing framework, trustees be required to demonstrate in their compliance plan how they propose to comply with governance and risk management requirements.

Draft Recommendation 17

The SWG also recommends that APRA consider, in consultation with all interested parties, the development of a prudential standard in this area.

Annual meetings

Draft Recommendation 18

The SWG recommends that the proposals to require superannuation funds to hold AGMs or that members be given the right to request a meeting at any time not be proceeded with.

Public disclosure of annual returns

Draft Recommendation 19

The SWG recommends that for funds other than those with less than five members, ASIC establish an electronic database for public use, which provides read-only access to audited accounts of the fund and also the fund information required to be given to members under the FSR Corporations Regulations. The SWG also suggests that the Government assess the costs and appropriate funding mechanism associated with the provision of information.

Draft Recommendation 20

The SWG recommends that as a component of its current review of annual returns, APRA undertakes further investigation of any information in annual returns that could be made public, and that APRA report to Government at the end of that review.

Draft Recommendation 21

The SWG recommends that, as a supplement to these requirements, the legislation be amended to require trustees to notify fund members of the presence, and nature, of any qualification of the auditor's report.

Compliance plans

Draft Recommendation 22

The SWG recommends that superannuation trustees be required, as a condition of their APRA licence, to maintain a compliance plan in respect of each fund that they operate, which would need to be submitted as a part of the fund registration process. The plan should be addressed at particular requirements in the SIS Act. The Government should consult with industry on which requirements in the SIS Act should be included in the compliance plan.

Draft Recommendation 23

The SWG recommends that the compliance plan be audited each financial year, as a component of the fund's existing audit procedures.

Draft Recommendation 24

The SWG recommends that superannuation funds be required to have an independent body monitor compliance with the plan, as follows:

- for funds with equal employer/employee representation, the trustees themselves would be able to perform this function on the basis that the trustee board already incorporates independent representation; and

- for other funds, a compliance committee would need to be established.

Draft Recommendation 25

The SWG recommends that appropriate enforcement measures be put in place to address non-compliance with the compliance plan. For example, a significant breach could be required to be reported both to APRA and to members, regardless of whether steps had been taken to remedy the breach. In addition, the SWG recommends trustees be required to notify members that they may seek a copy of their fund's compliance plan from the trustee.

Member approval for giving benefits to related parties by trustee

Draft Recommendation 26

The SWG recommends that the definition of 'significant event' in the ongoing disclosure requirements under the Corporations Act be amended to require the disclosure of non-investment transactions which are entered into by trustees with related parties.

Draft Recommendation 27

The SWG recommends that trustees be required to disclose in their PDS any in-house assets. The SWG recommends that the Government considers reducing the length of time that grandfathering arrangements apply for in-house assets.

Financial assistance to failed superannuation funds

Draft Recommendation 28

In view of the fact that the current provisions contained in Part 23 of the SIS Act have not yet been fully tested, the SWG recommends that the provisions not be changed at this time. However, the SWG recommends that the Government review the operation of Part 23 and consider possible amendments to it once the first decision under Part 23 has been made.

Longer term options – separation of prudential and retirement income provisions

Draft Recommendation 29

The SWG acknowledges that the SIS legislation is complex, and that separation of the prudential and retirement income provisions of the legislation may assist in achieving the goal of simplification of the legislation. The SWG acknowledges, however, that there are a number of practical implementation issues that will need to be addressed and consulted on in relation to such a proposal.

1 INTRODUCTION

This paper outlines draft recommendations of the SWG. The paper will form the basis for discussions at the second round of consultations to be held by the SWG, in Sydney and Melbourne on 6 and 7 March 2002 respectively.

The SWG is undertaking a consultation process on the Government's 2 October 2001 Issues Paper, *Options for Improving the Safety of Superannuation*. The Issues Paper raised a number of proposals for reform in relation to the supervision and governance of superannuation entities.

An industry roundtable was held on 13 December 2001, and written submissions were sought by 1 February 2002. The draft recommendations in this paper reflect comments received through industry meetings and submissions.

Copies of the Issues Paper, and subsequent Background Paper are available on request from the address below, or from the Treasury website at www.treasury.gov.au.

Superannuation Issues Paper
Superannuation Working Group
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Inquiries concerning the Issues Paper can be made to:

Sue Vroombout:	02 6263 3048
Simone Abbot:	02 6263 3124

2 UNIVERSAL LICENSING REGIME

Proposal

The Government invites comments on whether to apply a universal licensing regime to superannuation funds and, in particular, on the options:

- *of requiring trustees to hold an Australian Financial Services Licence (AFSL) to operate and issue interests in a fund (similar to the obligations on responsible entities of managed investment schemes); and/or*
- *of requiring trustees to hold an APRA licence similar to the obligation on all other prudentially regulated financial institutions; and*
- *relating to the form of minimum entry and operating standards that might be set by APRA.*

The Background Issues Paper (released on 24 December 2001) characterised the licensing options as: Option 1 – an AFSL licence to operate and issues interests in a fund; Option 2 – an APRA licence; and Option 3 – for the trustee to hold both an AFSL and APRA licence.

Views from the consultation process

There was general support in the submissions for a universal licensing regime for all superannuation funds

A number of submissions expressed concern that the need to hold two licences could lead to duplication and a blurring of the demarcation of responsibilities between APRA and ASIC. Many submissions (including those from AIG, Coles Myer, CPA Australia, Institute of Actuaries, Law Council of Australia and the Industry Funds Forum) argued that there should be only one regulator issuing licences. Most made it clear that as APRA was the body responsible for regulating the safety of superannuation, it should be the sole provider of a licensing system for superannuation trustees, although a few favoured an ASIC-only licence.

Submissions that did not support universal licensing focussed on concerns about the licensing of individual trustees and directors of corporate trustees (ACTU) and non-profit corporate and industry funds. There was concern that licensing in such circumstances would diminish the opportunities for employee representation and reduce the diversity of trustees. However, the Trustee Corporations Association of Australia observed that having fewer trustees would lower the costs of APRA oversight.

Some submissions also expressed concern at the potential costs of a licensing regime, particularly for smaller funds, and emphasised that licence criteria and the types of licence issued should take account of the nature of the trustee and types of funds being regulated. ASFA also flagged a need for better co-operation and information sharing between the regulators.

Consideration of the proposal

One of the key outcomes of the FSI was the establishment of a 'twin-peaks' model for regulation of the financial services industry. Under this model, APRA is responsible for prudential regulation and ASIC for consumer protection and market integrity regulation.

Licensing is one of the regulatory tools that can be used to address both prudential and consumer protection issues. In establishing the twin-peaks model, the FSI envisaged that both APRA and ASIC would have licensing systems available to them. The licence criteria would differ, however, depending on the regulatory aims that the particular licence is directed at. The FSI noted that there would need to be close co-operation between the regulators.

A licensing system under which one regulator, such as APRA, is solely responsible for licensing to address both prudential and consumer protection issues would be inconsistent with the regulatory framework that has been established following the FSI.

Dual licensing already exists for many Approved Trustees. Following the commencement of the FSRA on 11 March 2002, it will also exist for many other APRA-regulated bodies, including ADIs and insurance companies. As noted above, the APRA and ASIC licences are addressed at different regulatory aims and this is reflected in the licence criteria. In some cases, similar requirements will apply, such as competency, but for different regulatory purposes. Consideration needs to be given to whether the requirements for one regulatory purpose can be taken to be sufficient to meet those imposed for the other regulatory purpose. For example, under the FSRA, licence criteria addressed at the adequacy of resources and risk management systems are not required to be met by APRA-regulated bodies on the basis that APRA's requirements already address these criteria completely.

For other criteria, it may not be possible to say that the assessment by one regulator completely addresses the regulatory purposes of the other regulator. For example, an assessment by APRA that an institution is fit and proper to be an ADI, while relevant, may not fully address ASIC's assessment of whether the institution is competent in its dealings with individual customers. In such circumstances, it may be appropriate for one regulator to have regard to an assessment made by another, without making it determinative.

While it would be inconsistent with the post FSI regulatory framework to have a licence directed towards both prudential and consumer protection issues administered by a single regulator, there remains a question of whether licences are necessary to address both of these regulatory aims. Option 1 in the Background Issues Paper released by the SWG on 24 December 2001 was premised on the basis that a consumer protection licence might be sufficient and that no further licensing was needed to address prudential issues. As noted in the Issues Paper of 2 October 2001, however, such a licensing regime would not obviate the need for increased prudential oversight of smaller funds. The issue is whether a prudential licence is necessary to provide for that increased oversight, or whether it can be achieved in other ways.

In subsequent draft recommendations, the SWG, with support from a significant number of submissions, sees an important role for compliance plans in addressing prudential regulatory issues. While a compliance plan could be a stand-alone requirement, experience under the MIA regime is that it works extremely effectively as part of a licensing regime. Similarly, while it would be possible for one regulator to assess licensing and another to

assess the compliance plan, outcomes are more likely to be better co-ordinated and more cost effective for both the regulators and the industry if the same regulator that assesses licensing also assesses the compliance plan requirements.

The role envisaged for the compliance plan by the SWG is largely aimed at investment, outsourcing and governance and risk management issues. These are largely matters of more significance to the prudential regulator than they are to the consumer protection regulator. In light of this, the SWG believes that it is not appropriate solely to have a consumer protection licence, but that licensing is also necessary for prudential purposes. Thus the SWG does not favour Option 1.

Option 2, an APRA-only licence, implies that licensing is not necessary for consumer protection purposes and that a prudential licence is sufficient, with consumer protection aims being achieved in other ways. As noted above, the licence criteria for an ASIC licence are directed towards consumer protection aims. Such a licence has been in place for some superannuation funds under the former Corporations Law (now Corporations Act) since the SIS Act was introduced, and following the commencement of the FSRA will be extended to a wider range of APRA-regulated bodies. As a consumer protection measure, licensing has long been considered a necessary regulatory tool in the financial services industry to impose minimum entry levels. The SWG does not consider that it would be appropriate to remove outright the current consumer protection licensing regime for superannuation trustees.

Option 3 suggested dual licensing by APRA and ASIC, in recognition of the fact that licensing can address both prudential and consumer protection issues. The SWG is of the view that this is the appropriate outcome consistent with the post-FSI regulatory framework. It is also consistent with the recommendation of the Productivity Commission in its draft report, *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain Other Superannuation Legislation*, that superannuation entities be licensed by APRA subject to specific conditions.

The SWG is conscious, however, of the need to avoid regulatory overlaps that might impose undue costs on industry and, in turn, fund members. In view of this, the SWG does not believe that the ASIC licence should be extended to the operation of the fund, but should only apply to dealing in and/or advising on interests in the fund. This differs from the approach under the Corporations Act for managed investment schemes, the responsible entity of which is required to be licensed to operate, deal and advise. However, managed investment schemes are not subject to any prudential regulation, thus to achieve consumer protection aims it is important that the licensing requirements also address the entity's ability to operate the fund. By contrast, under Option 3, superannuation trustees will also be required to have an APRA licence. This licence will address the issues associated with the operation of the fund.

As suggested in the Issues Paper, the SWG considers that it should be the corporate trustee, or in the case of individual trustees, the 'notional trust entity' that is licensed. Thus each individual trustee would not be required to meet the licence criteria in their own right, but rather the trust entity as a whole must satisfy the licence criteria. This should address concerns that licensing might diminish the opportunities for employee representation and reduce the diversity of trustees.

Further, the SWG considers that, consistent with the approach that ASIC proposes to take with AFSLs, trustees should be able to outsource the satisfaction of the licensing obligations

to third parties. However, the trustees would be required to satisfy the regulator that they have appropriate systems in place to manage those outsourced functions.

There is also a question of whether it is appropriate to continue the FSRA exemption for non-public offer funds dealing in interests in the fund. Under FSRA, such funds will only require an AFSL for advising on interests in the fund. This was a continuation of the current ASIC no action policy for the dealing activities of such funds on the basis that they do not actively induce persons to become members of the fund.

As noted above, under FSRA, non-public offer funds will now require a licence to advise on interests in the fund. While the precise number of funds that will be licensed under this requirement is not known at this stage, it is likely that some non-public offer funds will require an AFSL. Those funds that will be licensed will be required to have in place compensation arrangements to cover loss or damage as a result of breaches of the law in relation to their advising activity. However, there will be no requirement for compensation arrangements for loss or damage suffered as a result of problems in the issuing of interests. Thus there will be a gap in the coverage of compensation arrangements in relation to dealing activity by non-public offer funds.

Given that the SWG is recommending that these funds obtain an APRA licence and will be required to meet standards of competence and other licence criteria, it may not be a significant additional burden for such funds to also obtain an AFSL to deal. This is particularly so given the recommendations that the SWG is making in relation to single entry point and avoiding overlaps (see discussion below). If it is not considered appropriate to require such funds to have an AFSL, the SWG believes that such funds should be required to have compensation arrangements in place (perhaps as a condition of their APRA licence) to cover loss or damage suffered as a result of problems in issuing interests.

As noted above, the SWG favours Option 3, which for some trustees will mean both an APRA and ASIC licence. The SWG is conscious of the need to reduce compliance costs to the greatest extent possible and to avoid overlaps in the licence criteria. While dual regulators of superannuation is a necessary consequence of the FSI 'twin-peaks' model, the SWG recognises that for superannuation in particular there may be a need to ease the burden of having to deal with two regulators for the same business. Unlike other prudentially regulated sectors, there is a much wider diversity in size and type of trustees in relation to superannuation. For the smaller non-public offer funds in particular, having to deal with two licensing processes may be a significant burden.

The SWG considers that the Government should explore the possibility of providing a single entry point for licensing of superannuation trustees by APRA and ASIC. The SWG is of the view that, if it is feasible from a systems perspective, it would be appropriate for trustees to apply to APRA and include in that application process all of the information required for both the APRA and ASIC licences. Thus, at least at the initial licensing stage, applicants would have a single interface with the regulators. Further into the licensing process, applicants will, of course, have to deal with both regulators, particularly when conditions are imposed on the licence. The SWG believes that further work should be done by the regulators in making the dual interface as user-friendly as possible.

Regard will need to be had to the existing processes that the regulators have in place (including the new e-licensing system that ASIC is putting in place for FSRA), the costs of establishing a new system and the benefits to industry of a single entry point process.

In addition to considering arrangements for streamlining the licensing process, the SWG also believes that there are a number of areas in which overlaps in the licence criteria should be specifically addressed in the legislation. In particular, as noted above, under the FSRA, APRA-regulated bodies are not required to meet the requirements for adequate resources and risk management systems as part of their AFSL. The SWG believes this is appropriate and should apply to superannuation trustees who will be required to have both an APRA and ASIC licence.

Further, the SWG believes that there is scope for the regulators to take into account each other's assessments in relation to the other licence criteria. Both regulators will be required to assess the trustee's competence. However, they will be assessing competence for different activities. APRA will be assessing the trustee's competence to operate the fund in a prudent manner, while ASIC will be assessing the trustee's competence to deal in and/or advise on interests in the fund. While the activities are different, many of the matters that each regulator will take into account in assessing competence may be similar. Further, it is likely that APRA's assessment of competence to operate the fund in a prudent manner will be deeper in some respects than ASIC's assessment. There may nonetheless be some considerations that ASIC has regard to that APRA may not.

The SWG does not believe that it is appropriate for ASIC to have regard definitively to APRA's assessment of competence. However, it believes that ASIC should be required, as a matter of law, to have regard to APRA's assessment of competence.

In addition to the licensing of trustees of superannuation funds, the SWG believes that there would be considerable merit in requiring trustees to register each of the funds for which they act as trustee. One of the regulatory difficulties identified by APRA is that a fund can be started up without APRA having any prior notice. They only become aware of the existence of the fund when an election is made under section 19 of the SIS Act to be a regulated fund for the purposes of that Act. That notice is required to be given within 60 days of the fund being established.

By contrast under Part 5C of the Corporations Act, in addition to the responsible entity of a managed investment scheme being required to be licensed, each managed investment scheme must also be registered with ASIC and a compliance plan must be lodged for each scheme. This registration process gives ASIC the opportunity to ensure that the responsible entity is appropriately licensed, that it will be able to comply with its obligations in relation to the particular scheme, that the conditions on its licence remain appropriate for that scheme and that it has a compliance plan for that scheme.

The registration process itself is not as detailed a process as is required for licensing. It requires the lodgment of the scheme's constitution, the compliance plan and a statement signed by the directors that the constitution and compliance plan meet the requirements of the law. ASIC must register the scheme unless the responsible entity is not appropriately licensed or the constitution and compliance plan do not meet the requirements of the law.

In relation to superannuation funds, the SWG considers that trustees should be required to provide notice of an intention to establish a fund. This is because, until such a time as contributions (trust property) are made to a fund, a fund does not exist as a trust. It should be a requirement that trustees cannot accept contributions into a fund unless the fund is registered. Consideration will also need to be given to how the requirement to register a fund would operate in the context of the current requirement to notify of intention to be

regulated under the SIS Act within 60 days. It may be that the latter requirement can be brought forward to the time of registration of the fund.

While the SWG has been conscious of minimising the compliance costs of licensing to the greatest extent possible, it may be that for some smaller funds the compliance costs of licensing, together with the other obligations being recommended by the SWG, make it uneconomic to continue operating. There are currently provisions under the SIS Act facilitating the transfer of assets to successor funds. The SWG has not considered these provisions in detail, but considers that the Government should review them to ensure that there are no unnecessary impediments to the winding up and transfer of fund assets.

Further, the SWG believes that there may be some merit in reviewing the threshold for SMSFs. This may be another avenue for enabling smaller funds to continue to operate without the cost of regulation under the SIS Act. The Small Independent Superannuation Funds Association has suggested that the test should be based on whether there are any arm's length members, rather than on a particular number (currently less than five). The SWG recognises that this is a sensitive issue, but believes that it is one that is worthy of consideration to address concerns about the safety of superannuation. What will need to be determined is whether there is a more appropriate test for determining which funds should be subject to prudential regulation and which ones do not need the same kind of intensity of regulation.

Given that there are over 11,000 prudentially regulated superannuation funds, some of which are already licensed, there will be significant implementation issues to be addressed.

These would include:

- consultation with industry on the form and content of a licence;
- transition period of two years;
- additional resources for APRA to implement the regime; and
- additional measures to ease the transition to the new licensing regime, including whether the existing successor fund provisions are appropriate and consideration of the test for SMSFs.

Draft Recommendations

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The SWG recommends that the SIS Act be amended to require that trustees of superannuation entities (other than SMSFs or EPSSSs) be licensed by APRA. The SWG recommends that the APRA licence include certain conditions. These would include that the trustee be required to:

- **comply with conditions on a licence, with other legislative requirements and with the covenants in the trust deed;**
- **have adequate systems in place to supervise functions which have been outsourced;**

- have adequate resources in place (financial resources, either through capital or insurance (see discussion on capital under 3.2), technological and human resources);

- meet certain minimum standards of competency;

- have adequate risk management systems in place;

- have a compliance plan in place, and have adequate arrangements in place for ensuring compliance with the plan;

- have adequate levels of professional indemnity insurance and material damage/consequential loss insurance in place; and

- meet any other conditions as prescribed in regulations or as required by APRA.

Licensees would also need to meet the licensing criteria on an on-going basis.

The SWG recommends that the Government give consideration to the appropriate enforcement powers to be given to APRA to suspend or remove trustees where the trustee breaches the conditions of its licence or the conditions on an on-going basis, or where existing trustees fail to obtain a licence from APRA.

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The SWG recommends that the Government consider the development of a single entry point where trustees are required to hold both an APRA licence and an AFSL, so that the trustee need only lodge one application with APRA to cover both licences. The application would need to contain sufficient information to meet the requirements for each licence. In considering this recommendation, the SWG suggests that the Government examine the following matters:

- the matters which ASIC should consider when licensing an entity which has already been licensed by APRA;
- the matters in relation to which ASIC should be required to consult APRA:
  - before ASIC imposes, varies or revokes a condition on a licence that would result in an APRA-regulated body being unable to carry on its usual activities (being activities in relation to which APRA has regulatory responsibilities); and
  - before ASIC takes action to suspend or cancel a licence of such a body;
- the matters of which APRA should inform ASIC if it has taken action that would impact on the conditions of an ASIC licence; and
- the memoranda of understanding which establish information-sharing arrangements between APRA and ASIC.

Implementation issues

Draft Recommendation 8

The SWG recommends that the Government consider the current threshold for SMSFs to determine whether it is an appropriate test for determining which funds require prudential regulation.

3 PRUDENTIAL STANDARDS–MAKING POWER

3.1 Power for APRA to make prudential standards

Proposal

The Government invites comments on whether APRA should be given a specific standards-making power similar to that provided to APRA in relation to the general insurance industry in the General Insurance Reform Act 2001.

Amendments to the Insurance Act included in the GIRA introduced the power for APRA to make and enforce prudential standards. High order prudential principles were included in the Act, with detailed requirements included in Prudential Standards, and then beneath the Standards are non-binding Guidance Notes. The Prudential Standards are disallowable instruments (meaning that they may be disallowed by the Parliament) and APRA is required to undertake a consultation process with industry in developing the standards.

Views from the consultation process

Submissions expressed a wide range of views on this proposal.

There was some strong support (Australian Bankers' Association, Trustee Corporations Association of Australia, MAP Funds Management) on the grounds that it would enable APRA to undertake appropriate prudential regulation of superannuation and provide it with the flexibility necessary to enable prudential regulation to keep up with the evolution of the superannuation sector.

However, there was also strong opposition on the grounds that it could give APRA de facto legislative power that would not be subject to proper legal or Parliamentary scrutiny (Law Council of Australia, some smaller superannuation funds) or that it had not been demonstrated that any extension of existing powers was necessary (PricewaterhouseCoopers, Westscheme). The Law Council suggested that it would be preferable to update and simplify existing regulations. ASFA also indicated that, while it supported the need for a strong and pro-active regulator, it was not convinced that there was a need for this power. It was noted that better use might be made of existing powers.

Among those submissions expressing some degree of support, concern was expressed about the need for APRA to have the appropriate resources to enforce any new standards and the possible costs to members (Hort Super, Meat Industry Superannuation Fund), the dangers of over-regulation (Commonwealth Bank) and the need to balance other objectives such as efficiency, competition, contestability and competitive neutrality. It was also observed that, although further divergence between the requirements for small and large funds may make transition from one to the other difficult, universal standards would impose prohibitive costs on small funds (Institute of Chartered Accountants, NSP Buck).

A number of submissions also emphasised that industry consultation would be necessary to ensure cost-effective implementation of any standards (Securities Institute of Australia, AMP).

Consideration of the proposal

The arguments in support of the proposal for APRA to have a prudential standards-making power, as highlighted in the Issues Paper and in submissions, include that such a power would:

- implement recommendation 33 of the FSI that APRA should be empowered to establish and enforce prudential regulations on any licensed or approved financial entity independently from the Executive Government. This was seen as important in the process of clarifying limits to the 'regulatory assurance'. The current process of making operating standards requires Treasury to advise Government on the content of the standards which are then made by the Governor-General, rather than APRA making the standards directly. It is argued that this is inconsistent with the FSI's recommendation. There would still be appropriate checks and balances for prudential standards, such as mandatory industry consultation and Parliamentary scrutiny;

- be consistent with other prudential regimes under which APRA has the power to make prudential standards. Those for general insurance were recently introduced and require mandatory consultation on standards which are disallowable instruments;

- be a faster and more flexible process than the making of regulations (operating standards). APRA would be able to make and consult on prudential standards themselves without having to involve Treasury and the Office of Legislative Drafting in the process. Treasury would, of course, be consulted on the content of the standard, but unlike the process of the making of regulations, would not be involved in the process of making the standard. There would be no need to use drafters unfamiliar with the technical subject matter (they would be drafted in-house by APRA staff), and concerns about access to scarce parliamentary resources would be eliminated. It would enable APRA to set its own drafting priorities, rather than being subject to the drafting priorities of the Government as a whole;

- enable standards to be written in plain English. Prescribing operating standards through regulation necessitates the use of legal language and form; and

- enable complete topics to be addressed within a single statement. Under the current operating standards, matters relating to a specific topic cannot always be found in a single place in the legislative framework, but across a spectrum of regulatory instruments. To date, superannuation circulars have been used by APRA to comprehensively address topics in plain English, however, these circulars are not legally enforceable.

There are a number of practical implementation issues arising from the current legislative framework into which the prudential standards-making power would be inserted.

The SIS Act already contains wide powers to make subordinate instruments applicable to the operation of superannuation funds, approved deposit funds and pooled superannuation trusts. For example, the operating standards power in Part 3 of the Act is only constrained by the requirements that standards relate to the operation of superannuation funds and are not inconsistent with the Act. Operating standards currently cover a wide range of matters including: contributions and benefits; portability; investments; governance and disclosure issues; actuarial, funding and solvency requirements; and winding-up provisions. In this, the SIS Act is materially different from the other prudential regimes overseen by APRA prior to

the introduction of prudential standards-making powers in these regimes (Banking Act, Life Insurance Act and especially the Insurance Act as amended by the GIRA).

Further, unlike the other prudential regimes, APRA is not the only regulatory body utilising the provisions of the SIS Act. ASIC also enforces certain consumer protection and disclosure provisions and the ATO administers the requirements for SMSFs. In addition, superannuation forms a key part of the Government's retirement income policy and the SIS Act includes retirement income policy provisions as well as prudential and consumer protection provisions. The current operating standards power would need to remain for retirement income and consumer protection purposes.

The provisions covering prudential, consumer protection and retirement income policy are tied through the concept of a 'complying fund' in the SIS Act. Accordingly, the bodies charged with implementing these policies – APRA, ASIC, ATO and the Treasury – all have an interest in any instruments made under the Act. Any proposed changes to give APRA a prudential standards-making power would need to take account of these other stakeholders.

In particular, there would need to be a clear delineation between prudential regulation and retirement income policy and close consultation on any prudential standards that might have the potential to impact on retirement income aims. Care would also need to be taken that there are no inconsistencies between prudential standards and operating standards made for retirement income purposes.

- While introduction of a prudential standards-making power of itself will not require significant legislative change, as prudential standards are introduced on particular topics there will need to be restructuring of the legislation and regulations to accommodate the standard. In particular, those provisions being addressed by the standard will need to be repealed and other provisions are likely to require amendment.

Care would also need to be taken to ensure that the introduction of a prudential standards-making power does not further increase the complexity of the SIS Act. The impact on implementation and compliance costs would also need to be considered. The SWG is conscious that in its draft report on released in September 2001 in relation to its *National Competition Policy Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain Other Superannuation Legislation*, the Productivity Commission noted that by giving APRA increased discretion to determine standards, the option could contribute to greater uncertainty amongst superannuation entities, requiring them in some instances to have increased resort to legal advice about the prudential standards. Consideration will need to be given as to how any such uncertainty can be addressed.

The SWG acknowledges that the existing operating standards power already provides a mechanism for making standards in a wide range of areas. The proposed prudential standards-making power, rather than being a new or increased power as such, can be regarded as a different process for exercising an existing power. It would provide APRA with greater flexibility in making standards, while still being subject to the same level of consultation and Parliamentary scrutiny as operating standards.

Thus, as a matter of principle, the SWG supports providing APRA with a prudential standards-making power. It acknowledges, however, that there are a number of practical implementation issues that will need to be considered and consulted on in granting such a

power, in particular, the implications for the structure of the SIS Act as a whole and for the other objectives of the Act.

Draft Recommendation

Draft Recommendation 18

The SWG accepts in-principle that APRA should be given a prudential standards-making power similar to the one it has in relation to general insurance. The SWG acknowledges, however, that there are a number of practical implementation issues that will need to be addressed and consulted on in relation to such a power.

3.2 Prudential standard: Investment rules

Proposal

The Government invites comments on the development of a set of prudential standards covering the investment activities of a range of types of superannuation funds. The main aims of these standards could be to ensure:

- *that the investment objectives and strategy of the fund are consistent with the expectations of fund members;*
- *that fund investments are sufficiently diversified so excessive risks are not borne by fund members;*
- *the appropriate management and oversight of delegated activities; and*
- *that the appropriateness of investments, and the risk/return profile of the fund are assessed on a regular basis.*

Views from the consultation process

While there was some unqualified support for this proposal and some equally unqualified opposition, most submissions emphasised particular concerns.

Submissions supporting the proposal tended to emphasise the need for appropriate risk management strategies to be followed and that this is already industry best practice.

Those opposing were generally of the view that it would be inappropriate for APRA to prescribe rules for investment of fund assets, as, reflecting the wide diversity in membership profiles in various funds, these are best determined by fund trustees. Many of these submissions expressed strong opposition to an overly prescriptive approach and/or indicated that existing powers under the SIS Act were sufficient (Australian Institute of Superannuation Trustees, Australian Venture Capital Association, CPA Australia, Institute of Actuaries, IFSA, KPMG, PricewaterhouseCoopers). A number suggested that it would be difficult to regulate without being overly prescriptive and that increased disclosure requirements may offer a better approach.

While submissions reflected a range of perspectives, other common themes were that:

- consistency between investment strategy and member expectations is the critical link;
- sufficient diversification is essential, but difficult to define; and
- the role of fund trustees, who need to follow appropriate risk management strategies, is critical.

Other specific comments in individual submissions included:

- support for strengthening the obligations on trustees to diversify investments, including by giving APRA the power to request, then require, a fund to follow an agreed asset diversification schedule on a case by case basis and to conduct field surveillance and audits to enforce arm's length rules (ASFA);
- consideration be given to restricting smaller superannuation funds to pooled investments in registered Managed Investment Schemes and Pooled Superannuation Trusts, unless they can demonstrate to APRA the ability to manage an alternative investment strategy (Westscheme);
- opposition to prescribed investment rules, as they would lead to more conservative investment strategies, diminishing retirement benefits (IFSA);
- opposition to any extension of the in-house assets 'net' or the abolition of such investments (the Small Independent Superannuation Funds Association (SISFA)); other submissions expressed the opposite view;
- high-level limits should be placed on large exposures, related party dealings and excessive concentration of risk (Trustee Corporations Association of Australia);
- risk analysis suggests APRA should focus on smaller corporate funds where diversifiable investment risks are most likely to occur (ASFA);
- regulation should be limited to fiduciary and integrity issues (Australian Venture Capital Association); and
- risks could be covered through access to capital, reserves, insurance or a statutory fund and a minimum level and increased frequency of investment reporting to trustee board meetings (NSP Buck).

In addition to particular suggestions, the ASFA submission provided a more comprehensive comparison of regulatory approaches in the OECD which drew on research undertaken by the World Bank (with evidence from the OECD). It indicated that, in general terms, investments tend to be regulated in one of two ways - either through the prudent person rule more prevalent in Anglo-American countries (including Australia), or through particular quantitative limits which are more prevalent in continental European countries. It also noted that as the prudent person approach is less prescriptive, investment returns tended to be higher in those jurisdictions which relied on the prudent person approach.

Consideration of the proposal

The SIS Act trustee covenants (contained in section 52) require superannuation funds to have investment objectives and strategies that align with member needs. In particular, the SIS Act

requires that investment strategies take into account portfolio composition, diversification and liquidity. The Issues Paper indicated that this requirement has been difficult to translate into practice, given the subjectivity involved in determining what constitutes a sufficiently diversified and liquid portfolio, and indeed what constitutes appropriate goals or strategies for funds.

Under the SIS Act, it is the trustees who are solely responsible and directly accountable for the prudent management of their members' benefits. It is the trustees' duty to make, implement and document decisions about investing fund assets and to carefully monitor the performance of those assets. Trustees' responsibilities when making investment decisions include formulating and implementing an investment strategy or strategies. This duty is codified in the SIS Act as a covenant.

APRA has, in the past, released a circular in relation to investment. However, this circular needs updating and currently lacks legal backing. It could form the basis of a prudential standard in relation to investment.

The SWG recognises that excessively tight prescription of investment classes allowed in superannuation portfolios, or other such regulation designed to alleviate the problem of potential losses, could dramatically reduce the returns produced by funds over a long time frame, to the detriment of fund members. Such rules may also be at odds with the prudent person approach reflected in the SIS Act covenants.

The Background Issues Paper identified three options to reform the SIS investment rules:

- Option 1: Revise the existing operating standards in this area;
- Option 2: APRA could make a prudential standard relating to investments (subject to APRA being given a standards-making power); or
- Option 3: Amend the SIS Act to require that funds must have a compliance plan to ensure proper consideration of the existing provisions.

The SWG considers that there would be considerable benefits in requiring the trustees to identify in their compliance plan the measures which the trustee is adopting to ensure that the fund's investment strategy matches the fund's objectives. Firstly, it would require the trustees to document how they will generally ensure that the investment strategy matches the fund's objectives, which provides an important accountability measure. Secondly, the members would be able to access the trustee's reasoning, by virtue of the fact that they could request a copy of the compliance plan from the trustee. Thirdly, such a document would provide a useful risk management tool.

The SWG also considers that trustees should be required to ensure that the investment strategy of the fund is in compliance with superannuation purposes specified in the sole purpose test contained in section 62 of the SIS Act. The sole purpose test provides that in order for a superannuation fund to qualify as a regulated superannuation fund, the fund must be maintained for the sole purpose of providing benefits to members on their retirement or on their reaching the age for payment of preserved benefits, or to a member's dependants or estate on the death of the member before retirement. Payment of other benefits is also approved as 'ancillary purposes' under the sole purpose test, and these include benefits on termination of employment, disablement benefits on termination of

service due to ill-health, benefits to a member's dependants or to the member's estate when the member dies after retirement.

The SWG also encourages APRA to consider in consultation with all relevant stakeholders how its current investment circular could be updated and whether it should be converted into a prudential standard.

Further, the SWG considers that the requirement to ensure that the investment strategy of the fund is in compliance with the sole purpose test should be addressed in the compliance plan and auditing processes. This also provides a further accountability measure.

Draft Recommendations

Draft Recommendation 10

The SWG recommends that trustees be required:

- **to ensure that the fund's objectives are clearly articulated; and**
- **to identify in their compliance plan the measures that they are adopting to ensure that the fund's investment strategies match the fund's objectives, and are in compliance with the sole purpose test contained in section 62 of the SIS Act.**

The SWG also recommends that an independent auditor be required to certify whether the fund's investment strategy is in compliance with the fund's objectives, as a part of the fund's annual compliance audit.

Draft Recommendation 11

The SWG recommends that APRA, in consultation with all interested parties, updates its current investment circular and consider the extent to which it should be reflected in a prudential standard.

3.3 Prudential standard: Capital adequacy

Proposal

The Government invites comments on the following issues relating to capital:

- *the need to reassess capital requirements for Approved Trustees with a view to aligning those requirements with the size of the fund and the actual operational risks in each fund. This could include a capacity for APRA to vary the minimum capital standard for different types of superannuation funds;*
- *the role of capital in funds without Approved Trustees, and means of raising such capital if it is considered appropriate; and*
- *whether the option allowing the substitution of capital held in custodians is appropriate to ensure that capital is available to meet the needs of fund members.*

Views from the consultation process

The most common comment made in submissions was that capital requirements should not be imposed on 'not for profit' funds. The major reason given was that this would destroy the lower cost structure currently available to members of these funds, thereby leading to lower retirement savings and greater concentration of superannuation into a small number of large funds.

It was suggested that other options such as indemnity insurance, arm's length investment rules, compliance and governance systems (Securities Institute, Law Council of Australia, Meat Industry Employees Superannuation Fund, a number of smaller funds), including personal liability for directors, may be just as effective. Such options would also avoid the distortions and inefficiencies that result from the unproductive tying up of capital. An alternative proposal provided that APRA develop a system of allocating points for certain protections, with sufficient points alleviating any need to satisfy a capital requirement (ASFA).

Further, it was argued that holding capital will not create a buffer against operational risk where there is a high degree of outsourcing (Law Council), and no capital adequacy requirement will satisfactorily address a catastrophic investment loss or avert fraud (Sunsuper).

However, the Australian Bankers' Association supported imposing capital requirements on funds without Approved Trustees, with capital to be raised directly by the employer(s).

The Trustee Corporations Association was among a number of organisations supporting the application of capital adequacy requirements to all commercial entities involved in operating superannuation funds and for these requirements to take into account the number and size of the funds for which services are being provided and have regard to risk mitigation through insurance.

The Industry Funds Forum opposed any change to the existing rules in this area for approved Trustees and noted that the key guard against operational risk is competent management of contractual risk, not capital adequacy. IFSA also opposed any increase in capital adequacy requirements.

NSP Buck proposed creating portfolio insurance aimed at building capital through a levy or premium rather than creating a capital reserve in isolation.

Consideration of the proposal

In the existing superannuation framework, capital requirements are limited to minimum requirements for Approved Trustees. Approved Trustees are required to hold $5 million NTA, a guarantee for that amount, or to comply with custodial or investment conditions. Those funds that operate without an Approved Trustee are not required to hold capital.

The Background Issues Paper proposed two options:

- Option 1: Reform of the existing requirements applying to Approved Trustees; and
- Option 2: Bring capital requirements for non-Approved Trustees into line with requirements for Approved Trustees.

It should be noted that in its draft report on the *Review of the* Superannuation Industry (Supervision) Act 1993 *and Certain Other Superannuation Legislation*, the Productivity Commission made the following recommendations which are relevant to this discussion:

> The net tangible asset requirements for approved trustees should be strengthened through legislative amendment. All approved trustees should be required to have a specified minimum amount of net tangible assets (or approved guarantee or combination thereof) regardless of their custodial arrangement. Approved trustees who use custodians should not be required to have more than the specified amount (Draft recommendation 4.1).
>
> The operating capital requirements for approved trustees should be revised, through legislative amendment, so that they represent a specified proportion of an approved trustee's operating costs (Draft recommendation 4.2).

The SWG accepts that the role of 'capital' in the SIS framework (expressed in terms of 'assets', and not fully defined) is different to the role of capital in an incorporated entity. The SWG considers that the role of the NTA requirement in the SIS Act is to demonstrate the financial substance of an Approved Trustee, and to be available to cover operational risks only, and in particular to cover the expenses associated with a wind-up resulting from a failure arising from operational risk (that is, a systems failure). It is not intended to cover investment risk. The SWG also accepts the view expressed by industry that many corporate and industry funds would have difficulties in arranging for capital to be available.

For corporate and industry funds that are not public offer funds, the SWG considers that operational risks could be addressed through a licence requirement that trustees have adequate levels of insurance in place. The ALRC's report into collective investments in 1992 gave consideration to whether negligence and fraud insurance should be required. At the time, the ALRC recommended that it would be desirable to have all single employer sponsored and industry schemes insured against loss due to fraud or negligence. However, the report indicated that there may be practical difficulties, particularly for smaller funds, in meeting such a requirement. The report strongly recommended that such insurance be obtained by all funds, and that the trustees should be obliged to disclose to members whether or not the scheme has this kind of insurance (Recommendation 3.1 from Report 59: Collective Investments: Superannuation).

Requirements for insurance already apply to Approved Trustees as licensing conditions, some of whom are quite small, and that at present there have been no difficulties in such trustees being able to obtain the necessary insurance. However, the SWG is conscious that the current difficulties in the insurance sector may mean some kinds of insurance are becoming more costly and less accessible. On this basis, the SWG suggests that the Government could explore whether it is viable to require all trustees (excluding SMSFs and EPSSSs) to gain insurance to cover losses arising from operational risk, and to enter into discussions with the insurance industry about the availability, costs and restrictions of such insurance. The SWG notes that, when introducing such a requirement to the managed investments framework, a market did not exist, but is now operating. If such a market is available, the Government could consider whether it is appropriate to incorporate this as a licence condition for all funds.

If these discussions suggest that the costs would be overly prohibitive, the SWG recommends that the Government consider alternative arrangements for dealing with losses

arising from operational risks. A number of the submissions from trustees proposed that their fund maintains a reserve specifically for the purpose of covering such losses. The Government could examine whether such a reserve would provide an appropriate arrangement for covering losses (although it is noted that reserves may exist only to enable the smoothing of investment returns). In doing so, regard would need to be had to the implications of maintaining reserves for the investment strategy of the fund.

The SWG considers that the current requirements in relation to trustees approved pursuant to section 26 of the SIS Act could be made more responsive to the risks inherent in the fund. However, given that such a framework would require detailed consultation, the SWG suggests that this could be achieved through, initially, aligning the capital arrangements with those applying to managed investments, which could be calibrated according to assets under management. While the SWG accepts that the managed investments capital requirements provide a crude measure, they are arguably less crude than the static arrangements that currently apply.

The Government could then consider developing a framework based upon the underlying risks of the fund. The SWG's recommendation in relation to compliance plans would assist in the movement to a risk-based capital framework, because the requirement for the compliance plan would increase the onus on the fund to identify and assess the risks relating to the fund.

In relation to concerns about relying on custodians to supply capital (either through the custodian providing capital itself, or through a bank guarantee), APRA requires applicants for approval as a trustee to have eligible assets of at least $5 million, or provide to APRA a certificate by a registered company auditor that certifies that the trustee was entitled to a benefit, in respect of its duties as trustee of an entity, of an approved guarantee of at least $5 million during the reporting period in question. APRA has a number of concerns with such a guarantee.

- If there were scope for a guarantee to be withdrawn under certain circumstances, the trustee would effectively have no fallback position in terms of capital. This is more likely to occur in times when the capital guarantee is required. The possibility of the trustee obtaining another guarantee in such circumstances would be effectively non-existent.

- The use of guarantees is inconsistent with capital requirements imposed on other APRA-regulated bodies and also in relation managed investment schemes regulated under the Corporations Act.

- Failure of the guarantor would leave the Approved Trustee without access to capital if required.

- A capital guarantee does not necessarily demonstrate financial substance or commitment on the part of the trustee. This is a critical point, as, in licensing a trustee, APRA is seeking a commitment from the trustee that they have the means to address operational and other problems that may potentially arise. Up-front capital is a means of demonstrating this commitment.

The SWG understands that in practice, since 1999, APRA has used its instrument of approval to require Approved Trustees who have responsibility for small APRA funds to have $5 million in NTA in their own right, regardless of whether or not they use an external

custodian. This has been because of the significant operational risks associated with large numbers of such funds. In addition, APRA has required all Approved Trustees who themselves do not have $5 million NTA to act only as a trustee for a defined list of superannuation entities. APRA has provided anecdotal evidence that some ADIs have sought to limit the scope of this guarantee. APRA advises that only a small proportion of Approved Trustees use the approved guarantee as a means of meeting the requirements of section 26(1)(b) of the SIS Act.

The SWG considers that access to capital through the custodian is not consistent with a prudential approach for Approved Trustees, and that Approved Trustees should be required to hold minimum capital in line with requirements outlined above.

The SWG also considers that an appropriate transitional period should apply to enable Approved Trustees to make alternative arrangements for the holding of capital. APRA should also be given powers to deal with trustees that are unable to meet these requirements after the end of the transitional period.

Draft Recommendations

Prudential standard: Capital adequacy

Draft Recommendation 12

For superannuation funds without a trustee approved pursuant to section 26 of the SIS Act, the SWG does not consider that capital is necessary. However, the SWG recommends:

- **that the Government explore whether it is viable to require non-public offer funds to gain insurance to cover losses arising from operational risk, and to enter into discussions with the insurance industry about the availability, costs and restrictions of such insurance;**

- **if it becomes apparent that a market is not available or that the costs of insurance are prohibitive, the SWG believes that the Government should consider alternative arrangements in order to address identified concerns.**

Draft Recommendation 13

For trustees approved pursuant to section 26 of the SIS Act, the SWG recommends that:

- **section 26 of the SIS Act be amended to require these trustees to have a minimum of $100,000 NTA or, where the value of the assets under management is greater than $10 million, NTA must equal 0.5 per cent of the assets under management up to a maximum of $5 million;**

- **Approved Trustees which use an external custodian should be required to have NTA in accordance with requirements specified in the previous paragraph, and that the requirements in the SIS Act be amended to prevent Approved Trustees from relying on custodians to hold NTA or an approved guarantee or combination thereof;**

- a two year transitional period be provided from the date of commencement of the legislative amendments, to enable those Approved Trustees relying upon custodians to cover capital arrangements to make appropriate arrangements for the holding of capital;

- the legislation be amended to provide for the suspension or removal by APRA of trustees who are unable to meet the capital requirements after the end of the two year transitional period; and

- the Government consider, in the longer term, how capital requirements for Approved Trustees could be assessed against the risks of the fund.

3.4 Prudential standard: Outsourcing

Proposal

The Government invites comments on whether a prudential standard on outsourcing should be extended to superannuation funds, and whether the forthcoming ADI standard provides an appropriate model.

Views from the consultation process

While the submissions indicated broad support for the development of standards relating to outsourcing arrangements, there was concern at a number of aspects that could affect the implementation of outsourcing contracts. Several submissions queried whether APRA was adequately resourced to undertake such supervision. Submissions also expressed concerns in relation to:

- the provision of unspecified powers to APRA (Industry Funds Forum);

- the concept that trustees would be required to give APRA prior notification before being able to make an appointment or enter into contractual obligations, particularly where timing may be critical (ASFA, Corporate Superannuation Association); and

- applying outsourcing standards for ADIs to superannuation funds, noting the differences (ABA).

Consideration of the proposal

APRA has identified a number of concerns in relation to outsourcing activities, including:

- failure to put in place formal legal agreements for outsourcing arrangements;

- failure to execute an arrangement where a contract does exist;

- lack of coverage within agreements with respect to key risks or issues that should be considered as part of an outsourcing arrangement;

- failure to adequately specify recourse to service providers in the event of failure to fulfil obligations; and

- inadequate ongoing risk monitoring control processes.

The Issues Paper proposed the development of standards for superannuation entities when entering into contracts with third parties for the provision of services, with implementation either through amendments to the SIS Act, a new operating standard or a new prudential standard.

Currently, the SIS Act regulates, to a limited extent, custodians and investment managers. The operating standards-making powers which exist in the SIS Act do not extend to making standards binding on third parties. This limits the extent to which operating standards may regulate the outsourcing of superannuation entities' functions to others. The same problem would probably arise in relation to a power to make prudential standards unless the relevant provisions made it clear that they could bind third parties. However, there may be a limit to the Commonwealth's constitutional power to bind third parties. Arguably, such powers could be augmented with provisions saying that certain identifiable third parties are bound by operating standards, provided those third parties were sufficiently connected with the superannuation entity to be within the Commonwealth's constitutional reach.

APRA does not have any formal powers directly in respect of service providers. Typically APRA has required the regulated entity to include any requirements for APRA to have access to the service provider in the outsourcing contract. For example, under the new prudential standard (*Risk Management - Operational risk guidance note (outsourcing)*), insurers are required to ensure that records held by a service provider are readily available at all times to the insurer and, where APRA considers it necessary, to APRA. This would mean that the insurer would have to ensure this is included in its contract with the service provider.

The SWG considers that universal licensing of all superannuation trustees would assist in the management of risks associated with outsourced entities. Firstly, a condition could be placed on the trustee to require that they have adequate systems in place to supervise functions which have been outsourced to third parties. Secondly, as with the approach taken in the insurance regime, APRA could require the trustee, as a condition of its licence, to insert a term into a contract with a service provider, that provides APRA with a right of access to the third party (this would also ensure existence of formal legal arrangements).

Both conditions would sit well within the current superannuation framework, by ensuring that the trustee retains responsibility for its own activities and those which it outsources. It would also place the responsibility on the trustee to negotiate its own contract, and would not require APRA to participate in these commercial dealings, which would require significant resources on APRA's part. A licence condition would provide sufficient flexibility to enable APRA to remove a trustee's licence if the trustee does not have appropriate arrangements in place to deal with service providers.

It was suggested during the consultation process that APRA could 'pre-vet' all service providers, rather than considering the relationship between the trustee and third parties on an individual basis. Whilst the SWG understands that the various service provider markets are relatively concentrated, requiring APRA to pre-vet such organisations outside of the context of their relationship with specific funds would, in effect, establish a new regime of supervision, which would require additional supervisory resources. It would also require significant legislative amendments, given that APRA does not currently have the supervisory powers required to undertake this role. Applying conditions on the trustee's

licence would appear to be a more effective use of APRA's time and resources, and would avoid questions about extending the Commonwealth's constitutional supervisory reach by ensuring that the responsibilities continue to rest with the trustee.

Given the concentration within these sectors, it is likely that, over time, such contract terms would become the norm.

Requiring a trustee to prepare a compliance plan would also ensure that the trustee identifies and assesses all relevant risks, including in relation to third parties.

Draft Recommendations

The SWG notes that the APRA licence, recommended earlier in this paper, could include a condition that the trustee has adequate systems in place to supervise functions which have been outsourced. In addition, the SWG makes the following recommendations.

Draft Recommendation 14

The SWG recommends that, as a condition of the APRA licence, trustees be required to include a term in any contracts with third party service providers that provides APRA with a right of access to the third party, in the event that APRA has concerns about the impact of the activities of the third party on the APRA-regulated entity.

Draft Recommendation 15

The SWG also recommends that APRA consider, in consultation with all interested parties, the development of a prudential standard in this area.

The SWG also notes that risk management in relation to outsourced entities would be addressed through the compliance plan.

3.5 Prudential standard: Governance and operational risks

Proposal

The Government welcomes comments on a reassessment of existing governance requirements on superannuation trustees and funds.

Views from the consultation process

The majority of submissions supported some formal policy or development of best practice guidelines to mitigate governance and operational risk. While not supportive of the implementation of a prudential standard that would cover governance and operational risk, the majority of submissions were supportive of the refinement of existing operating standards already in place. However, this support was qualified by the view that any new standards imposed should not be overly onerous or costly to implement or monitor.

In addition, a large number of submissions linked the development of a more formal policy on governance and operational risk to the use of compliance plans, such that funds should demonstrate how they plan to mitigate such risks as part of an audited compliance plan.

The few submissions that did not support the proposals were either of the opinion that the current arrangements were adequate and that increased monitoring by APRA would solve the problem, or that changes would unnecessarily increase an already high level of complexity. The Corporate Superannuation Association noted the importance of ensuring that trustees are well trained and stated that no change in regulatory approach was required.

Consideration of the proposal

Good governance promotes transparency, accountability, independence and responsibility. Ultimately these factors should promote the safety of members' funds and result in better disclosure of information to fund members. Effective risk identification and management forms a key component of sound governance. A fund's governance may be compromised without a framework for management of risks faced by it.

Operational risk is arguably the largest risk faced by superannuation funds given that investment and market risk is usually borne by fund members in accumulation funds and employers in defined benefit schemes. Operational risk is the risk resulting from a breakdown of processes, people, systems, internal controls or corporate governance, or from external events.

Components of operational risk are covered in various aspects of the SIS legislation. However, there is no all-encompassing standard that requires a superannuation fund to fully identify, assess, and manage the full range of operational risks that a fund faces. While the SIS legislation does contain some requirements with respect to risk management, these tend to be widely dispersed throughout the legislation, often with little logical connection. Similarly, the requirements relating to governance are spread throughout the SIS framework.

The Issues Paper proposed either:

- the introduction of a prudential standard to cover governance and risk management, and removal of the corresponding sections from the SIS regulations, which would require the introduction of a prudential standards-making power within the SIS Act; or

- combining existing provisions contained within the SIS regulations, and placing the governance and risk management related items into one operating standard within the regulations, rather than having multiple provisions covering various topics as is currently the case.

The SWG considers that a licence condition could require that all trustees have in place appropriate risk management systems. This would ensure that a particular standard is applied to all trustees.

In addition, the SWG considers trustees should also be required to address how they intend to comply with various provisions relating to governance and operational risk, which are spread throughout the legislation. The compliance plan could facilitate this process, as it could require compliance to be demonstrated against a list of specified provisions contained in the SIS framework. The SWG recommends that the Government consult with industry on the range of provisions that should be incorporated in the compliance plan.

Draft Recommendations

The SWG notes that the APRA licence, recommended earlier in this paper, could include an ongoing obligation that the trustee has in place adequate risk management systems.

Draft Recommendation 16

The SWG recommends that, as a component of the licensing framework, trustees be required to demonstrate in their compliance plan how they propose to comply with governance and risk management requirements.

Draft Recommendation 17

The SWG also recommends that APRA consider, in consultation with all interested parties, the development of a prudential standard in this area.

4 ANNUAL MEETINGS

Proposal

The Issues Paper proposed two options:

- superannuation funds be required to hold annual general meetings (along the lines of the provisions in section 250N of the Corporations Act); or
- superannuation fund members be given the right to request a meeting at any time (as registered investment schemes are required to do).

The Government welcomes comments on these options, including the extent of powers that members could have (for example, voting powers to remove trustees or fund managers, or whether members could only seek, through a meeting, more detailed information and explanations from trustees and managers).

Views from the consultation process

Industry submissions indicated almost universal opposition to the proposal to hold annual meetings. The concerns raised related to compliance costs, which would be passed on to members, and implementation practicalities. Specific concerns were raised in relation to the difficulty in determining voting rights, the potential for annual meeting resolutions to conflict with trust law requirements (for example, trustees cannot be subject to member direction, and they must ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries), and the lack of support by members for such proposals previously.

However, some submissions noted that the objective of the proposal to improve member activism could still be achieved through other means, such as provision of information to members and member education. One submission suggested that an independent compliance entity could act as 'member champion' if directed by the regulator or members.

Consideration of the proposal

The purpose of this proposal was to give members the opportunity to hold trustees to account more directly – effectively bringing superannuation into line with other similar types of investments (for example, managed investments). It was seen as an opportunity to increase member activism and for members to have a greater say over their retirement benefits. It could also facilitate greater member scrutiny of fund activity.

As noted above, submissions were not supportive of the proposals and a number of concerns were raised. They included:

- the interaction with the trust structure for superannuation funds and the established trust relationships including fiduciary obligations;
- establishing appropriate allocation of voting rights;
- implementation difficulties, including how members might be able to get time off work to attend meetings; and

- compliance costs.

In many employer-sponsored funds, the equal representation rules provide an avenue for members to be more involved in the operation of their fund. There are also a number of other fora for members to voice their dissatisfaction with their fund, including internal dispute resolution mechanisms and through the Superannuation Complaints Tribunal.

This proposal was underpinned by the aim of facilitating better member scrutiny of trustee performance. It is noted that other recommendations of the SWG, in particular those relating to licensing, as well as measures to increase disclosure, will also achieve this objective.

Accordingly the SWG considers that:

- the protections already in place offer better opportunities for fund members to communicate with the trustee and to query various decisions than either of the proposals put forward; and

- the concerns underlying the proposals for member meetings could be dealt with more effectively by better disclosure and a greater compliance focus.

Draft Recommendation

Draft Recommendation 18

The SWG recommends that the proposals to require superannuation funds to hold AGMs or that members be given the right to request a meeting at any time not be proceeded with.

5 PUBLIC DISCLOSURE OF ANNUAL RETURNS

Proposal

The Government welcomes comments on whether all superannuation fund annual returns be made public either through ASIC or APRA.

Views from the consultation process

Submissions generally supported increased public disclosure of annual returns. Most of the supporters agreed that transparency would be enhanced through improved disclosure.

Those few who did not support this proposal considered that only members of funds really need such information (and they already receive it) especially given that employer-sponsored funds are not open to the public.

Other comments related to the need to address compliance costs, commercial sensibilities and privacy issues (ASFA). It was also noted that insufficient uniformity in the way in which fees and investment returns are disclosed made it harder to make meaningful comparisons (Hort Super). It was also suggested that it would be more efficient to lift standards for funds where information is not available rather than to prescribe new rules (Securities Institute). Another submission called for APRA to release a proposal for industry consultation on how it planned to achieve this disclosure before this proposal was accepted.

Consideration of the proposal

The aim of this proposal is to make trustees more accountable and increase market transparency by making key superannuation fund financial information available to the public and market at large. Making such information publicly available could enable the market to better scrutinise fund performance and place greater discipline on the trustee.

The SWG acknowledges that trustees are required to make a range of information available to members through disclosure requirements, and that trustees are also required to provide financial information to APRA.

The current requirements with regard to disclosure of certain general and specific information to members are contained within Part 2 of the SIS Regulations. The provision of information is currently restricted to fund members, with no requirement for full public disclosure. These obligations will be replaced by similar requirements under the FSRA from 11 March 2002.

While trustees are obliged to provide information to members under the disclosure requirements, information provided by trustees to APRA (annual returns, audited financial statements) is not made available to fund members. However, the information APRA receives via annual returns will, in some instances, be reported to members as part of the annual reporting requirements under the SIS regime, most notably the statement of financial position and the statement of net assets. Members may also ask for a copy of the audited financial statements.

In many employer-sponsored funds, the equal representation rules provide an avenue for members to be more involved in the operation of their fund. However, this information is not always available to the market to enable ongoing comparisons.

Submissions generally indicated support for improved disclosure to the wider community of information about fund performance. There is a question of how much information should be disclosed to the public: all of the information provided to APRA in its annual returns; only fund information that is provided to members and audited financial accounts; or some combination of the two?

Quite detailed information is currently provided to APRA in annual returns and it may not be appropriate for all that information to be disclosed to the public at large. Further, APRA is currently conducting a review of the information required in annual in the context of the implementation of the Data Act. In light of that review, the SWG considers that at this stage the information that should be disclosed to the public should be the fund information that is provided to members along with the audited financial statements. This is consistent with the requirement for responsible entities of registered managed investment schemes to make the annual reports for registered schemes public.

Once APRA has completed its review of the annual return information, further consideration could be given to whether there is any additional information that could usefully be disclosed to the public at large.

The Issues Paper proposal covered all regulated superannuation funds, except SMSFs and EPSSSs. The SWG is conscious that there could be privacy concerns associated with making public the financial statements of funds with a small number of members. It proposes, therefore to exempt from these publication requirements small APRA funds (those with less than five members which are required to have an Approved Trustee).

The Issues Paper suggested that either APRA or ASIC could make this information available on their public databases. There was little comment in submissions about which organisation should make this information available.

APRA has an existing public database, and is currently enhancing its annual return collections and data warehousing systems as it implements the requirements of the Data Act. While APRA does receive annual return information, it does not, at this time, have a readily available system to make this information publicly available.

ASIC is generally responsible for disclosure and has existing comprehensive data systems and search facilities. By amending certain regulations, ASIC would be able to require that fund information provided to members be forwarded to them, and may, in the first instance, be the appropriate body to provide this disclosure function.

At present, while members of superannuation funds are given summary financial information and can request the audited financial statements of the fund, there is no requirement that they be advised of a qualification on the auditor's report. The SWG considers that as an additional measure to improve trustees' accountability, particularly given the important role proposed to be played by the audited compliance plan, any qualification of the auditor's report should be notified to members. This could either be required to be disclosed annually or as a significant event.

Draft Recommendations

The SWG considers that there would be benefits in increasing the public access to information about superannuation funds, and makes the following recommendations.

Draft Recommendation 19

The SWG recommends that for funds other than those with less than five members, ASIC establish an electronic database for public use, which provides read-only access to audited accounts of the fund and also the fund information required to be given to members under the FSR Corporations Regulations. The SWG also suggests that the Government assess the costs and appropriate funding mechanism associated with the provision of information.

Draft Recommendation 20

The SWG recommends that as a component of its current review of annual returns, APRA undertakes further investigation of any information in annual returns that could be made public, and that APRA report to Government at the end of that review.

Draft Recommendation 21

The SWG recommends that, as a supplement to these requirements, the legislation be amended to require trustees to notify fund members of the presence, and nature, of any qualification of the auditor's report.

6 COMPLIANCE PLANS

Proposal

The Government welcomes comments on whether compliance plans should be required for superannuation funds.

A compliance plan is a document that sets out the measures an entity will apply to ensure that it complies with the law and its constitution.

Views from the consultation process

A majority of submissions supported the introduction of compliance plans. There was a general (but not universal) consensus that the benefits would far outweigh the costs. Furthermore, submissions agreed that compliance plans strengthen monitoring and help ensure that risks are adequately identified, assessed and addressed. Different views were expressed on whether, where functions were outsourced, the compliance plan should be limited to functions undertaken by trustees. CPA Australia proposed requiring regular audit sign-off.

Some submissions drew an explicit link between this proposal and licensing. While supporting a compliance plan requirement, one submission cautioned against the risk that by requiring trustees to focus on the details of their compliance arrangements, trustees may lose sight of the 'big picture'.

The Corporate Superannuation Association opposed the proposal on the grounds that it would add little, if any, value to the existing requirements of the SIS Act. A small number of other submissions also opposed it because it is already best practice and appropriate for larger funds; because required plan content would need to be specified; or because any additional benefits were expected to be outweighed by the costs.

Consideration of the proposal

Compliance plans codify risk management processes and practices that a well-run trustee would go through as a matter of course. They are an essential piece of the regulatory framework for managed investments. ASIC has indicated that it is one of its most useful tools in enabling early detection of problems.

The SWG agrees with submissions that there is considerable merit in requiring trustees of superannuation funds to prepare and lodge a compliance plan. Further, it agrees that the more significant issue is reducing compliance costs to the maximum extent possible, while maintaining the effectiveness of the compliance plan regime.

The compliance plan requirements for managed investment schemes under the Corporations Act only apply to managed investment schemes with 20 or more members. They are acknowledged as being world class, but they also come at a significant cost. The impact of compliance costs on the end benefit of members in superannuation funds is an important consideration to be taken into account in determining the scope and content of compliance plans for superannuation funds. Given the long term nature of superannuation, the fact that it is compulsory and at present many members do not have a choice of the fund that their

contributions are invested in, there may be merit in considering reducing some of the requirements that currently apply in relation to managed investment schemes, to reduce the costs that will ultimately be borne by fund members.

As the funds of particular regulatory concern to APRA are some of the smaller funds, the SWG does not consider it appropriate to exempt smaller funds from the compliance plan requirements. However, it believes that it is a further reason for considering whether all of the requirements in relation to compliance plans to be prepared for managed investment schemes are necessary for superannuation funds.

Under the Corporations Act, responsible entities are required to prepare a compliance plan covering all aspects of compliance with the law and their governing rules. For trustees of superannuation funds, the SWG believes that the regulatory aim can be achieved by requiring the plan to address only a number of specific issues, including investment, outsourcing and governance and risk management. This list could be expanded if necessary by the making of regulations. This would be in addition to the more general requirement for a compliance audit as part of the audit of the fund's financial position under section 113 of the SIS Act.

Further, under the Corporations Act where less than half of the directors of the responsible entity are independent, the responsible entity is required to establish a compliance committee. That committee is charged with monitoring the extent to which the responsible entity is complying with the plan, reporting breaches to the trustee and to the regulator where appropriate steps have not been taken to remedy the breach. The SWG believes that such a committee should not be required for funds that have equal member representation. In those cases, the trustees should be charged with monitoring compliance with the plan and reporting on breaches to the regulator.

The Corporations Act also requires that the compliance plan be audited annually. The SWG does not envisage that this would be a separate audit requirement, but rather that it would form part of existing auditing requirements. This should assist in reducing the costs of the auditing process.

Draft Recommendations

The SWG considers that compliance plans are an important regulatory tool in enhancing the safety of superannuation. It makes the following recommendations.

Draft Recommendation 22

The SWG recommends that superannuation trustees be required, as a condition of their APRA licence, to maintain a compliance plan in respect of each fund that they operate, which would need to be submitted as a part of the fund registration process. The plan should be addressed at particular requirements in the SIS Act. The Government should consult with industry on which requirements in the SIS Act should be included in the compliance plan.

Draft Recommendation 23

The SWG recommends that the compliance plan be audited each financial year, as a component of the fund's existing audit procedures.

Draft Recommendation 24

The SWG recommends that superannuation funds be required to have an independent body monitor compliance with the plan, as follows:

- for funds with equal employer/employee representation, the trustees themselves would be able to perform this function on the basis that the trustee board already incorporates independent representation; and

- for other funds, a compliance committee would need to be established.

Draft Recommendation 25

The SWG recommends that appropriate enforcement measures be put in place to address non-compliance with the compliance plan. For example, a significant breach could be required to be reported both to APRA and to members, regardless of whether steps had been taken to remedy the breach. In addition, the SWG recommends trustees be required to notify members that they may seek a copy of their fund's compliance plan from the trustee.

7 MEMBER APPROVAL FOR GIVING BENEFITS TO RELATED PARTIES BY TRUSTEE

Proposal

The Government welcomes comments on whether members must approve the giving of benefits to related parties by the superannuation fund trustee.

Views from the consultation process

With only a small number of exceptions, submissions did not support the proposal to require members to approve the giving of benefits to related parties.

Some submissions (ASFA, Industry Funds Forum, Corporate Superannuation Association) opposed adopting the relevant provisions of the Corporations Act, arguing that the existing protections of the SIS Act are stronger. A number of the submissions questioned the proposal on the grounds of practicality: they indicate that it is virtually impossible to get member approval for related party benefits, especially for larger funds. Clear disclosure to members was suggested as a better alternative.

Other submissions also indicated that the proposal would only be appropriate if the trustee intended to purchase new in-house assets which are not listed investments. Concerns were also raised in relation to multi-employer funds, where equity investments in those employers are managed at arm's length.

Consideration of the proposal

There are a number of different kinds of related party transactions that can occur in relation to superannuation, including non arm's length dealings with members, investments in assets of the employer and transactions with service providers who are related to the trustees of the fund on non arm's length terms. The SIS Act includes a number of provisions dealing with related party transactions. The provisions are designed to limit the risks associated with superannuation fund investments, and to ensure that superannuation savings are preserved for retirement purposes.

Substantial amendments were made to the in-house asset rules with the passage of the *Superannuation Legislation Amendment Act (No. 4) 1999*, which came into effect on 23 December 1999. In summary, the amendments widened the application of the in-house asset restrictions to related parties of a fund, and included, as in-house assets, investments in a related trustee and any assets subject to a lease or a lease arrangement with a related party. An in-house asset of a fund is:

- a loan to, or investment in, a related party of the fund; or
- an investment in a related trust of the fund; or
- an asset of the fund subject to a lease arrangement between the trustee of the fund and a related party.

The amount of in-house assets that a fund may have is generally limited to five per cent of the market value of a fund's assets.

There are significant grandfathering provisions attached to these requirements. Transitional provisions allow fund investments or leases in place at 11 August 1999, and which were not in-house assets at the time, to continue without being subject to the new rules. While the permitted level of in-house assets generally remains capped at five per cent of fund assets, the transitional rules allow additional investments in existing related party assets to be made until 30 June 2009 in certain limited circumstances. Some of the concerns that have been raised in relation to in-house assets have arisen as a result of this grandfathering.

These rules do not, however, address concerns about transactions with related party service providers.

In many employer-sponsored funds, the equal representation rules provide an avenue for members to be advised, and even involved in decisions to enter such transactions. For other funds, there are limited opportunities for members to become aware of these kinds of transactions. The proposal was intended in large part to address the related service provider kind of transactions, rather than the in-house assets or dealings with members. It was, however, addressed at all related party transactions.

A number of concerns were raised with the proposal, including:

- compliance costs with a new regime, including difficulties in disseminating information in a cost-effective manner;
- difficulties with developing workable voting rules; and
- the view that the existing SIS Act provisions worked well to protect member interests in this area – for example the requirements of trust law and covenants in section 52 of the SIS Act to act in the best interests of members.

The SWG accepts that there is not a compelling case to change the existing in-house asset provisions. However, it considers that the level of disclosure of the extent of in-house assets, including whether funds have any assets/liabilities that are covered by the grandfathering regime, is not sufficient. Public offer superannuation funds are required to provide prospective members with information about the fund prior to their becoming members. Other funds must give members certain information within three months of the person becoming a member. Following the FSRA, this information will be required to be given in a PDS. The SWG considers that it would be appropriate for trustees to disclose in the PDS the extent of in-house assets held by the fund. Any significant change to such assets would also be required to be disclosed to members.

Further, the current provisions do not address other related party transactions, including related service provider arrangements. While the SWG agrees that member approval for such transactions is unlikely to be practical, it believes that there should be some disclosure of any such transactions that are entered into on non-arm's length terms to members. Trustees could be required to include in the PDS any associations that they have with service providers and then disclose as a significant event any non-arm's length transactions that they have entered into with such service providers. This could be achieved by expanding the definition of 'significant event' in the ongoing disclosure requirements that will be included in the Corporations Act by the FSRA.

Draft Recommendations

The SWG accepts the view put forward in submissions that it would be impractical to require members to give their approval to the giving of benefits to related parties by the trustee. Nevertheless, the giving of such benefits can have a significant impact on the financial position of the fund.

Draft Recommendation 26

The SWG recommends that the definition of 'significant event' in the ongoing disclosure requirements under the Corporations Act be amended to require the disclosure of non-investment transactions which are entered into by trustees with related parties.

Draft Recommendation 27

The SWG recommends that trustees be required to disclose in their PDS any in-house assets. The SWG recommends that the Government considers reducing the length of time that grandfathering arrangements apply for in-house assets.

8 FINANCIAL ASSISTANCE TO FAILED SUPERANNUATION FUNDS

Proposal

The Government invites comments on the circumstances under which Part 23 could be broadened, and how any compensation should be funded, including whether funding of broader compensation arrangements by industry levies would be supported.

The Issues Paper indicated that a broadened Part 23 could include misleading or deceptive conduct.

Views from the consultation process

There was very little support for the broadening of Part 23 of the SIS Act to include compensation for acts that are misleading or deceptive. Many submissions made mention of the fact that Part 23 had not yet been tested and that changing existing provisions before it could be determined whether they were operating effectively was not in the best interests of the industry.

Submissions were concerned that a broadening of Part 23 would increase the burden on effectively managed, low-risk funds to provide compensation for poorly managed high-risk funds. Submissions were also of the opinion that widening Part 23 would lead funds to reducing their own levels of protection, resulting in increased moral hazard, a position that was widely condemned. In conjunction with this, the majority of submissions were not supportive of a levy system to provide compensation, preferring that it be provided by some form of insurance or consolidated revenue.

ASFA supported reworking Part 23 to ensure a more timely and efficient application of the current provisions and expressed support for the capping of restitution and the implementation of a more formal definition of 'substantial diminution' within Part 23.

Consideration of the proposal

Part 23 of the SIS Act provides a clear framework for providing financial assistance to regulated superannuation funds (other than SMSFs) that suffer a loss as a result of theft or fraudulent conduct, subject to certain conditions. For an accumulation fund, these include that the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits. For a defined benefit fund, it is so much of a loss that a standard employer-sponsor is required to pay to the fund, but would be unable to do so without becoming insolvent. Further, the Minister must determine that the public interest requires that a grant of financial assistance be made.

A court does not have to decide whether there was theft or fraudulent conduct; rather, it is left to the Minister making the determination to be convinced in his or her mind that theft or fraudulent conduct did occur.

If the Minister determines to grant financial assistance, the Minister must also determine whether the assistance is to be paid out of:

- the Consolidated Revenue Fund; or

- the Superannuation Protection Reserve funded through a levy on certain superannuation funds.

The Issues Paper invited comments on the circumstances under which Part 23 could be broadened, and how any compensation might be funded.

The underpinning reason for this proposal was a concern that the provisions of Part 23 would not be sufficiently broad to meet community expectations about financial assistance to failed superannuation funds. However, the SWG acknowledges that, following on from existing Government policy that financial assistance be funded by industry levies, any expansion in the test could increase the burden on well-run superannuation funds.

As with other financial investments, the Government does not explicitly guarantee superannuation savings. However, given the special characteristics of superannuation - compulsion, preservation rules, limited choice and portability - as well as its role in retirement income policy, the SIS Act does provide protection for superannuation fund members that suffer loss as a result of theft or fraudulent conduct.

Such a safety net was supported by the FSI, although its recommendation 55 suggested certain limits on the provision of financial assistance:

> Where losses as a result of serious fraud are incurred by beneficiaries of superannuation funds (other than excluded funds), the Treasurer should have powers, on the advice of the [APRA] to levy superannuation providers at a rate not exceeding 0.05 per cent of assets where such restitution is considered to be in the national interest. Restitution should be limited to 80 per cent of the original entitlement of beneficiaries as determined by [APRA].....

While the Government has accepted this recommendation, the provisions of Part 23 have not been used to date (although a number of applications are currently being considered by the Government) and the provisions of this Part have not been tested in practice.

However, it is noted that the first and second report on Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services by the Senate Select Committee on Superannuation and Financial Services highlighted the amount of time required to assess applications under Part 23. The Committee recommended that the Government look at ways to expedite the process. Industry submissions also flagged concern that the decision making process under Part 23 is too slow.

As noted above, prior to making a grant of financial assistance, the SIS Act requires that certain tests be met. The legislation provides the Minister with substantial discretion to determine whether these tests have been met. For example, the Minister has to come to a view as to whether theft or fraudulent conduct has occurred. A conviction is not necessary.

To assess whether there has been a loss suffered by a fund as a result of theft or fraudulent conduct, which has caused a substantial diminution of the fund leading to difficulties in the payment of benefits, requires a thorough assessment of the facts of the case at hand. Ascertaining these details is not simple, and recovery action or investigations can take some time. This reflects the general complexity of events surrounding fund failures.

A decision on a grant of financial assistance which is made prior to gaining and assessing all of the facts could be challenged on administrative or judicial grounds. This is especially the

case when it is likely that any grant would be funded by levies on other superannuation funds.

A broadening of the test to include losses arising from misleading or deceptive conduct was generally not supported. Similarly, changes to the levy provisions were also not supported.

Given that the efficacy of the current provisions has not been fully tested, and the lack of industry support of any change, it seems inappropriate at this time to recommend changes to Part 23.

Draft Recommendation

The SWG does not consider that the current test relating to 'eligible loss' contained in Part 23 of the SIS Act should be broadened to allow assistance to be paid for losses arising from misleading and deceptive conduct at this stage.

Draft Recommendation 28

In view of the fact that the current provisions contained in Part 23 of the SIS Act have not yet been fully tested, the SWG recommends that the provisions not be changed at this time. However, the SWG recommends that the Government review the operation of Part 23 and consider possible amendments to it once the first decision under Part 23 has been made.

9 LONGER TERM OPTIONS – SEPARATION OF PRUDENTIAL AND RETIREMENT INCOME PROVISIONS

Proposal

The Government seeks views on the separation of the prudential and retirement income provisions of the SIS Act.

Views from the consultation process

With only a small number of exceptions, submissions did not support the separation of prudential and retirement income provisions. A number of concerns were raised including:

- APRA needing more time and resources to apply the existing law effectively (Industry Funds Forum); and
- a preference for the SIS regime, which encompasses internal governance requirements and has the advantage of being specialised and focused.

A number of submissions (Trustee Corporation Association, Australian Bankers' Association, ARISA, Institute of Actuaries) favoured a separation of prudential and retirement income provisions as a longer-term objective, but indicated that this would be a very large task and that they did not consider it a high priority one.

However, most submissions did not support such separation, even as a longer-term goal, and suggested that it would result in added complexity and costs, and be confusing for trustees and members not to have a sole regulator responsible for superannuation.

The ATO noted that the proposal would have significant implications for it and require the resolution of a number of difficult practical issues, especially as many requirements of the SIS Act currently have both a prudential and a retirement income focus.

Consideration of the proposal

The SIS Act comprises provisions covering prudential regulation, retirement income policy and investor/consumer protection requirements. A substantial body of subordinate legislative instruments exist to give effect to these provisions, the development of which is done in consultation with APRA, ASIC, the ATO and the Treasury.

The Issues Paper put the view that, arguably, the triple targeting of the SIS Act to prudential, investor/consumer and retirement income regulation has resulted in legislation that is both poorly designed to achieve desired outcomes and unnecessarily complex. The joint administration of some provisions also impedes transparency and accountability for the achievement of regulatory outcomes. Accordingly, it was proposed to clearly target the arrangements by placing them in separate legislation. It was argued that this could reduce complexity, and promote clear accountability for the different limbs of the regulatory framework.

Separation of prudential and retirement income provisions may improve transparency and accountability under the SIS Act. It may also enable simplification of the regulatory

framework. Others have argued that separation, rather than simplifying, could increase the complexity of the regulatory framework - while it would leave APRA with a clear piece of superannuation prudential legislation to administer, it would mean that superannuation trustees would need to look to at least an additional piece of legislation. Industry submissions particularly highlighted this point, with ASFA commenting that the 'main benefits [of the proposal] are for the regulators, which gain their own definable patch, rather than for superannuation fund trustees, who will find it more difficult to determine and monitor their responsibilities' (page 46). The Productivity Commission also noted in its draft report that:

> while this option has some apparent advantages, it is not clear to the Commission whether it would reduce the overall complexity and prescription of the legislation or compliance costs. It is also not clear whether the option would increase the effectiveness of the legislation in meeting its objectives, or whether this benefit would outweigh the costs involved with the exercise of greater regulatory discretion and additional uncertainty. (page 129)

The SWG supports reforms to simplify the legislative framework, including the separation of the retirement incomes and prudential elements of the SIS Act. However, it acknowledges that the proposed separation of prudential and retirement income elements would involve significant resources, and that care would need to be taken to ensure that the compliance burden was not increased. Undertaking such a task should be a longer-term reform.

Draft Recommendation

Draft Recommendation 29

The SWG acknowledges that the SIS legislation is complex, and that separation of the prudential and retirement income provisions of the legislation could assist in achieving the goal of simplification of the legislation. The SWG considers, however, that there are a number of practical implementation issues that will need to be addressed and consulted on in relation to such a proposal.