12 February 2014

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By email: superannuationconsultation@treasury.gov.au

Dear Mr McCrea

Better regulation and governance, enhanced transparency and improved competition in superannuation

I am pleased to enclose a submission prepared by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia.

The Committee would welcome the opportunity to discuss the submission further. In the first instance, please contact:

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Yours sincerely

MARTYN HAGAN
SECRETARY-GENERAL

Better regulation and governance, enhanced transparency and improved competition in superannuation

The Treasury

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

12 February 2014

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Executive summary

This submission responds to the discussion paper *Better Regulation and Governance, Enhanced Transparency and Improved Competition in Superannuation* released by Treasury that canvasses issues of governance, transparency and default superannuation funds in modern awards.

A better approach to regulation

The Law Council recommends longer consultation and transition periods.

Recent reforms to superannuation regulation have been characterised by inadequate consultation and a piece-meal approach which has seen broad - but incomplete - obligations being introduced, often without evidence of proper consideration.

Industry has often had to endure the pressure associated with fast approaching commencement dates, unable to confidently commence compliance preparations while it waits for further details concerning specific compliance obligations and possible exemptions.

These details sometimes come too late or not at all, in which case there are sometimes last minute deferrals or other forms of relief provided. Sometimes the relief comes too late for funds which have already taken action, and those funds experience no practical relief but rather the frustration associated with having thrown away costs on unnecessary action at the expense of members.

Better governance

The Law Council recommends that the definition of 'independent' be aligned with its underlying purpose.

The appointment of independent directors is presumably not an end in itself, but rather a means to an end. In defining 'independence', regard should be had to whatever end is being pursued, whether that be conflicts of interest, skills and competency or parity with listed entities.

In prescribing a minimum number or proportion of independent directors, the Australian Government should be mindful of not causing the boards of superannuation trustees to become inefficiently large. At the same time, the responsibilities that independent directors will have to carry should be assessed. If future regulations will require committees to be chaired by independent directors and to include a majority of independent directors, the resulting work-load issues should inform policy development as to how many independent directors should be on each board.

Encouraging or requiring member-representative and employer-representative board positions to be filled by independent persons who have been selected by the relevant stakeholders is potentially a way of accommodating both philosophies, without enlarging board sizes.

Choice dashboards

The Law Council recommends that the design of product dashboards be re-considered. In particular, the design of choice dashboards should allow sufficient flexibility to reflect the wide variety of choice products and provide meaningful disclosure to choice members.

Choice dashboards should not be governed by the same requirements which currently apply to MySuper dashboards, because those requirements are fundamentally flawed in how they require ‘return targets’ to be published.

Those requirements may compel trustees to publish misleading and deceptive information and prevent MySuper products from being ‘true to label’ in so far as the targeted rate of investment return is concerned.

Any prescription as to how return targets must be framed would fetter the duties of trustees to formulate investment objectives in the best interests of the members of their funds.

Most members will not understand the difference between a return target and an investment objective. A typical member cannot be expected to differentiate between a target and an objective.

The dashboard requirements should be reviewed and rectified. Funds should then be allowed at least six months – after the requirements have been finalised – to comply with those requirements.

Portfolio holdings disclosure

The Law Council recommends that complete transparency of portfolio holdings be re-considered and that greater sophistication, including a materiality threshold and commercial confidentiality protections, be introduced.

Some superannuation funds have exposure to over 15,000 holdings. Even a simple spreadsheet of those holdings will run for several hundred pages.

For the disclosure to be meaningful, the disclosure should be made on an option-by-option basis, rather than on a whole-of-entity basis. For funds which offer a large number of options, the total disclosure could run into thousands of pages.

There is an urgent need for a materiality threshold to be introduced. Suggestions have been made that only a number (for example, 50) of the largest holdings need to be disclosed, or perhaps holdings which represent more than 1% of total holdings. These are sensible suggestions and would facilitate the major portfolio holdings being disclosed in the product dashboard, which would promote access by members.

The current requirements have been drafted simplistically, apparently only with listed equities in mind. Further attention must be given to derivatives, unlisted assets, cash and fixed interest securities.

Exemptions are required to protect trustees who would otherwise be at risk of breaching third party confidentiality restrictions – for example, obligations under benchmark licensing agreements in the case of passively managed investment options.

Disclosing the carrying value of unlisted assets will give other transaction counterparties access to information which is highly sensitive from a commercial perspective. Australian superannuation funds would be at a strategic disadvantage in transactions involving foreign pension funds, sovereign funds and other institutional investors which are not subject to the same disclosure regime.

This has potential to result in Australian superannuation trustees paying higher prices on acquisitions and receiving lower prices on disposals than would have been achievable in the absence of these disclosure requirements.

Funds should be allowed at least 12 months after all details have been finalised prior to those requirements taking effect.

Enhancing competition in the default superannuation market

The Law Council recommends that a fund with a MySuper product be eligible as a default fund under a Modern Award.

It is not necessary or desirable for a MySuper product to be assessed against any additional factors in order to be a default fund under a Modern Award.

It is highly doubtful that any panel of experts could in fact reliably identify any default funds that are better than any other for all of the people covered by an award and failure to do so may expose the panel (or the agency that commissioned them) to legal liability or moral hazard.

Any additional criteria would overlap with the legislative requirements applying to MySuper products and their imposition would effectively duplicate the role of the Australian Prudential Regulation Authority (APRA) in assessing and monitoring funds that are authorised to accept Superannuation Guarantee contributions.

About the Law Council of Australia's Superannuation Committee

The Law Council of Australia is the peak national representative body of the Australian legal profession; it represents some 60,000 legal practitioners nationwide. Attachment A outlines further details in this regard.

This submission has been prepared by the Law Council of Australia's Superannuation Committee (the Committee), which is a committee of the Legal Practice Section of the Law Council of Australia.

The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

Part 1: A better approach to regulation

This submission responds to the discussion paper *Better Regulation and Governance, Enhanced Transparency and Improved Competition in Superannuation* released by Treasury that canvasses issues of governance, transparency and default superannuation funds in modern awards.

Focus question #1 – compliance costs

The Australian Government's commitment to consider the costs of proposed new regulatory requirements in dollar terms is noted. Two observations can be made in that regard: one regarding the collection of data about compliance costs, and the other pertaining to inefficiencies in regulatory processes which lead to costs being unnecessarily incurred or thrown-away.

Collection of cost data

When preparing submissions, it is often easy to focus on substantive or philosophical issues. Even when input is sought from industry regarding the likely compliance costs, as a practical matter, these questions are often overlooked when preparing submissions. This may be due to a number of factors. For example, it may be difficult to arrive at a meaningful estimate in the time available. Perhaps the implementation costs will be borne by segments of business or industry which are not typically involved in the process of writing submissions. Further still, some times submissions may be made by those who do not have visibility over the full spectrum of costs that may be incurred. For example, submissions by lawyers may only be able to comment on legal costs, submissions by accountants may only be able to comment on accounting costs and so forth. Even submissions by industry may not be able to accurately comment on the likely costs, because these will depend on the extent to which the relevant work is ultimately conducted internally (and borne as an overhead cost) or outsourced to service providers (and borne as an out of pocket expense).

For these reasons, data collected through consultation processes as to the likely costs may be incomplete. A more accurate means of obtaining reliable information about compliance costs would be to engage in direct consultation on a confidential basis with specific industry participants after adequate details of the proposed regulatory requirements are known.

Inefficiencies in regulatory processes

In recent times, there have been a number of instances where supposed regulatory relief has provided little by way of real relief due to the regulatory relief being formalised too late in the process.

Regulatory reforms often pertain to processes which will affect hundreds of thousands of members in the case of large superannuation funds. As a practical matter, it is not unusual for significant amounts of coding changes to be made from a systems perspective and for substantial volumes of documentation to have to be prepared and printed and so forth.

The lead-time required to take these steps can be significant, in the order of weeks or months depending on the extent of the changes. Superannuation funds do not have resources sitting idle, so all work needs to be scheduled having regard to other business priorities and the available resources.

For all these reasons, the practical deadline for commencing implementation will always be significantly earlier than the regulatory deadline for achieving compliance.

In the absence of formal relief, prudent superannuation funds have found themselves in the unenviable position of having to choose between (a) commencing implementation, in case relief is not forthcoming, even if they lack detail as to what must be done or (b) doing nothing, but risking non-compliance in the event that relief (even rumoured relief) is ultimately not forthcoming.

A recent example is the relief from the obligation to include MySuper product dashboards with periodic statements. Although relief had been rumoured to be forthcoming, this was not ultimately confirmed until mid-December 2013, only a fortnight prior to the legislative commencement date. By this time, some superannuation funds had already commenced their implementation work and, when the relief was ultimately confirmed, the costs incurred in doing that work were thrown away.

In the same way that commencement dates ought to allow for reasonable transition periods, Government and regulators should ensure that regulatory relief is provided a reasonable period ahead of the commencement date.

Part 2: Better governance

Focus question #2 – definition of 'independence'

Our committee does not make submissions on issues of policy. However, we can make observations from a logical and drafting perspective.

The definition of 'independence' ought to be drafted so as to achieve the policy end which is being targeted by Government.

Having independent directors is presumably not an end in itself, but rather a means to an end. The definition should be drafted so as to achieve that end.

For example, if the intention is to avoid conflicts of interest arising due to perceived allegiances to particular employers or corporate groups, presumably the definition of 'independence' would be drafted so as to meaningfully add to the requirements which already apply under the prudential standard on Conflicts of Interest.

On the other hand, if the intention is to improve the skill set on boards, presumably the definition of 'independence' would be drafted so as to address whatever issues the Government believes the prudential standard on 'fit and proper' is failing to address.

Particular failures in the recently enhanced 'fit and proper' requirements or the requirements concerning the identification and management of conflicts of interest have not been identified. Any definition of 'independence' should be consistent with those aspects of the Prudential Standards adopted by the Australian Prudential Regulation Authority (APRA).

In contrast, if the policy intention is to align the governance of superannuation funds more closely with the governance of listed entities (which would not seem to us to be an end in itself), it would seem to follow that the ASX Principles should form the basis of whatever requirements apply to the boards of superannuation trustees. Otherwise, the observation could still be made that superannuation funds do not meet the same requirements as those applying to listed companies. That said, some modifications would need to be made so as to take into account the differences between corporate and trust structures.

Independent directors should be independent of the shareholders of a corporate trustee, subject to there being a materiality threshold or exception in cases where directors hold shares themselves in the corporate trustee (often as nominees).

Further, being a member of the superannuation fund should not preclude a director from being considered independent. By way of analogy, an independent director on the board of an Australian bank ought not lose their independent status merely because they become a customer of the bank by opening a bank account. Oddly, the existing legislative requirements would preclude this.

However, ordinary conflict of interest principles ought to apply in cases where an independent director is in a particular membership category and an issue arises, for consideration by the Board, which affects different classes of membership differently.

It would be logical for the definition of 'independence' to require independence from management and material service providers, in which case it would be anomalous if there was no exclusion period which applied to a person who had only recently ceased being an executive officer or being associated with a material service provider. An exclusion period

of three years would seem to strike a balance and be consistent with the arrangements applying to auditors.

Given that the pool of qualified directors may not be large, directors should not be prohibited from having multiple directorships. The existing framework of legal requirements and directors' duties is adequate to manage the issues that can arise when a person has multiple directorships.

Focus question #3 – appropriate proportion of independent directors

The potential for requirements in this area to result in superannuation trustees having significantly larger boards of directors is noted, especially if trustees merely add independent directors in addition to the directors already on their boards of directors.

For example, an existing board of 10 directors could grow to 15 directors if one-third of the directors must be independent, or grow to 20 directors if half of the directors must be independent, and the requirement is met by adding additional directors to the board.

If this were to occur, this would be counter-productive from the point of view of efficient decision-making and from a cost perspective due to the additional directors' fees.

In this regard, it is noteworthy that some of Australia's largest listed companies have boards comprising 12 or less directors. The board of BHP Billiton only has 12 directors and the boards of the Commonwealth Bank of Australia, Westpac and ANZ Bank have less than 10 directors.

In light of the above, an alternative would be to encourage (or to require) member-representative director positions and employer-representative director positions to be filled by persons who qualify as independent directors. For example, members could elect (or a member representative body could select) an independent person to be a member-representative director, and an employer could elect or select an independent person to be an employer-representative director. This kind of approach could potentially achieve the policy objective of increasing the number of independent directors on boards of superannuation trustees, but without increasing the size of trustee boards.

Under Regulation 4.08 of the Superannuation Industry (Supervision) Regulations, boards which are subject to the basic equal representation rule may only make decisions by two-thirds majority. If only one-third of directors were independent, it would theoretically be possible for a resolution to be passed even though all the independent directors were opposed. That said, Australian boards generally operate on a consensus basis, so perhaps this is merely a theoretical risk rather than a real material risk.

In setting the required proportion, Government should have regard to the work which will be required or expected to be undertaken by independent directors. If future regulatory requirements will require board committees to be chaired by independent directors, or require board committees to comprise a majority of independent directors, this could place the independent directors under considerable strain unless there is a sufficient number of independent directors to assist with the workload.

For example, if a board of six directors were to include two independent directors (i.e. one-third), any committee which had to comprise a majority of independent directors would necessarily have to include both those independent directors and would only be able to include one other director.

The independent directors could potentially find themselves being on every committee.

Focus question #4 – independent chairs

It can be useful for boards to have an independent chair. If the independent directors were, in practice, to be junior or in extreme cases subservient to the other directors, the policy-end underpinning the requirement to have independent directors is unlikely to be achieved. Requiring the board to be chaired by an independent director may go some way to mitigating this risk.

Focus questions #5 and #6 – mode of election

The comments above about the potential merit in encouraging (or requiring) independent persons to be appointed to fill member-representative and employer-representative director positions are relevant in this context.

On the other hand, the rationale for having independent directors need not be muddled with the rationale for the basic equal representation rule and perhaps the independent directors could be appointed by resolution of the other directors.

As a general proposition, it is important that flexibility be retained to accommodate different fund structures across the retail, corporate and industry fund sectors.

Focus question #7 – further conflict of interest changes

It would be best to allow the changes introduced by the Stronger Super reforms to be bedded down before introducing any further measures.

Focus questions #8 and #9 – maximum tenure, external appraisals

It would be best for non-enforceable guidance to be provided by APRA in this area to allow flexibility for industry.

Focus questions #10 – form of regulation

Any changes to the current basic equal representation rules would require legislative change since APRA prudential standards cannot override the *Superannuation Industry (Supervision) Act 1993* (Cth).

Enshrining any new requirements in legislation would also be consistent with the stated policy objective of limiting the pace of future regulatory changes, since legislative change generally proceeds more cautiously than changes to regulatory guidance, prudential standards or other forms of subordinate legislative instruments.

Focus questions #11 and #12 – transitional periods

As a general proposition, a transitional period of at least three full financial years is likely to be sufficient. This would also allow any recent appointments for three-year-terms to proceed their natural course, following which the question of reappointment could be considered in light of whatever requirements there may be with regard to independent directors.

If the new requirements take effect sooner than this, trustees may be required to comply with the requirements by simply adding additional directors, which could result in over-sized boards, as noted above in the response to Focus Question #3.

Part 3A: Enhanced transparency – Choice dashboards

Focus question #13 – consistency between dashboards

Members of the Superannuation Committee understand from their clients that there are significant problems with the requirements applying to MySuper dashboards. For example, the definition of 'return target' for the purposes of MySuper dashboards is defective and flawed.

As a result, the requirements relating to the disclosure of 'return targets' carries a real risk of fettering the ability of trustees to fulfil their obligation under the Investment Governance Prudential Standard to formulate appropriate investment objectives.

Those same requirements may compel trustees to publish misleading and deceptive information and prevent MySuper products from being 'true to label' in so far as the targeted rate of investment return is concerned.

These concerns are outlined in further detail below.

For these reasons, the requirements for choice dashboards should not be the same as those currently applying to MySuper dashboards.

Ideally, the MySuper dashboard requirements should first be revisited and fixed, in which case the same requirements could then be adopted (with some flexibility to accommodate variety) for choice product dashboards.

Focus question #14 – single CPI benchmark

It is not appropriate to compel trustees to publish a CPI-linked return target.

The Investment Governance Prudential Standard charges trustees with the obligation to formulate an investment objective. This is an obligation which trustees must fulfil by acting in the best interests of members, having regard to all the relevant circumstances of the fund.

There is no reason to assume that the most appropriate investment objective will always bear some correlation to CPI.

Numerous other types of investment objective are readily conceivable. Some trustees may prefer an AWOTE-linked objective with a view to generating returns which bear some correlation to salary growth. Other trustees may consider it appropriate to adopt an absolute return objective, whereas others may target a rate of return which tracks a market benchmark or which focusses on yield, rather than capital growth, for example.

All of the above types of investment objectives are entirely legitimate and permissible.

Product dashboards become misleading and deceptive when they publish a 'return target' which is different from the investment objective which applies to the relevant investment option.

There is another reason why 'return targets' are problematic for industry. APRA has defined 'return target' in a way which effectively means that trustees must disclose the investment return which they are precisely 50% confident of achieving. Many funds are

more disciplined than this and have historically published investment objectives which they have a much higher level of statistical confidence in achieving. Not surprisingly, these investment objectives are lower (due to conservatism) than the much higher return target which APRA is requiring funds to publish. The investment strategies employed by trustees have been designed to achieve the actual (and conservative) investment objective, not the artificial and inflated return target which insisted upon by APRA.

It is doubtful whether whether most members will understand the difference between a return target and an investment objective. A typical member cannot be expected to differentiate between a target and an objective.

As such, the existing requirement for MySuper dashboards to include a return target (as defined by APRA) exposes trustees to an unreasonable risk of liability for misleading and deceptive disclosure.

Focus question #15 – net return or net investment return

Presumably the Australian Government is minded to see dashboards include performance figures which reflect the actual changes to member account balances. As such, the intuitive temptation to require dashboards to disclose returns after taking into account all fees whatsoever is understandable.

However, this intuitive response can result in misleading and deceptive data being included in product dashboards.

The issue arises because investment returns are readily explainable in percentage terms, whereas some fees (for example, administration fees) are often set in dollar terms.

Difficulties arise when trying to deduct dollar-based fees from returns expressed in percentage terms.

The MySuper dashboard requirements attempt to address this by requiring dollar-based fees to be converted into a percentage on the assumption that the member has an account balance of exactly $50,000. However, very few members (if any) would have an account balance of precisely $50,000 for the entirety of a financial year.

As a result, the conversion of dollar-based fees into a percentage is inaccurate for almost all members. The net return figure is therefore inaccurate for almost all members and creates a risk of liability for trustees for misrepresentation.

In contrast, the net investment return figure would generally be an accurate reflection of the investment returns received by all members in the relevant option (leaving aside non-investment dollar-based expenses).

Focus question #16 – risk measures

From a legal perspective, it is important the requirement to disclose investment risk does not expose trustees to the risk of liability for misrepresentation or misleading and deceptive statements.

Intuitively, it is understandable why the view has been taken that members should be put on notice of how often negative investment returns may occur.

However, this has the potential to become misleading and deceptive in cases where an investment option is at risk of having infrequent but substantial negative returns which are likely to far outweigh the more frequent – but small – losses in another investment option.

For example, under the current risk classification methodology, an option which is expected to have negative returns in five years out of every 20 years will be classified as being riskier than another product which is only expected to have negative returns in three years out of every 20 years, even if the first product would only have very small negative returns in those years compared to much more significant losses in the second product.

It is suggested that consideration be given to adding a metric which explains to members the extent of the negative returns in negative years, on average. Actuarially, it is possible to calculate a 'conditional tail expectation' value, for example, which would provide this kind of information to members. Submissions could be sought from industry on this point.

There is a risk that typical members will be confused by the proposals foreshadowed in the discussion paper, as these would result in members being given dashboards which disclose how their option has performed relative to a CPI-linked return target in percentage terms, the risk of underperforming AWOTE in probability terms, and the risk of suffering negative returns in binary terms.

Focus question #17 – carve outs

It is common for superannuation funds to offer both an accumulation and pension version of the same investment option. Different fees and charges may apply to the accumulation and pension versions, which in turn affect the calculation of the return target and of the net returns. However, the investment options are generally identical in all other respects.

Industry would benefit from flexibility to issue a single product dashboard for both the accumulation and pension version of an investment option. This would involve allowing flexibility for the dashboard to include different return targets, different performance figures and different performance graphs in the one dashboard.

The current carve-out for defined benefit funds should be retained. For example, the investment objectives for defined benefit funds will often be different from the types of return targets which are being contemplated in the discussion paper and in existing legal requirements. Similarly, investment return data is only of secondary and indirect importance to a defined benefit member.

Focus question #18 – liquidity measure

If Government were to require some liquidity measure to be included in dashboards, Government should be mindful of not creating a metric which might precipitate a run on the fund in the event that the published level of illiquid assets approaches some critical limit which might also be published.

It is questionable whether a typical member would take any comfort from knowing what percentage of assets within their chosen investment option comprises liquid assets. This kind of figure will not necessarily be meaningful in the abstract and, at the very least, would need to be considered in light of what the trustee's target or budgeted level of illiquid assets is. Even then, this would not necessarily convey the risk of redemptions or switches from the investment option being suspended or impacted by market events.

Focus question #19 – commencement date

The commencement date should be at least six months after the date on which the content requirements are finalised and made available to industry and their advisers, so as to allow the relevant calculations and logistical preparations to be undertaken in an orderly fashion. In this regard, it should be borne in mind that large funds will need to

prepare a large number of dashboards and not all of the data will necessarily be of a kind which is currently being calculated.

Part 3B: Enhanced transparency – portfolio holdings disclosure

The Law Council supports a portfolio holdings disclosure regime that balances the legitimate need for a sensible level of information to be given to members against the costs and other adverse consequences of meeting the regime's requirements.

Focus question #20 – preferred disclosure model

Of the alternatives presented in the consultation paper, the 'second alternative model' is probably preferable– that is, while funds would be required to "look through" associated entities, trustees would not need to "look through" non-associated entities.

That said, this will not be sufficient on its own and will need to be accompanied by an appropriate materiality threshold and other exemptions for unlisted assets and circumstances where trustees would be breaching third party confidentiality obligations if they were to make full disclosure.

Furthermore, it cannot be assumed that because a superannuation trustee makes available an investment offered by a related party that this will necessarily ensure that that the relevant information is easily available to that trustee. Any investments or service provider arrangements are expected to be conducted on an arm’s length basis, so it cannot be assumed that the information will be provided without a cost for the additional service provided. Although look through is required by the APRA reporting standards in the context of associated entities (and so there is an argument that trustees already have some of the information), there remain other issues about aggregation of the information in a different form, and control over how the information is presented to members.

This approach, combined with a meaningful materiality threshold and other exemptions (as outlined below) would lessen the administrative burden/cost on trustees (given that information is already being collected and reported to ARPA) and would still provide members with a sensible and comprehensible level of disclosure. It would alert members to either the identity of the 'final investment' (for example, in the case of separately managed portfolios) or the identity of the person(s) responsible for making actual investment decisions (for example, in the case of collective investment vehicles).

In contrast, adopting the 'first alternative model' of imposing a separate disclosure regime on managers/responsible entities of collective investment vehicles would simply transfer the compliance burden to those vehicles (but still ultimately at the cost of superannuation fund members) and would continue to result in an excess of information being provided to members in a manner that is less than 'user-friendly'.

<u>Need for additional exemptions</u>

In addition to the above proposals, to ensure that trustees are not faced with a situation where they are required to weigh up the consequences of breaching duties of confidence owed to third parties and the obligation to make disclosures under the regime, the Law Council suggests that all requirements to make disclosures under the regime be subject to a defence for non-disclosures which are required to ensure compliance with *bona fide* third party confidentiality obligations imposed on the trustee (or its agents or delegates).

For example, disclosing the holdings of an investment option which is passively managed may breach the terms of the relevant benchmark licensing agreement.

Similarly, if an investment option is entirely managed by a single investment manager, disclosing the holdings of the option may breach confidentiality obligations owed to that particular investment manager. In contrast, where there are multiple investment managers, the holdings of the various managers will be blended, thereby ensuring that the holdings of particular investment managers remain confidential.

In a small proportion of cases, the mere fact that a fund has made an investment in a particular vehicle/investment may itself be confidential information – a trustee should not be forced to choose between its duty of confidence (and the contractual consequences of breaching that duty) and its obligation to disclosure information under the regime.

This issue, whilst still important, becomes less critical assuming the 'second alternative model' described above is adopted (i.e., as the mere fact that an investment has been made by a fund in a non-associated entity is far less likely to be confidential than the "look-through" information which would otherwise need to be disclosed under the current formulation of the rules).

If a broad exception for disclosure of confidential information is not provided, at the very least those who are currently bound by confidentiality obligations (as at the deferred commencement date of the regime) should not be required to disclose information that puts them in breach of those obligations.

Need for further detail

Industry urgently requires direction and detail on a range of presentational issues associated with the regime, for example:

- how to present derivative contract positions (both exchange-traded and over-the-counter) in a meaningful and consistent manner;
- how to address the issues raised by securities lending agreements being in place in respect of fund assets as at the relevant reporting dates; and
- whether it would be appropriate to aggregate particular types of investment exposure on a counterparty-by-counterparty basis (for example, for cash, fixed income and term deposit holdings held with a particular counterparty).

Along similar lines, it ought to be sufficient for trustees to disclose the weighting of particular holdings in percentage terms, rather than having to disclose the number of shares and price per share in absolute terms (which is the current requirement).

Focus question #21 – compliance costs

Submissions from trustees and their custodians may address the issue of compliance costs. However, in light of the comments in response to focus question #1, they may not necessarily address this issue.

In addition to the direct costs of compliance, Government should bear in mind the unintended investment costs which may indirectly be suffered as a result of the disclosure requirements.

Disclosing the carrying value of unlisted assets will give other transaction counterparties access to information which is highly sensitive from a commercial perspective. The current carrying value of an unlisted asset may be an indicator of what value the trustee

expects to pay for further shares in that asset or what price the trustee would require from a purchaser of its holding. As such, the disclosure requirements give an unfair negotiating advantage to foreign pension funds, sovereign funds and all other counterparties who are not subject to the same disclosure requirements.

This has potential to result in Australian superannuation trustees paying higher prices on acquisitions and receiving lower prices on disposals than would have been achievable in the absence of these disclosure requirements.

These should be considered a cost of compliance.

Focus question #22 – entity level or product level disclosure

For the information to be useful to members, the information should be provided at a product level (i.e. the level at which members make investment decisions). In many cases however, funds do not segregate assets for different investment options but rather allocate returns on a broader pool of assets to the investment options offered, so it is questionable whether separating the information into product level disclosures will be practical in all cases. A notional allocation of pooled assets may have to be undertaken and ought to be permitted by the requirements.

Focus question #23 – materiality threshold

The Law Council strongly supports the introduction of a suitable materiality threshold for the regime.

The investment options offered by some large superannuation funds have exposure to over 15,000 securities. The disclosure documents would therefore run for several hundred pages for each option. Since it is not unusual for large funds to offer a large number of investment options, the total report will comprise several thousand pages.

This represents an unreasonable burden and it is unrealistic to suppose that members will find this useful.

A materiality threshold would allow a more sensible balance to be reached between the need to disclose all 'material' information (which is ultimately all that members are likely to be genuinely interested in) with the administrative cost/burden of requiring disclosure of all information.

Focus question #24 – impact on transparency

A materiality threshold would promote transparency to the extent that members or the public are able to access and understand the data to a greater extent. It does not promote transparency for meaning to be lost amongst the sheer volume of data. Having sufficient transparency to enable meaningful questions to be asked should suffice.

Focus question #25 – type of materiality threshold

The materiality threshold could be set at a level such that the resulting list of holdings was sufficiently manageable to be able to be included in the product dashboard, thereby boosting accessibility and systemic transparency.

This would potentially be achievable if the materiality threshold was such that only (say) the 50 largest holdings, or holdings representing more than 1% of the relevant pool of assets, were required to be disclosed.

To illustrate the point, why is it material (in the sense that applies to Product Disclosure Statements) for holdings of less than 1% to be disclosed to members, given that this is unlikely to affect the investment decisions of members? If a member has an account balance of $50,000, a holding which carries a weighting of 0.5% would only represent $250 of their account balance.

Focus question #26 – commencement date

A commencement date should be set that is appropriate to allow funds sufficient time to collate the necessary information and for the presentation issues highlighted above to be appropriately worked-through with industry.

As the regime is not yet in place, a 1 July 2014 start date seems to be premature.

It would be more appropriate to adopt a commencement date which is at least 12 months after the disclosure requirements have been finalised, and not before 1 July 2015.

This is necessary because trustees and their advisers cannot sensibly commence implementation until after the precise disclosure requirements are known and because of the extent of the system changes, the data collection burden and the extent of the discussions which need to be entered into with investment managers and collective investment vehicles, many of which will be based offshore and therefore unfamiliar with the requirements.

Part 4: Enhancing competition in the default superannuation market

It is not necessary or desirable for a MySuper product to be assessed against any additional factors in order to be a default fund under a Modern Award. This is because:

(a) it is highly doubtful that any panel of experts within the Fair Work Commission (FWC), or the Full Bench of the FWC, could in fact reliably shortlist and select any default funds that are better than any other for all of the people covered by an award and failure to do so may expose the panel (or the agency that commissioned them) and the FWC to legal liability or otherwise Government to moral hazard;

(b) any additional criteria overlap with the legislative requirements of all MySuper products and their imposition would effectively duplicate APRA's role in assessing and monitoring funds that are authorised to accept Superannuation Guarantee contributions;

(c) recent and ongoing consolidation within the superannuation industry, and the legislative requirement for MySuper products to have sufficient scale, has already reduced the number of funds that can accept default contributions (the number of MySuper authorisations is currently well under 200) and it is likely to result in a considerable reduction in the number of funds, simplifying the default fund selection process for employers;

(d) placing a limit on the number of funds that are to be selected as default funds, will have a significant impact on the viability of a fund which is not selected, thus reducing competition. The Law Council does not have an

opinion about whether competition is a relevant measure for designing the default superannuation system.

Focus question #27 – the new status quo and its objectives

There is a real risk that the new model which commenced on 1 January 2014 will not achieve its objectives. A sound process in which employees, employers and superannuation fund trustees could have confidence would require a significant amount of work to ensure that all relevant considerations are taken into account and no irrelevant considerations are taken into account by the panel selecting the default funds. It would also require open and transparent submissions (including by trustees), the ability to challenge and test submissions, decisions with reasons and an appeal process, among other things. This will be time consuming and costly without any real benefit to employees and employers.

Even assuming the process is sound, it is unclear what criteria would provide a proper basis for the expert panel and the Full Bench of the FWC to shortlist and then choose the 15 funds to be listed on a particular award. The trustee of each fund will already have been assessed by APRA and is reviewed on an ongoing basis by APRA. This had been a very thorough process.

In exceptional cases it is possible that a fund may be able to better meet the needs of a particular group of employees (for example, stevedores may be able to secure insurance in one fund but not others). In this case, it would be a matter for the trustee of the fund to promote the fund's suitability with industry employers and employees. These cases are likely to be quite rare and should not dictate a process for all awards. Finally, given that the bulk of superannuation contributions are default contributions, the proposal to limit the number of default funds on an award will have a significant impact on the ongoing viability of a fund which is not selected, thus reducing competition.

The process does not require the applicant to name the awards on which they wish to be named. The process seems to work on an all-or-nothing approach. A number of industry funds are understood to be concerned by this, as they may wish to apply to be named in only the awards within their industry segment.

Focus question #28 – the Productivity Commission's model

Nothing more than a MySuper authorisation should be necessary to be an eligible default fund for any employee. Given the simplicity of MySuper products, and the difficulty of identifying funds that are better than others over a person's working life, there is no obvious basis upon which to distinguish one fund as being better on an ongoing basis for employees covered by individual modern awards than any other fund. Information about cost, past performance, investment strategy and insurance will all be publicly available.

Focus question #29 – who acts as the 'quality filter'

It is doubtful whether the Full Bench of the FWC or an expert panel within the FWC, or any other institution, person or group of people, could reliably shortlist or choose 15 better or more suitable default funds from all funds offering MySuper products, particularly given the broad coverage of modern awards.

If an expert panel within the FWC and/or the Full Bench of the FWC were required to do so, questions arise as to whether they should provide reasons for their decisions, or rank

the funds nominated by the award, and whether they should be liable in the event, for example, that the selected default fund performs poorly, or does not provide adequate insurance cover for members. The Australian Government would be exposed to the risk of claims for compensation by employees who feel they have suffered loss, given that the default fund would have been selected by what would be considered to be an Australian Government agency.

If the panel or other body is not liable for its selection, it is questionable how much confidence employers and employees could have in the funds nominated in an award, particularly where the selection process is not transparent and subject to review.

There is also the significant issue of whether the expert panel and/or the FWC would be liable for losses caused to funds that were omitted from an award.

Focus question #30 – listing 'high quality funds'

While this model is better than the inclusion of a prescribed list of default funds in awards, how will the list of high quality funds be selected and will the body making the selection be liable for losses caused by reliance on the list? Again, if there is no responsibility or liability assumed for the list, its value is doubtful.

An alternative may be for APRA to include on its website information to assist employers in choosing a default fund, this might include the factors they should take into consideration in choosing a default fund. The relevant information is likely to be available on APRA's website (performance, fees and so on). However, for the reasons discussed above, APRA should not specify an 'approved list' or make recommendations on what superannuation funds would be suitable as default funds.

Focus question #31 – corporate funds

If the purpose of the expert panel selecting 15 default funds to include in an award is to identify the most suitable funds for employees in the industries covered by the award, there is no obvious reason to exclude the corporate fund from the process. However, a grandfathering regime should apply to all existing default funds (including corporate funds). There is a significant risk to employees if their employer cannot continue to contribute to their existing fund, the most significant being the loss of insurance cover.

This will be an issue that needs to be addressed on an ongoing basis since the existing proposal includes a process by which funds will move on and off awards. Issues include:

(a) the disruption and potential for employees to suffer loss (for example, investment losses and costs) as a result of their superannuation arrangements being moved to new default funds from current default funds;

(b) the effect on decision-making by funds in relation to longer term investments (such as investment in infrastructure) where there needs to be some level of certainty as regards expected contribution in-flows and out-flows in order to be able to commit to less liquid investments.

Attachment A: Profile of the Law Council of Australia

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

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

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

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

Through this representation, the Law Council effectively acts on behalf of approximately 60,000 lawyers across Australia.

The Law Council is governed by a board of 17 Directors – one from each of the Constituent Bodies and six elected Executives. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive, led by the President who serves a 12-month term. The Council's six Executive are nominated and elected by the board of Directors. Members of the 2013 Executive are:

- Mr Michael Colbran QC, President
- Mr Duncan McConnel President-Elect
- Ms Leanne Topfer, Treasurer
- Ms Fiona McLeod SC, Executive Member
- Mr Justin Dowd, Executive Member
- Dr Christopher Kendall, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.