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20 February 2014

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

Dear Sir / Madam

Last week, Mercer lodged its submission on the discussion paper on this topic.

As indicated on the covering letter to our submission, we indicated we would be providing further information to support our recommendations. The attachments to this letter include this additional material.

Attached to this letter, you will find:

- Attachment 1: An executive summary which repeats the recommendations made in our submission
- Attachment 2: Detailed Responses to the specific questions in the discussion paper
- Attachment 3: An outline of issues relating to the criteria to be used for determining default fund lists
- Attachment 4: A summary of some of the adverse outcomes likely to arise from the current Fair Work legislation in relation to default funds
- Attachment 5: Details about Mercer.

Please contact me or David Knox (03 9623 5464) if you would like more detail on our comments and recommendations.

Yours sincerely,

David Anderson
Managing Director & Market Leader, Pacific

ATTACHMENT 1: EXECUTIVE SUMMARY

Part 1: A Better Approach to Regulation	
ISSUE	**MERCER'S RECOMMENDATION**
Improving efficiency and reducing red tape	Our recommendations to improve efficiency and reduce red tape include: • Allowing funds to continue providing insurance covering loss of limbs/sight and inability to perform daily living activities and similar definitions beyond 1 July 2014 • Varying the scope and format of the remuneration disclosure requirements • Amending the various Acts, Regulations and Class Orders so that disclosure requirements are easier to follow by appearing in a single place • Reviewing current disclosure requirements to enable funds to more effectively communicate to members in a cost efficient manner • Clarifying and enabling all disclosure material to be issued using electronic means • Specifying notional taxed concessional contributions (as used for concessional contributions limits) as the amount of notional defined benefit contributions for Division 293 tax purposes • Enabling deferred Division 293 tax to be paid from any superannuation fund (rather than just the fund in which the benefit accrued) • Amending Tax Ruling 2010/1 to provide a more practical approach to determining the maximum deductible personal contribution for a year and requiring the ATO to take into account the likely costs on the industry of any future methodology changes it proposes • Conducting a cost benefit analysis of the APRA statistics with the aim of significantly reducing reporting requirements. Greater emphasis should be placed on the value and cost to fund members rather than the value which might be obtained by non-members from results published by APRA • Removing the tax on death benefits with the cost being at least partly offset by the removal of the anti-detriment provisions • Modifying Part 9 of the SIS Regulations by deleting the existing requirements for Funding and Solvency Certificates and additional requirements for funds which are technically insolvent. Consideration could be given to replacing them with requirements which are more consistent with SPS 160 • Clarify that certain actuarial services are not subject to the Tax Agents Services legislation.

Part 2: Better Governance

ISSUE	MERCER'S RECOMMENDATION
Mandated percentage of independent directors on superannuation boards	It is difficult to argue that superannuation funds should be held to a different standard of governance to those applicable to Australian listed companies, Approved Deposit Institutions, Life Insurers and General Insurers. They all have requirements for a majority of independent directors on the board. Therefore we believe it is inevitable superannuation will be held to the same standard as other APRA regulated entities in the finance and insurance sector. The presence of suitably qualified independent directors on superannuation trustee boards will ultimately strengthen our superannuation system, and a consistent approach to director representation across all segments and entities will provide a simplified structure for effective governance of the superannuation industry. We recognise the need for a transition period for all regulated entities to meet the same standard. Some meet this requirement today. Others will require substantial reform of the board composition to meet this long term standard. As such, for the transition period, we recommend a principles-based board composition and effectiveness program be adopted and enforced via APRA Prudential Standards.
Definition of 'Independent'	The definition of "external director" in Section 601JA(2) of the Corporations Act should be used for independent directors. Modifications would be necessary to exclude officials of any organisation (such as a Union, employer body or employer) who appoint the directors of the trustee board. The definition of independent should, as far as possible, be consistent with other definitions relevant to corporations because inconsistencies generally lead to greater complexity and red tape. Consideration should also be given to whether there should be greater alignment with other definitions, for example the definition of non-executive director in Superannuation Prudential Standard SPS 510. We also suggest a principle which encourages trustee board members to be a member of the fund. This would be assisted by legislation clarifying fund members do not have a conflict of interest merely in relation to them being a member of the fund.

<table>
<tr><td>Should superannuation fund boards have independent chairs?</td><td>We believe the chair of superannuation trustee boards should be independent.

A principle of the desirability rather than mandating independent chairs could be introduced during the transition period.</td></tr>
<tr><td>Process for appointing directors on superannuation fund boards</td><td>We recommend each fund be able to determine how its board members are appointed. This could include maintaining the existing appointment process which will avoid considerable expense that may be incurred if appointment processes had to be changed. This flexibility will allow for the most appropriate appointment system for the particular fund. Those responsible for appointing board members would need to take into account the principles and requirements for independent directors.

Additional protections would be necessary to ensure an appropriate mix of board members, effectiveness of the board, and mechanisms by which the board can be made more effective and, in extreme cases, replaced. Protections should include the following:
APRA able to remove a board or individual and appoint a replacement where APRA considers the Board is not operating effectively
Development of a skills matrix necessary for an effective board (this could include skills and experience and demographic factors appropriate to the fund's particular circumstances)
A requirement for the board to liaise with those responsible for appointing board members to ensure a board which comprises the skills set out in the fund's skills matrix (this is consistent with Superannuation Prudential Standard SPS 510)
Regular independent board effectiveness reviews
Disclosure of whether each board member is independent and, if not, any relationship with an employer/employer organisation, union/employee association or fund promoter
Requirements to disclose the appointment process
Amending member disclosure requirements so trustee board directors disclose whether they are a member of the fund.</td></tr>
<tr><td>Management of conflicts of interest</td><td>New Governance standards in APRA prudential standards should be revisited in two or three years once practical experience has been obtained. However, consideration could be given to mandatory training in conflicts of interest in relation to superannuation within board members' first two years of office.</td></tr>
</table>

Appointment terms for directors	Mandated maximum terms would add further red tape to our system. More importantly it could lead to the loss of highly skilled and experienced directors. Board renewal should be considered as part of the board effectiveness reviews.
Board effectiveness	Boards, as a whole, should be regularly assessed. Board decisions are made as a collective. Individual directors should be part of the process but not be subject to regular performance appraisals. Independent board effectiveness reviews should be conducted at least every two or three years and should concentrate on whether the board is acting effectively and appropriately and whether it could be strengthened by changes to its membership. Board effectiveness could also be improved by establishing a best practice principle that the board set expectations for each of the board members taking into account the fund's strategy, policies, objectives and skills set. These expectations are likely to vary depending on the skill set of each board member.

Part 3A: Choice product dashboard

ISSUE	MERCER'S RECOMMENDATION
Can a choice product dashboard help enhance transparency?	We do not believe product dashboard requirements for choice products should proceed. If they do, this should only occur after detailed consumer testing. At least for some investment options, different requirements to those for MySuper dashboards may be necessary. If the Government does decide to proceed with product dashboard requirements for Choice products, we strongly encourage the delay in their introduction to no earlier than 1 July 2016. Mercer supports the Government's commitment to increasing the quality of information available to superannuation fund members and employers. However – we strongly believe introducing a choice product dashboard would add little value to superannuation fund members. It would largely be disclosure for the sake of disclosure adding a significant compliance burden on funds, resulting in additional unnecessary costs which would be passed on to members. We expect members who choose a particular investment option are generally reasonably engaged with their superannuation. Product dashboards are unlikely to provide relevant information for these engaged/sophisticated members. In any case, the MySuper dashboard requirements are inappropriate in their current format and may confuse members rather than assist them. There are many unresolved problems with MySuper dashboards that should be rectified before consideration is given to dashboards for choice products. Meanwhile, we recommend the following changes: ▪ Show net investment return rather than net return to reduce confusion and provide more appropriate information ▪ Review the risk measure which should be based more on the risk of providing unacceptable retirement outcomes ▪ Remove requirements to show dashboards on periodic statements ▪ Clarify the fees to be disclosed ▪ Clarify the term "return target" ▪ Consider showing returns for periods shorter than 10 years where 10 years' experience is not available.

Part 3B: Portfolio holdings disclosure	
ISSUE	**MERCER'S RECOMMENDATION**
What level of portfolio holdings disclosure is appropriate?	We believe the current legislative requirements are overly onerous and the compliance costs will far outweigh the benefits. Mercer supports disclosure of portfolio holdings to the extent this does not impose an onerous regulatory burden and or excessive costs. This could be achieved by amending the disclosure requirements to reflect the following principles: • Not require a look through to assets underlying pooled funds (with some other look through exemptions) • Include a materiality threshold determined on a size basis – eg. assets more than 2% reported with those under a confidential agreement de-identified. With such changes, funds would be able to place more emphasis on providing information on a product (or option) basis rather than a whole of fund basis. This will be more relevant to members considering a particular investment option.
Implementation issues	The 1 July 2014 timetable appears to be unachievable, particularly if reporting to the individual product level is required. Delaying the commencement date for portfolio holding disclosure by at least one year, would allow industry and regulators appropriate time to determine an appropriate level of reporting that provides useful and informative information to members without significantly increasing the burden on superannuation funds. As such the earliest feasible reporting date would be 1 July 2015.

<table>
<tr><th colspan="2">Part 4: Improved competition in the default superannuation market</th></tr>
<tr><th>ISSUE</th><th>MERCER'S RECOMMENDATION</th></tr>
<tr><td>Transparency, contestability & reducing red tape</td><td>Mercer recommends the provisions specifying default funds be removed from Modern Awards with employers being able to choose any fund offering a MySuper as their default.

The existing model is not transparent or contestable and provides additional cost and administrative complexity for employers, employees and superannuation funds. We are particularly concerned that many employees and other members of superannuation funds will be adversely affected financially by the new requirements.

This will avoid the following outcomes which are likely to arise if the legislation is not amended:
An estimated million new accounts may need to be established because the current employer default fund is not listed in the relevant Modern Award, resulting in
a blow out in the number of lost members
two sets of administration fees for relevant employees, potentially on an ongoing basis as it is unlikely many will go to the effort of merging their existing and new accounts. For those who do merge accounts, a withdrawal fee will be incurred
A potential loss of insurance cover where members may not satisfy the relevant underwriting requirements to be eligible for cover in their new fund and who may lose existing cover permanently if they rollover their existing account to the new fund or if their existing account is no longer sufficient to provide ongoing insurance cover
Hundreds of thousands of employees potentially becoming members of funds which are less appropriate to their circumstances (including higher fees and less appropriate insurance arrangements)
Additional cost and red tape for employers in choosing a new default fund, advising employees and processing requests from employees who wish to retain their existing fund
Additional cost and red tape for employers who have employees covered by more than one Modern Award where it may be necessary to have different default funds for different groups of employees and potentially change an individual employee's default fund each time the employee changes roles and becomes subject to a different Modern Award with the adverse impacts on the employee being repeated each time
Significant costs being incurred by superannuation funds in applying to the Fair Work Commission for listing under in excess of 100 Modern Awards. These costs will be passed onto members.</td></tr>
</table>

ATTACHMENT 2: DETAILED RESPONSE TO DISCUSSION PAPER QUESTIONS

Part 1: A Better Approach to Regulation

1. The Government has committed to identifying (in dollar terms) measures that offset the cost impost to business of any new regulation. What suggestions do you have for how the regulatory compliance burden can be reduced?

There are many instances of unnecessary red tape in superannuation legislation.

We have listed below a small number of the more urgent issues. Items 1 and 2 are particularly important as virtually all funds will be currently developing their approach to the current legislative requirements:

1. Definition of permanent incapacity

From 1 July 2014, it will no longer be possible to provide insurance payable in the event of the loss of limbs and/or sight for new members joining a superannuation fund. Likewise, definitions covering inability to perform daily living activities will also be banned for new members. (Such insurance can continue for members already insured for such benefits.)

Loss of limbs/sight coverage has been an integral part of the definition of total and permanent disability insurance policies for over 40 years. This had been accepted by the ATO with premiums being tax deductible. However, several years ago, the ATO apparently changed its mind and, as a result, when the Simpler Super legislation was drafted, the tax deductibility of premiums for such cover was removed.

Following several years of discussions and negotiations involving thousands of hours of effort by the industry, a reasonably practical solution was eventually achieved. This enabled premiums for the standard loss of limbs/sight definition to be considered tax deductible – taking into account the almost negligible portion of the total premium such insurance coverage represented.

Although “inability to perform daily living activities” definitions have been of more recent origin, a similar outcome as for loss of limbs was achieved. Such definitions were developed to better cater for the widening scope of superannuation where many members were not in the work force or were casual employees for whom the standard definition of permanent incapacity, with its connection to the cessation of employment, was not really appropriate.

The Stronger Super legislation changes have removed the ability for funds to use these long standing and relevant benefits for new members.

As a result:

- Almost all group insurance policies will need to be renegotiated by trustees and insurers in respect of new members
- Changes will be necessary in PDSs and incorporated by reference documents in relation to the changes in definitions
- Confusion amongst members will increase as the definition of total and permanent disablement for existing members will differ from the definition applicable to new members

In practice, these are red tape changes which will result in very considerable cost to superannuation funds.

The new restrictions will not benefit members and will have a significant adverse impact on those members who would have received insurance proceeds under the current definitions but not under the replacement definition (assuming cover under a replacement definition is available, which may not always be the case).

The new restrictions are unlikely to result in tax savings as our recommendation relates only to definitions under which the premiums are already fully tax deductible and premiums are unlikely to fall when the legislated restrictions come into force.

Recommendation: Funds should be allowed to continue providing ancillary definitions (such as loss of limbs) to new members post 1 July 2014 subject to:

- ***the definition being consistent with the definitions for which premiums are considered to be fully tax deductible under Regulation 295-465 of the Income Tax Assessment Regulations 1997***
- ***the insured benefits being subject to preservation (as is currently the case) until an appropriate condition of release has been satisfied.***

As a separate exercise, the definition of permanent incapacity in the SIS legislation should be reconsidered so that it encompasses definitions which are more appropriate to the growing number of superannuation fund members who are not permanent employees. This could be incorporated into the Government's consultation process (as announced by The Assistant Treasurer on 31 January 2014) to address pricing, availability and the deficiencies in the current life insurance market).

2. Disclosure of Executive Remuneration for RSE licensees

We submit that the scope for disclosure of executive remuneration for RSE licensees in the SIS Act is too broad and should be aligned with the disclosure regime already in place under the Corporations Act for listed entities. Our comments relate both to classes of persons subject to remuneration disclosure and the format of the disclosure.

Scope
New section 29QB of the SIS Act inserting the remuneration disclosure requirement draws on the long existing concept of "executive officer" in the SIS Act, which previously was used for limited purposes (e.g. rules in relation to disqualified persons).

The term "executive officer" is defined in section 10 of the SIS Act to mean 'executive officer, in relation to a body corporate, means a person, by whatever name called and whether or not a director of the body, who is concerned, or takes part, in the management of the body'.

However, section 300A of the Corporations Act 2001 requires disclosure of the remuneration arrangements for key management personnel. The definition of "key management personnel" (KMP) in section 9 of the Corporations Act draws on the meaning given to that term in the Accounting Standards. Australian Accounting Standard AASB 124 defines "key management personnel" as 'persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.'

The concept of executive officer under SIS is broader than the key management personnel in the accounting standards and in our view the two concepts should be aligned.

Recommendation: The definition of "executive officer" should be reconsidered to avoid persons not in a position of requisite authority being required to publicly disclose their remuneration.

Format
The regulation underlying section 29QB of the SIS Act (ie SIS Reg 2.37) specifies a far more detailed approach to executive remuneration disclosure to that which is applicable to listed companies under the Corporations Act.

Recommendation: The two regimes under the SIS Act and the Corporations Act should be aligned in this regard with a view to achieving simplicity.

3. Disclosure Legislation

There has been a huge growth in the level of disclosure required covering Product Disclosure Statements, periodic statements, Significant Event Notices as well as websites.

There is an overarching requirement for disclosure to be clear, concise and effective. However the legislation specifying the disclosure requirements is not clear, not concise and not effective.

Staff and advisers of each APRA regulated superannuation fund spend hundreds of hours each year trying to find and understand the current requirements which consist of:

- Requirements in the Corporations Act, many of which are overridden or modified by the Corporations Regulations, Schedules to the Regulations or ASIC Class Orders
- Requirements in the Corporations Regulations which may have been overridden by Schedules to the Regulations or modified by ASIC Class Orders
- Requirements in the SIS Act which may be modified by ASIC Class Orders
- Requirements in the SIS Regulations which may be modified by ASIC Class Orders
- Requirements in APRA Prudential Standards
- Requirements in Family Law legislation

Recommendation: Superannuation funds would be able to significantly reduce costs if the disclosure requirements were:

- ***Extracted from the general disclosure requirements applicable to other financial products***
- ***Modified by treating exit statements differently to other periodic statements with non-relevant requirements being removed (removing the need for some Class Orders)***
- ***More clearly worded (removing the need for some Class Orders)***
- ***Set out in a single place (for example, requirements for periodic statements should be included in one place rather than being spread throughout multiple Acts, Regulations and other material)***
- ***Developed taking into account the long lead time necessary to modify disclosure systems***

4. Amount of disclosure

The industry is currently in a state of disclosure overload. Mercer is a keen supporter of disclosure, and also supports consistent disclosure across the industry, however the effectiveness of the current disclosure requirements has been reduced due to the volume and format of disclosure required.

Effective disclosure is also important to fund members. A recent study showed 90% of members considered it important or very important that their superfund provides communications that are easy to understand and use [June 2013 Mercer Super Trust Member Experience Study].

Another study found 46% of members taking a literacy test on superannuation correctly answered 4 or less out of 10. This suggests working Australians need help in understanding issues related to their superannuation [Mercer Super Sentiment Index, February 2013].

It is therefore important the mandated requirements result in material which is not only easy to understand and use but also does not include unnecessary information which will dissuade readers from reading the material.

Product Disclosure Statements (PDSs)

When PDS requirements were first introduced, it was necessary to include “everything a member needs to know”. Lawyers tended to take a conservative approach which led to PDSs of extreme length, often over 100 pages. The position was not helped by ASIC who considered these lengthy PDSs still did not include everything a member needed to know. Long PDSs became even longer. The red tape requirements resulted in high cost and little value.

Most members found their PDS unreadable. New requirements to produce short “8 page” PDSs were implemented to solve this problem. In general, this has been a step forward, however in many cases, 8 pages was insufficient to include even key information, particularly taking into account the amount of mandated wording which must be incorporated with some paragraphs being repeated several times. Prospective members and members now have to find the additional key material on the fund’s website. Further, the mandated wording is often not relevant to particular circumstances – leading to greater confusion – and in some cases could be considered misleading.

Recent requirements to add further information to PDSs (without adjustment to the maximum number of pages and minimum font size) are putting further pressures on licensees by making it more difficult to provide the required material in a consumer friendly manner.

Periodic statements

Periodic Statements (other than exit statements) are generally the most important communication from the fund to the member each year. Members are more likely to read this material than anything else sent to them by their fund. However red tape requirements are discouraging members from reading these statements. The length of periodic statements has steadily increased as more and more requirements are added, generally providing little value but increasing costs and reducing the likelihood the statement will be read at all. Requirements to include generic information such as 5 and 10 year investment returns, details of the proposed transfer of Accrued Default Amounts and Product Dashboards on periodic statements are inappropriate. For exit statements they are totally unnecessary whilst for ongoing members, inclusion in the fund's annual report would be more appropriate.

On the other hand, the provision of appropriately designed benefit projections on periodic statements would represent a significant step forward in concentrating members' minds on planning for retirement. However, for effective communication, RSE Licensees need to be given more freedom to provide projections in user friendly form. As a minimum, ASIC Class Orders relating to projections would need to allow greater flexibility.

Product Dashboards

We have commented further in our response to Part 3 on some of the inadequacies with the current MySuper Product Dashboard requirements.

Website Disclosure

Our response to Part 3, whilst supporting disclosure of some asset details, highlights the need to limit the disclosure and not go to the extreme lengths suggested in the discussion paper issued in 2013.

Disclosure represents a very significant proportion of the costs of running a superannuation fund. Communication to members should assist them to better understand their superannuation and to encourage engagement. However, we believe some of the current legislative requirements make it more difficult to achieve these aims.

Recommendation: Current disclosure requirements should be reviewed to enable funds to more effectively communicate to members. This should include detailed consumer testing.

5. Uniform Electronic Disclosure and Transaction Provisions

The Electronic Transactions Act (ETA) was enacted in 1999 with the intent of facilitating Electronic Commerce following the introduction and the fast take up of the internet. Although the ETA permits all forms of electronic transactions and communications, the effectiveness of this legislation is undermined by the ability to, by regulation, exempt other legislation from the operation of the enabling provisions of the ETA.

In particular Items 28 and 29 in Schedule 1 to the Electronic Transactions Regulations exempt the Corporations Act and regulations, while items 142 and 143 exempt most provisions of the SIS Act and regulations from the operation of the Electronic Transactions Act. By contrast, there is no exemption in respect of the Superannuation Guarantee Act.

Both the Corporations Act and the SIS Act have an ad hoc approach to facilitating electronic transactions and disclosure which has not been updated to reflect developments in technology and allow the industry to take advantage of the numerous efficiency and productivity benefits to be gained from adopting the technology.

Recommendation: The exemptions from the Corporations Act and the SIS Act (and their respective underlying regulations) in items 28, 29, 142 and 143 in Schedule 1 of the Electronic Transactions Regulations should be removed and the appropriateness of the remaining exemptions in Schedule 1 be revisited generally.

6. Division 293 tax and application to defined benefit arrangements

Despite Division 293 tax effectively applying from 1 July 2012, significant gaps in the legislation remain.

Notional contributions for defined benefit members

Regulations specifying how notional contributions are to be determined for defined benefit members need to be finalised. Draft regulations issued in 2013 were widely condemned by the industry as being inappropriate. The draft regulations would require defined benefit funds to obtain actuarial advice to determine notional contribution rates using a similar approach to that used for the superannuation surcharge. These calculation requirements, as well as system requirements to implement them, were extraordinarily unwieldy and costly when the superannuation surcharge was in operation. The industry argued strongly and successfully for a simpler method to be used in relation to determining notional concessional contributions when excess concessional contribution tax was introduced.

It was therefore a significant concern when the draft regulations resurrected a surcharge type method. We also note the draft regulations were extremely ambiguous which meant there would have been a need for many months of consultation between the ATO and actuaries before a consensus on their meaning could be established.

The use of the surcharge method would also result in long delays in the reporting of notional contributions for the 2012/13 year bearing in mind the need for considerable clarification and the complex calculations and systems programming which would be required.

It is also likely such an approach would result in considerable confusion for members with different notional contributions being used for Division 293 tax purposes from the notional concessional contributions used for excess contributions tax purposes.

Recommendation: Notional taxed contributions (as used for concessional contributions limits) should be specified as the notional defined benefit contributions for Division 293 tax.

Payment of deferred tax

Members of defined benefit funds are able to defer any Division 293 tax relating to their defined benefit component until their benefit becomes payable. This is a necessary feature of the tax as it avoids the payment of tax from an active defined benefit interest.

However, the deferral system falls down at the time the payment of tax is triggered. At that point the tax can only be paid from the defined benefit fund in which the benefit accrued or from non-superannuation sources. Hence if the member has already transferred their benefit to another fund, the member cannot use their superannuation assets to pay the tax. This may not be a significant concern where the member has satisfied a retirement condition of release as the tax can be paid by withdrawing money from any superannuation account. However it can potentially create significant financial hardship in cases where the member's superannuation cannot be accessed to pay the tax. Although such problems can be avoided by remaining in the defined benefit fund until the tax is paid, this will require funds to establish systems to warn members against rolling over their benefit whilst at the same time having to comply with portability requirements to rollover the benefit within three days. If a benefit is rolled over, further costs may be incurred dealing with complaints from the member.

We also note, in some cases, the fund rules may not allow the member to remain in the fund after ceasing to be a defined benefit member.

The rules relating to deferred tax appear to have been designed from a public sector superannuation fund perspective without properly taking into account the highly variable private sector defined benefit arrangements.

Recommendation: The legislation should be amended to enable release authorities in relation to deferred Division 293 tax to be provided to any fund in which the member holds a superannuation interest.

7. Deductions for personal contributions and TR

ATO Tax Ruling TR 2010/1 sets out, among other things, the approach to determine whether a superannuation provider still holds a contribution for the purpose of determining the maximum amount which an eligible member can claim as a tax deduction in a particular year. This method is generally only of relevance where the member has made a partial withdrawal since the contribution was made.

Although the legislation could have been interpreted in a number of ways, the method chosen by the ATO was likely the most complex method of the various options available. This resulted in significant costs to funds in changing systems and processes – costs which would have been avoided if a more appropriate method had been adopted.

Even where systems have been updated, funds continue to incur costs in staff training, maintaining systems and explaining outcomes to members.

Recommendation:

- ***The ATO should be required to take into account the likely costs on the industry of any proposed methodology before issuing Tax Rulings and similar***
- ***The relevant parts of 2010/1 should be withdrawn and replaced with a First In First Out type methodology – an approach which will be far easier to explain and calculate.***

8. APRA Statistics

The amount of statistical information which must be provided to APRA on either a quarterly or annual basis has been expanded significantly. Each item reported involves a cost to fund members. The need for all of the voluminous statistical requirements is questionable and the value of the resultant information to APRA and the industry is likely to be significantly less than the cost of producing it.

Recommendation: A cost benefit analysis of the APRA statistics should be performed with the aim of significantly reducing reporting requirements. Greater emphasis should be placed on the value and cost to fund members rather than the value which might be obtained by non-members from results published by APRA.

9. Tax on death benefits

Following the Simpler Super changes in 2007, the tax on superannuation benefits was simplified significantly with a major exception being the tax on death benefits. Although no tax applies if the benefit is paid to a death benefit dependant, significant tax can apply if the benefit is paid to a non-death benefit dependant (generally adult children). This can lead to the following:

- Considerable additional pressure and concern for a member close to death as they may be forced to consider whether they withdraw their super tax free (under a terminal medical condition or retirement condition of release) where no tax will be payable or take no action and have their death benefit beneficiaries significantly impacted by tax
- Opportunities to minimise the tax using withdrawal and re-contribution strategies, with the associated advice and transaction costs, with the result that the tax is paid by the uninformed or unprepared, often being those at the lower end of the income scale.

Tax on death benefits is further complicated by complex and poorly designed anti-detriment provisions.

Recommendation: Tax on death benefits should be removed with the cost being at least partly offset by the removal of the anti-detriment provisions.

10. Defined benefit issues

APRA Superannuation Prudential Standard SPS 160 now sets out the requirements for the actuarial control of defined benefit arrangements for APRA regulated funds. These replaced and expanded the former requirements in Part 9 of the SIS Regulations which have effectively been withdrawn for APRA regulated funds. However, in addition to SPS 160, Part 9 of the Regulations imposes requirements for Funding and Solvency Certificates and additional requirements for funds which are technically insolvent. These requirements overlay a different system of actuarial control on top of the SPS 160 controls, adding further red tape, unnecessary costs and confusion.

The employer contributions necessary under the Funding and Solvency Certificate requirements would be lower or the same as the contributions which would be determined under the SPS 160 provisions. This, together with the regular monitoring requirements under SPS 160, would appear to make the Funding and Solvency Certificate requirements redundant.

Recommendation: Part 9 of the SIS Regulations should be modified by deleting the existing requirements for Funding and Solvency Certificates and additional requirements for funds which are technically insolvent. Consideration could be given to replacing them with requirements which are more consistent with SPS 160.

11. Tax Agent Services legislation

Prior to the passage of the Tax Agent Services Legislation, Treasury indicated it would not be necessary for actuaries to become Tax Agents in order to prepare various actuarial certificates under the Income Tax Assessment Act. However it appears the Tax Agents Board may have a different view. Where the legislation requires actuaries to perform a particular actuarial function, even if it has a connection to tax, we consider it inappropriate if the actuary also has to be a Tax Agent.

Recommendation: The Government should clarify that certain actuarial services are not subject to the Tax Agents Services legislation.

Part 2: Better Governance

Equal representation has been an important evolutionary step in improving governance of super funds. However, in an age where:

- superannuation funds have become large financial institutions;
- most are now open to the public; and
- equal representation is not mandatory for all fund types

we consider it is no longer appropriate for equal representation to be mandated by legislation.

It is also difficult to argue that superannuation funds should be held to a different standard of governance to those applicable to Australian listed companies, Approved Deposit Institutions, Life Insurers and General Insurers. They all have requirements for a majority of independent directors on the board.

Therefore we believe it is inevitable superannuation will be held to the same standard as other APRA regulated entities in the banking and insurance sectors. We note APRA Prudential Standards in these areas require at least 50% independent trustees.

The presence of suitably qualified independent directors on superannuation trustee boards will ultimately strengthen our superannuation system, and a consistent approach to director representation across all segments and entities will provide a simplified structure for effective governance of the superannuation industry.

We recognise the need for a transition period for all regulated entities to meet the same standard. Some meet this requirement today. Others will require substantial reform of the board composition to meet this long term standard. As such for the transition period, we recommend a principles-based board composition and effectiveness program be adopted and enforced via APRA prudential standards.

The key aim for any large financial institution should be to ensure the most appropriate people sit on the boards. A board should preferably include a number of individuals, each bringing different skills which will complement those of the other board members. These differences will create a stronger board overall. The inclusion of independent trustees is likely to assist in this aim.

The obligations on trustees imposed by general law, the SIS legislation and APRA's prudential standards clearly indicate trustees and individuals on trustee boards must act in the best interest of members. This is the case, irrespective of how and by whom they have been appointed. Irrespective of the type of trustee director, they must all act in the best interests of the members and hence it should make no difference whether they are member appointed, employer appointed or, for that matter, independent.

The current equal representation requirements impose barriers to achieving an optimal board membership for many funds. In some cases, it may sometimes be difficult to find people who are willing to become board members as either employee or employer representatives. Those that are prepared to join the board may be willing and well-intentioned but may lack the skills required by a trustee or trustee board member in today's environment. Achieving an ongoing equal mix has also created practical difficulties, particularly where one or more trustees have been unable to continue in their role or where it has proved difficult to find volunteers.

The existing rules also create difficulties where trustee boards or employer sponsors want to have independent trustees to improve their governance. In some cases, employer sponsors (or union sponsors) have had to use some, or all, of their 50% quota to appoint board members who would otherwise have been considered independent. This is not an ideal work-around.

We consider it is appropriate for the Government to consider whether there are better approaches to board composition. However any new system should provide the freedom, subject to proper monitoring, for funds to achieve an optimal level of expertise on their trustee boards. In our view the appropriate mechanism would be a principles-based board composition and effectiveness program enforced by APRA prudential standards.

Before commenting further, we provide some details of the appointment processes in relation to three sectors of the superannuation industry.

Corporate funds

When equal representation was introduced, there were over 10,000 corporate funds, the vast majority of which were effectively operated by a trustee appointed by the sponsoring employer. Equal representation was initially feared by many employers who were concerned with the loss of control of "their" superannuation fund. However such fears proved to be almost entirely unfounded with employee/member representatives adopting an appropriate "trustee hat" rather than an "employee hat" when making trustee decisions.

Since then, the number of corporate funds has shrunk rapidly, and there are now only about 100 such funds. The biggest problems with equal representation in this sector are now:

- the practical problems associated with achieving 50/50 representation and the costs of running elections for member representatives (generally member representatives in this sector are elected rather than being appointed by a union)
- difficulties in finding appropriately skilled volunteers from both the employee and employer groups.

Although many funds have highly skilled and competent trustee directors, overall, the addition of independent trustees with relevant skills is likely to lead to better governance outcomes in the longer term.

The downside is the additional remuneration costs for independent directors, noting most current trustee directors of corporate funds provide their services voluntarily. In reality, this could be seen as a subsidy by the employer as time spent on trustee duties is normally performed during business hours with employers commonly supporting employer and employee representatives to perform their trustee duties as part of their normal working week. However trustee remuneration will become a more obvious cost to the superannuation fund following the appointment of independent directors. This may place more pressure on such funds to merge with a larger retail master trust or industry fund.

Industry funds

The introduction of equal representation broadly coincided with the birth of industry funds. We believe it has served these funds well. Initially, it alleviated potential concerns the funds were being run by the trade union movement. Subsequently, the performance of trustee boards of industry funds has raised few concerns. Where questions have been asked, it is generally, as it is within other sectors, in relation to the overall competence of the trustee board rather than the method of appointment.

As with other types of funds, the appointment process should be irrelevant. All board members are required to act in the best interest of members. Thus, even though many members may not be a member of the union who appointed some of the board members or the employer may not be a member of the relevant employer body, the appointed board members need to act for all members.

However, the addition of independent trustees should, overall, improve governance standards. We note many industry funds already have independent trustee directors.

Retail funds

Retail funds are generally not subject to the equal representation requirements. Generally, trustee boards have been appointed by the financial institution running the product and usually consisted of senior executives of the institution. Public confidence in their superannuation products has been maintained due to the high regard in which these institutions have generally been held. In recent years, there has been an increase in the number of independent board members who have been appointed, on a voluntary basis, to the boards running the institution’s superannuation products.

Members of the Financial Services Council (FSC) will, from 1 July 2014, be subject to a mandatory FSC standard requiring a **majority** of independent board members (with an independent chair) in relation to these superannuation products.

Despite not being subject to the equal representation requirements in relation to the trustee board, retail funds are generally required to establish policy committees for groups of members relating to particular employers. The constitution of each policy committee is subject to equal representation requirements. Such committees only have advisory powers and can, as many of them have done, vote themselves out of existence.

As such committees cannot make decisions for the trustee; any requirement for independent membership is likely to have the following consequences:

- increased costs (remuneration for independent members)
- no additional value
- an increased likelihood policy committees will cease to operate as existing committees will quickly realise the additional red tape and higher costs (which will flow through to their members as higher fees) cannot be justified

Hence any requirement for independent members of policy committees will be counterproductive and should not be adopted. In fact it would be preferable for the equal representation requirements to be removed, noting such committees have advisory powers only and the trustee would be aware of any employee/employer bias within the policy committee and could take this into account in its decision making.

What should 'independent' mean for superannuation fund trustees and directors?

2. What is the most appropriate definition of independence for directors in the context of superannuation boards?

Careful consideration needs to be given to the definition of "independent". Unless considerable care is taken, it will become very difficult for some funds to find an appropriate person with the desired skills to act as an independent board trustee member.

"Independent" implies the person is not a member of the fund. However it would generally be considered preferable for a trustee board member to be a member of the fund as, intuitively, they might adopt a higher standard of care if their own money was at risk.

"Independent" also implies the person is not employed by an employer sponsor of the fund and is not a director of the employer sponsor. For funds with a large number of employer sponsors, this could significantly reduce the number of persons who might satisfy the term independent. If the definition is extended to those who have worked for a sponsoring employer in the last x years, the problem would become even more serious. If the independent director changes employment, they may lose their independent status if their new employer is a sponsoring employer of the fund.

In relation to retail funds, "independent" implies the person has no employment (or directorship) connection with the financial institution providing the fund at the present time or in the previous x years.

Any definition of independent for this purpose should, as far as possible, be consistent with other definitions relevant to corporations. (Inconsistencies generally lead to greater complexity and red tape.)

In particular the definition of "external director" in Section 601JA(2) of the Corporations Act should be used as a base. Modifications would be necessary to exclude officials of any organisation (such as a Union, employer body or employer) who appoint the directors of the trustee board.

Consideration should also be given to whether there should be greater alignment with other definitions, for example the definition of non-executive director in Superannuation Prudential Standard SPS 510.

We also suggest a principle which encourages trustee board members to be a member of the fund. This would be assisted by legislation clarifying fund members do not have a conflict of interest merely in relation to them being a member of the fund.

Proportion and role of independent directors

3. What is an appropriate proportion of independent directors for superannuation boards?

As indicated earlier, the banking and insurance industries are subject to a minimum of 50% independent directors. This is also consistent with the ASX guidelines for corporations. It is difficult to argue that superannuation funds should be held to a different standard of governance in the longer term. However we recognise the need for a transition period and flexibility which can be achieved through a principles-based board composition and effectiveness program enforced by APRA prudential standards.

We do not believe rules mandating board composition should be enshrined in legislation as this would increase red tape, potentially resulting in

- higher costs in relation to the remuneration of independent board members
- the loss of some experienced and skilled board members and limited flexibility to appoint the most appropriate set of board members with a wide range of skills
- a continuation of difficulties in attracting and, in some cases, electing appropriate employee and employer representation

4. Both the ASX Principles for listed companies and APRA's requirements for banking and insurance entities either suggest or require an independent chair. Should superannuation trustee boards have independent chairs?

Where possible, we consider the chair should be independent. However, during a transition period, there should be a principle of the desirability of independent chairs rather than mandating independent chairs.

Process for appointing directors on superannuation trustee boards

5. Given the way that directors are currently appointed varies across funds, does it matter how independent directors are appointed?

Superannuation Prudential Standard SPS 510 states (paragraph 11):

> "The Board must ensure that the directors and the senior management of the RSE licensee, collectively, have the full range of skills needed for the effective and prudent operation of the RSE licensee's business operations, and that each director has skills that allow them to make an effective contribution to Board deliberations and processes. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the RSE licensee's business operations, including its legal and prudential obligations, and to ensure that the RSE licensee's business operations are managed in an appropriate way taking into account these risks. This does not preclude the Board from supplementing its skills and knowledge by engaging external consultants and experts."

In other words, the board must currently be involved in the appointment process. This is appropriate as it is the board itself which best understands its current skill set. We believe the board should continue to be involved in the process of appointing board members. This does not mean the board must appoint the members directly but rather they ensure through negotiation with the group or groups who appoint the board that the relevant skill set is achieved.

Bearing in mind the wide range of existing processes for electing board members, we recommend each fund be able to determine how independent directors are to be appointed. This could include maintaining the existing appointment process which will avoid considerable expense which may be incurred if appointment processes had to be changed. This flexibility will allow boards and fund sponsors the ability to determine the most appropriate appointment system for the particular fund. However we recommend the process for selecting trustee board members should be clearly disclosed to members.

6 Should the process adopted for appointing independent directors be aligned for all board appointments?

Again we consider the legislation should not mandate who can appoint board members. This should be determined by the board and, as relevant, the sponsoring employer, union or financial organisation.

We note this is consistent with Superannuation Prudential Standard SPS 510 (see above).

The appointment process we have proposed would need to be backed up by the above provisions of SPS 510 and other protections to ensure the effectiveness of the board and mechanisms by which the board can be made more effective and, in extreme cases, replaced.

We consider these protections include the following:

- The ability for APRA to remove a board or individual board members and to appoint a replacement board/board member where APRA considers the Board is not operating effectively
- A requirement for each board to develop a skills matrix in which it sets out the skills it believes are necessary for the board as a collective (this may include financial and investment skills, a knowledge of superannuation and relevant tax legislation but could also include more general skills such as an affinity with the members – for example it may be appropriate for a matrix to include a mix of gender and age requirements and/or a geographical spread of board members or mixture of employer/employee/pensioner/union representatives). The matrix should reflect the fund's particular circumstances
- A requirement for the board to liaise with those responsible for appointing board members to ensure the appointed members result, as far as possible, in a board which comprises the skills set out in the fund's skills matrix as well as meeting any requirements for independent directors
- Regular independent board effectiveness reviews (see response to question 9)
- Requirements to disclose whether each board member is independent and, if not, any relationship with an employer/employer organisation, union/employee association or fund promoter
- Requirements to disclose the appointment process
- Amending member disclosure requirements so trustee board directors disclose whether they are a member of the fund

The above approach has significant advantages over other appointment processes including:

- Decisions will be made based on the board's needs
- More likely to enable a board to have a wide ranging skill set
- Avoids the need to change current appointment rules but allows flexibility for individual funds to choose an appointment process which suits their particular circumstances
- Avoids the need for costly elections in which members are unlikely to have sufficient knowledge of the candidates to make an informed vote (although elections could still be held where appropriate)
- Minimises the opportunity to stack a board through an election process (we expect only a small percentage of members would vote in an election, potentially enabling a group to gain seats on the board by gaining a high percentage of votes cast but with support from only a small number of members)
- Through disclosure, provides information to enable members to change funds if they are dissatisfied with the board's processes

Management of conflicts of interest

7. Are there any other measures that would strengthen the conflict of interest regime?

Governance requirements have recently been expanded with new prudential standards being issued by APRA. We expect these requirements will be sufficient. In any case, it is too early to review these new requirements. The Governance standards should be revisited in two or three years once practical experience has been obtained.

However, consideration could be given to mandatory training of board members in relation to conflicts of interest in relation to superannuation within their first two years of office.

Ongoing effectiveness of superannuation trustee boards

8. In relation to board renewal, should there be maximum appointment terms for directors? If so, what length of term is appropriate?

We do not consider there should be further red tape which mandates a maximum term for directors. It is more important for each board to consider its own circumstances. Imposing a maximum term could result in the loss of highly skilled and experienced directors with no guarantee their replacements will be able to match the skills and experience lost. In the case of corporate funds, in particular, difficulties in finding the required number of suitable member representatives will increase.

On the other hand, we accept there may be cases where turnover of board members could produce benefits. However we consider it better to address this through board effectiveness reviews (refer to our comments on Q9.) rather than a mandated process.

9. Should directors on boards be subject to regular appraisals of their performance? Implementation issues

We believe it is inappropriate for any individual board member to be subject to regular performance appraisals as all board decisions are made as a collective. However it is important for the board, as a whole, to be regularly assessed and for individual directors to be part of the process.

We see this being achieved through an independent board effectiveness review. Such a review should be conducted at least every two or three years by an independent person and could involve the reviewer:

- Attending at least one board meeting
- Holding individual discussions with each board member, past board members (where considered relevant), the secretary to the board and the most senior fund executive(s) who is/are not on the board
- Providing a written report which includes specific recommendations (if any are required) as well as any other suggestions which the Board should consider. (These recommendations/suggestions could include consideration of board renewal strategies)

The effectiveness review should concentrate on whether the reviewer considers the board is acting effectively and appropriately and whether it could be strengthened by changes to its membership or changes in how trustee directors are appointed.

Board effectiveness could also be improved by establishing a best practice principle that the board set expectations for each of the board members taking into account the fund's strategy, policies, objectives and skills set. These expectations are likely to vary depending on the skill set of each board member.

10. Would legislation, an APRA prudential standard, industry self-regulation or a combination be most suitable for implementing changes to governance? What would the regulatory cost and compliance impacts of each option be?

Clearly changes to existing legislation would be required to replace/remove existing requirements.

Under our recommended approach, existing appointment processes could continue subject to the additional requirements relating to independent trustee directors and best practice principles suggested above enforced through APRA prudential standards. This will minimise costs for funds which would otherwise be required to amend their appointment processes.

The costs to funds are unlikely to vary significantly if the amendments are imposed by prudential standard or legislative change. In either case, the following issues would need to be considered:

- Analysis and amendments to the board's constitution) and possibly trust deed – (estimate of $20,000 or more if change is mandated – not our recommendation)
- Advising members – costs would be minimised by providing the advice in the fund's annual report (this would require a sufficient transition period and ASIC not considering this is a significant event which requires earlier notice) – perhaps $3,000 if advised in the annual report or up to hundreds of thousands or millions of dollars if a separate mail out is required (printing and postage costs)
- Potential increase in remuneration costs for trustee board members – costs will vary depending on the approach chosen, type of fund and current board structure and remuneration but could range up to $200,000 a year
- Effectiveness review – likely to cost, on average, around $20,000 per annum

11. What is the appropriate timeframe to implement the Government's governance policy under each option?

Refer to our response to Question 12.

12. Given that there will be existing directors appointed under a variety of terms and conditions, what type of transitional rules are required?

Questions 11 and 12 are closely related so we have answered them together.

The requirements should be introduced through APRA prudential standards rather than legislation (for consistency with the banking and insurance industries).

The implementation time frame and need for transitional provisions will depend on the type of fund and its existing rules. We recognise the need for a transition period for all regulated entities to meet the same standard. Some meet this standard today. Others will require substantial reform of the board composition to meet this long term standard. As such, for the transition period, we recommend a principles-based board composition and effectiveness program be adopted and enforced through APRA prudential standards.

Part 3: Enhanced transparency—choice product dashboard and portfolio holdings disclosure

Part 3A. Choice product dashboard

13. Should a choice product dashboard present the same information, in the same format, as a MySuper product dashboard? In answering this question you may wish to consider, if the choice product dashboard is to present different information, what should it include and why?

Before answering this question, consideration should first be given to the requirements in relation to MySuper dashboards.

In our view, the MySuper dashboard requirements:

- are inappropriate in their current format
- are more likely to confuse members than assist them due to the inherent inconsistencies with other disclosure requirements and policies. For example
  - Net returns must be shown net of administration fees, investment management fees and tax. However, for periodic statements, 5 and 10 year return histories must be shown net of investment management fees and tax – not administration fees whilst the yearly return must generally be shown as the movement in unit prices (which can be inconsistent with the required method of calculation of net returns for longer periods in periodic statements and the method which must be used for product dashboards). In addition long- standing industry practice for investment returns shown in a range of published return surveys is to show returns net of investment fees. Administration fees vary from fund to fund depending on the range of member services provided which vary significantly from fund to fund. We do not think it is appropriate to deduct these administration fees when showing returns which are designed to be compared with those of other funds.
  - Fees taken into account in the dashboard appear to be based on the best estimate of fees for the year however the fee table in the PDS must include the maximum fee which might be payable
  - The requirement to show long term return **targets** in excess of CPI is potentially confusing for members of funds with investment policy statements and product disclosure statement investment **objectives** aiming to outperform AWE or AWOTE. In addition funds' investment statements and product disclosure statements generally have investment objectives covering different periods than the 10 years prescribed, and for choice options within a fund different periods will generally apply depending on the type of investment option. For example cash options are generally designed for members with short term investment objectives. The different periods can result in different targets and the result is likely to be member confusion.

  - The use of the word return target is also confusing as the target is not an objective but rather is supposed to be the best estimate of the return over 10 year period, whereas an investment objective is the return the licensee expects its investment managers to produce and a measure on which they will be judged. In practice ,many funds have investment objectives which are not based on a best estimate but based on some other principle
  - Net returns are based on the fees applicable to a member with an account of $50,000. The net returns disclosed will rarely be relevant to accounts of other sizes.

- may mislead members
  - Returns are required to be shown net of investment fees and all administration fees. This gives misleading measures of investment performance given some funds have higher administration fees than others because of additional services provided to fund members
  - For corporate master trusts, the allowance for fees does not reflect any discount in the fees actually payable by members of large employee groups, which can be significant – the regulations require a higher and effectively irrelevant and misleading fee to be disclosed
  - The regulations not only mandate the disclosure of an irrelevant and misleading fee, but the problem is compounded by requiring the net returns to also be net of the incorrect fees. This can further mislead members by implying actual investment returns are lower than other funds when it is actually the administration fee (which may not be charged for members with corporate discounts) which results in the lower apparent return
  - Rolling ten year returns can also be misleading as they reflect fee levels in previous years. Where the former default option has been rebadged as a MySuper but with lower fees), the historical returns may not be a fair indication of performance
  - The dashboard has a single measure of investment risk which completely ignores some other features of investment risk. We believe the current design of the dashboard will lead members to invest too conservatively. If a single measure of risk is to be required, it would be preferable to be based around the risk of producing unacceptable retirement outcomes.

- have been inconsistently applied by funds with different RSE licensees interpreting the requirement in different ways. (The difficulties with MySuper dashboards have not been helped by confusing drafting and unclear advice from the Regulators. The draft legislation and Regulator advice have changed over time. At one stage, ASICs sample dashboard was incorrect as it showed only 9 years of return history rather than 10. The inconsistency in application, together with the requirements to mislead members (refer comments above) means dashboards should not be used to compare funds.

We also note many dashboards are unable to provide investment performance details as the MySuper product has adopted a new investment strategy. (For example, many licensees have taken the opportunity to introduce a lifecycle investment approach at the same time as introducing their MySuper product.) Although it is acknowledged investment performance should be considered over longer rather than shorter periods, the inability to show investment performance for funds with new and innovative investment options has reduced the value of MySuper dashboards.

In addition, requirements to show product dashboards in periodic statements appear to be disclosure overkill. Periodic statements are already of excessive length due to already onerous legislative requirements, which discourages members from reading them. The addition of dashboards will increase the length making periodic statements even more unreadable.

The requirement to include dashboards in exit statements has no logic at all as the member has already left the fund and the dashboard no longer has any relevance (if it ever did). It is unnecessary red tape which adds no value.

In other words, there are already many unresolved problems in relation to MySuper dashboards which should be rectified before consideration is given to dashboards for Choice products.

Even then, we believe dashboards should not be mandated for Choice products. The requirement to show product dashboards for products with a large number of investment options adds a significant compliance burden on funds, which will result in additional costs which will be passed on to members.

If dashboard requirements are to be introduced for choice products, consideration should be given to whether the consumer benefits outweigh these compliance costs. In our view, the consumer benefits are very small (see below) whereas compliance costs can be significant.

Although an appropriately designed dashboard for a MySuper product could be a useful reference point for disengaged members (assuming they look at the dashboard which is unlikely), Choice members are generally much more engaged and may seek financial advice in relation to their investment strategy. The provision of a dashboard, no matter how well designed is unlikely to provide sufficient information to satisfy the needs of these investors. In fact, we expect dashboards for Choice products may add to the confusion in relation to the following:

- Many choice members may have chosen more than one investment option. The impact of fixed dollar fees (generally applicable to the member's total account rather than each investment option) will be exaggerated by the product dashboard as the full fixed dollar fees will presumably need to be taken into account in the dashboard for each option. However, a member with five investment options will only pay one fixed dollar fee, not a separate fee for each option. It will be difficult to design the requirements in a way which will not duplicate the impact of such fees for members with more than option. This will also impact on the disclosed net returns.
- Choice members are more likely to have large account balances and hence more likely to be eligible for discounted administration fees. As the dashboard does not take such discounts into account, the results are likely to be misleading
- Different investment options may have different return targets or return targets expressed in different formats
- If they follow the model of the MySuper product dashboards the choice dashboards would contain information which differs from that in the Product Disclosure Statement for the same investment option, thus confusing members

In conclusion, we recommend choice dashboard requirements do not proceed.

Net investment return versus net return

14. Is it appropriate to use a single benchmark (CPI plus percentage return) for all choice product return targets?

No. As indicated in the discussion paper, many choice options may use a benchmark which is based on AWE or AWOTE rather than CPI. (Of course, the same can be said for many MySuper products where the licensee continues to assess the investment managers on an AWOTE type benchmark with the CPI based return target solely used for dashboard purposes.)

Nevertheless, there is a very wide range of choice products, many used for specific purposes including cash products which may have a very short term purpose. For cash, a 10 year target (irrespective of whether it is based on CPI or other index) appears inappropriate.

In any case, a CPI based target may be inappropriate for cash (where some form of Reserve Bank rate may be more appropriate).

On the other hand, allowing more flexibility is likely to increase complexity and confusion.

As there is no ideal solution, this issue adds weight to our recommendation of not proceeding with dashboard requirements for choice products.

15. Should both net investment return (investment return net of investment costs only) and net return (investment return net of all associated costs) be used to measure a product's investment return on the choice product dashboard? In considering this question, you may wish to consider:

- If including an additional measure for a product's investment return would add unnecessary complexity.

Including net investment return and net return will add further to member's confusion. If dashboards are to be of any use to disengaged members, they must be simple and straightforward. Inclusion of both returns will add further complexity to material which is already very difficult for disengaged members to understand.

We believe only one basis of returns should be shown on dashboards and that is the net investment return (i.e. net of investment costs only). This would be more consistent with the net returns which must be shown on periodic statements. As such, it will reduce confusion.

Returns net of administration and investment fees should not be shown at all. This will result in dashboards providing a fairer comparison of investment returns. The current requirements potentially mislead members where:

- There are different levels of service included in administration fees
- Discounted fees apply to members of a large employer group in a corporate master trust
- Discounted fees apply to individual members with higher account balances
- Some, or all, of the administration fee is dollar based meaning the returns are only relevant to those with a $50,000 account balance.
- Funds charging higher fees which cover higher levels of service where It is more appropriate to compare fees using a fee table

- If both net investment return and net return are used on the choice product dashboard, whether they should also be used on the MySuper product dashboard.

We recommend the MySuper dashboard requirements be amended to include net investment returns only (i.e. net of investment fees only) for the same reasons as outlined above.

- Whether it is appropriate to use a single time horizon, for example 10 years, when calculating target net return and net return for the range of possible choice products.

A single time horizon is not appropriate. The requirement to show a 10 year return is inappropriate for choice products such as cash or term deposits designed for investors with a short term time horizon.

Measuring a product's investment risk

16. Should the choice product dashboard include both a short-term (volatility) and long-term (inflation) risk measure? In considering this question, you may wish to consider:

- Is the SRM model the best measure of short-term investment risk?
- What would be the most suitable measure of long-term risk to include on the product dashboard?
- Is it possible to present a long-term risk measure in a similar format to the short-term risk measure (that is High/Medium/Low)?
- Would including an additional risk measure add unnecessary complexity to the product dashboard?

Developing an easily understood measure of risk is a difficult task. Various measures have advantages and disadvantages. For example, the MySuper dashboard has a single measure of investment risk which completely ignores some other features of investment risk. We believe the current design of the dashboard could lead members to invest too conservatively. However our concerns are unlikely to be addressed by adding another risk measure to the existing measure. Any other measure will also have its advantages and disadvantages. Adding another measure may further increase confusion.

We recommend consumer testing of the current measure together with ongoing industry discussions and consultation aimed at improving the measure. In our view, if a single measure of risk is to be required, it would be preferable to be based around the risk of producing unacceptable retirement outcomes.

Additional carve outs

17. Are additional carve outs from the choice product dashboard obligations required? If so, why are these additional carve outs required? In considering this question, you may also wish to consider identifying where the gaps in the current carve out provisions are.

In addition to the carve outs referred to in the discussion paper, we recommend the following carve-outs also apply:

- Closed investment options: These may be closed to all new monies or just closed for new members. They may have been closed due to a previous low take up rate but the trustee did not wish to disrupt existing assets invested in the option. In such cases, costs of producing the dashboard will far exceed any value generated
- Options for accumulation members which have a crediting rate which is based loosely on the return of another investment option, but with smoothing applied, or guaranteed minimum annual returns etc.

- All wrap account products (it is not clear whether the existing carve out adequately covers these)
- Any option which is solely invested in a financial product offered by an investment manager not related to the RSE licensee (even though the product may have a range of underlying assets) – such products are merely made available by the RSE licensee and although the licensee must determine the appropriateness of the product, it is the trustee/licensee of the product who should be responsible for disclosure (for example, in such cases PDSs can be issued by the provider of the product rather than the RSE licensee.)
- Cash options – these are generally used for short term purposes and hence much of the dashboard may be irrelevant.

A liquidity measure

18. Should a measure of liquidity be included on the choice and/or MySuper product dashboard? If so, what would a suitable measure be?

Potentially yes. However coming up with a single liquidity measure will be a difficult exercise which will take some time to resolve and requires significant industry consultation.

Implementation issues

19. Should the commencement date for the choice product dashboard be delayed beyond 1 July 2014? Is so, what date would be suitable for its commencement? What would be the benefits and costs to such a delay?

We do not believe product dashboards for choice products are necessary and hence the requirements should not proceed at all. If the Government does decide to proceed with product dashboard requirements, we strongly encourage the delay in their introduction to no earlier than 1 July 2016.

This is essential to enable:

- A review of the experience of the operation of MySuper product dashboards after 12 months of operation
- Any necessary refinements of MySuper dashboards to occur and subsequent experience reviewed
- Proper consumer testing to occur
- A proper review of other unnecessary requirements relating to dashboards (such as requirements to include them on periodic statements)
- Appropriate carve-outs being determined
- Appropriate amendments to legislation and finalisation of requirements to occur whilst leaving sufficient time for funds to implement such requirements.

Otherwise, the confusion and problems relating to MySuper dashboards will be repeated in the Choice environment leading to significant unnecessary costs.

The benefits of such a delay considerably outweigh the disadvantages, particularly as, in our view, dashboards for choice products will add little value for choice investors.

Part 3B. Portfolio holdings disclosure

Presentation of portfolio holdings

20. Which model of portfolio holdings disclosure would best achieve an appropriate balance between improved transparency and compliance costs? In considering this question, you may wish to consider the various options discussed above:

Prior to addressing each of the specific questions posed, it is important to note that Mercer supports disclosure of portfolio holdings to the extent that this does not impose onerous regulatory burdens on funds and/or excessive costs. The key beneficiaries of information on underlying holdings are existing and prospective members. As such, it is worth considering that these members are also the same individuals that would bear the cost of any overly onerous disclosure requirements through higher administration fees. It is also worth noting, that if information provided is very detailed, members may not be able to understand what the information means, let alone be interested in it.

- Should portfolio holdings disclosure be consistent with the current legislative requirements (that is, full look through to the final asset, including investments held by collective investment vehicles)?

No. The current legislative requirements are overly onerous. Mercer does not consider the benefits of full transparency outweigh the compliance costs associated with full look through to the final asset. Portfolio holding disclosure models should differentiate between assets held in pooled funds, and assets acquired through mandates on behalf of superannuation funds, or purchased directly by funds. Assets acquired in mandates are typically purchased by an underlying manager, with the assets later held by a custodian on behalf of superannuation funds. As such, funds readily have access to information on underlying assets through their custodian and should be able to provide this information on a timely basis. In contrast, funds often lack full look through to assets held on their behalf in pooled funds. Obtaining this information from underlying managers can be slow and require funds to commit significant time and cost to meet reporting objectives. In these circumstances, superannuation funds should report the units they hold in pooled funds.

Another complication that arises with reporting of full look through to the asset is the holding of derivative positions. Reporting of individual derivatives held may lead to reporting outcomes that are not clear or understandable to end users, particularly for over the counter (OTC) derivatives. Further, the reporting of derivatives may be of little meaning unless these are matched up with underlying holdings. For example, this may arise where a short position in ASX200 futures is used to hedge market exposure arising from shares in several Australian companies. Similarly, foreign exchange forwards used to manage currency exposure from international investments are unlikely to be of interest, or understandable to most members.

- Should the managers/responsible entities of collective investment vehicles be required to disclose their assets separately? To give effect to this requirement, legislation would require all collective investment vehicles to disclose their asset holdings, regardless of whether some of its units are held by a superannuation fund.

No. As noted above, we do not believe that superannuation funds should have to report assets held through underlying pooled funds and as such, do not support collective investment vehicles (i.e. pooled funds) being required to disclose their investment holdings. Furthermore, introducing rules where pooled funds must disclose their asset holdings regardless of whether some of its units are held by a superannuation fund may lead to unintended consequences. For example, funds unwilling to fully or publicly disclose their asset holdings may decide to not offer certain products to Australian clients, or withdraw from the Australian market altogether, limiting the breadth of products on offer. Furthermore, should this information be reported, it would be reported on a lagged basis, so the information reported would be of limited use to members and/or APRA.

- Should portfolio holdings disclosure be limited to the information required to be provided to APRA under Reporting Standard SRS 532.0 Investment Exposure Concentrations?

Yes. SRS 532.0 already requires an extensive amount of information to be disclosed by superannuation funds. Information disclosed above these requirements is unlikely to provide additional benefit to members, though will entail significant costs for these members through higher administration fees. Furthermore, having two separate, but similar reporting processes may only serve to increase a steadily growing regulatory burden on superannuation funds, particularly smaller funds.

22. Should portfolio holdings information be presented on an entity level or at a product (investment option) level?

Whether portfolio holding information should be presented on an entity level or at a product level is ultimately dependent on how onerous look through reporting requirements are. Less onerous look through reporting requirements would allow funds to have capacity to report information at the multi-asset product level. Providing information at the multi-asset product level (e.g Growth, Conservative etc.) is more likely to be of relevance to members, given the diverse range of products on offer at most funds, and the various needs and circumstances of fund members.

For example, underlying assets for a product with an 85% growth allocation are likely to be fundamentally different to that of a product with a 30% growth allocation, in much the same way as the risk profiles and age profiles are likely to be different for the members of these two respective products. Aggregating the underlying assets of these two multi-asset funds is likely to lead to a sub-optimal outcome where funds still have to expend significant time and cost reporting data, only for this to be of limited use to members and other users of the data.

Further, aggregating this data limits comparisons that may enable members or advisers to select products that are suitable for their needs. In other words, limiting the look through data to that required by SRS 532.0 will enable Superannuation funds to be able focus efforts on reporting at the actual product level, which will ensure that information is relevant to current and prospective fund members.

Nevertheless, we do not support reporting the look-through exposures of single asset class products, such as Australian shares, cash etc. For example, reporting the information for a cash or term deposit portfolio is likely to lead to a large amount of information that is of limited benefit to members being reported.

Materiality threshold

23. Is a materiality threshold an appropriate feature of portfolio holdings disclosure?

Yes. Providing information on small holdings is likely to be of limited use to end users and come at a significant cost to superannuation funds.

24. What is the impact of a materiality threshold on systemic transparency in superannuation fund asset allocation?

Portfolio holding disclosure requirements should focus on what benefits would accrue to superannuation fund members. While systemic transparency is important from the perspective of estimating how exposed the superannuation industry to a particular risk or range of risks at an aggregate level, more appropriate methods exist to improve information in this area. In particular, APRA can use the information gained through its ongoing prudential supervision and periodic reviews of superannuation funds to improve systemic transparency and subsequently understand how exposed the industry is to particular risks.

Subsequently, while we acknowledge that superannuation fund members may be exposed to systemic risks, portfolio holding reporting should focus on providing information that is both relevant to members, and is something that they are able to act on. As such, we believe it is important for reports to provide information to members (at a low cost to superannuation funds) on asset class and geographic exposures to enable them to make informed decisions about whether their investment strategy is appropriate for their own individual circumstances.

In other words, there are more appropriate means available to improve systemic transparency, and as such the Government should be clear that the intent of portfolio disclosure requirements is to inform members of asset class, geographic and other relevant concentrations within portfolios.

Given these considerations, a materiality threshold for portfolio disclosure would assist superannuation funds to meet the objectives of providing relevant information to fund members at a reasonable cost.

25. What would be the most appropriate way to implement a materiality threshold?

A materiality threshold should be determined on a size basis, such that any assets which are more than 2% are required to be reported, with a clause that any assets held under confidentiality agreements be de-identified to provide only general information (such as asset class and country).

We note that the reporting requirements for KiwiSaver products in New Zealand may serve as an appropriate model. Funds in New Zealand are required to report the top 10 holdings in any option, with any non-associated pooled fund being treated as a single security.

Implementation issues

26. Should the commencement date for portfolio holdings disclosure be delayed beyond 1 July 2014? Is so, what date would be suitable for its commencement? What would be the benefits and costs to such a delay?

Yes. The 1 July 2014 timetable appears to be unachievable, particularly if reporting to the individual product level is required. Delaying the commencement date for portfolio holding disclosure by at least one year, would allow industry and regulators appropriate time to negotiate an appropriate level of reporting that provides useful and informative information to members without significantly increasing the burden on superannuation funds (as discussed above). As such the earliest feasible reporting date would be 1 July 2015.

Part 4: Improved competition in the default superannuation market

27. Does the existing model (which commences on 1 January 2014) meet the objectives for a fully transparent and contestable default superannuation fund system for awards, with a minimum of red tape?

No. The existing model does not satisfy these objectives. It is not transparent or contestable and appears to **maximise** the amount of red tape for employers, employees and superannuation funds. A particular concern is that many employees and other members of superannuation funds will be adversely affected financially by the new requirements.

Transparency and contestability

Standing before the FWC

As indicated in the Treasury Discussion Paper, the Productivity Commission noted, when commenting on the previous system, that “industrial parties, that is, employer and employee organisations, play a central role in determining which superannuation funds are listed in awards. This is because under workplace relations laws, they have standing to apply to the Fair Work Commission (FWC) to make changes to awards and are entitled to be heard when the FWC is considering changes to the awards. There is the potential for a conflict of interest where representatives of the employee or employer association (and often both) appearing before the FWC are also represented on the board of an industry superannuation fund.”

Although the new system provides some improvements in this area, this only occurs as part of Stage 1 of the process of determining the funds which will be listed in Modern Awards. Individual funds have standing with the Commission during Stage 1. However, there is still some doubt whether individual funds will have standing during the critical Stage 2 process where the lists of funds to appear in each Modern Award are determined.

Assessment Criteria

Transparency and contestability has been improved slightly by specifying a number of criteria which must be considered by the expert panel in determining which funds are listed at Stage 1 of the process. However we have concerns with the appropriateness of a number of these criteria, particularly in the early years. Some of our concerns are listed in Attachment 3 of this submission.

15 fund limit

Generally a maximum of 15 funds will be listed in each Modern Award (a higher number may be listed in special circumstances). This imposes a somewhat arbitrary limit on the number of funds to be listed. We expect there will be many funds which, in any proper ranking, will be of very similar standard. Thus, many funds may not be listed, not because they are more expensive, less efficient or less likely to provide appropriate investment returns, but merely because the FWC had to draw the line at 15 funds with those funds being determined on some potentially arbitrary or best guess basis – at least in relation to those funds just below or above the cut-off point. In any event, any decision by the FWC will presumably be based on an assumed general group of employees covered by each Award. It will be difficult to take into account a whole range of employers and employees with different circumstances.

Legislation does not allow proper competition

The Fair Work Act does not allow the FWC to take into account discounted fees negotiated by employer groups with a particular fund to reflect economies of scale. Those funds which offer such discounts are therefore placed at a disadvantage as the fees which may actually be applicable to a particular employer are not taken into account when determining the Stage 1 default fund list. At Stage 2 of the process, these funds may continue to be at a disadvantage as, although very cost efficient for large groups of employees, they may be less attractive to smaller employer groups.

Similarly, large employers who are using a corporate master trust as their default fund are unable to utilise the alternative arrangements available to corporate funds and Tailored MySuper products unless:

- A Tailored MySuper is established in the Master Trust (at a likely higher cost to members); or
- The employer establishes a new corporate fund (at an even higher cost), potentially reversing the trend of winding up corporate funds.

We also note, where a fund includes Tailored MySuper products in addition to the generic MySuper, if the generic MySuper is listed, there will be nothing to gain by also having the Tailored MySuper listed. However, because the FWC decision making process in relation to these corporate and Tailored MySuper funds is to be conducted at the same time as the general Stage 1 process, it will be too risky for the employer with a Tailored MySuper to wait until the Modern Award lists have been determined before deciding whether to apply under the Tailored MySuper route. In other words, red tape costs in applying will be incurred when they may not have been necessary (i.e. if the overarching master trust is listed). Similarly it will be too late to establish a new Tailored MySuper product or corporate fund if the employer's current default master trust is not listed in the relevant awards.

Significant advantage to listed funds

Not only does the new system operate as a barrier to competition, it provides a very significant advantage to those funds which appear on the Modern Award default fund lists.

Funds not on the lists will need to spend much more in marketing costs if they are to remain in business as they will need to attract members on a member by member basis. Listed funds have a significant advantage as they can limit their marketing to employers, potentially being able to attract a significant number of new members by winning one new employer client.

This is likely to perpetuate the initial lists with unlisted funds likely to fall further behind their listed competitors because they were not successful in being listed in the first place. In other words, the process will be a self-fulfilling prophecy with the listed funds succeeding and non-listed funds failing not because of their relative merits but due to the significant advantages in being listed.

The new approach will also effectively exclude new players from the market which will also reduce competition. New funds, irrespective of their quality, would be effectively excluded from the default fund market, at least until the next review of default fund lists which may be up to four years away.

Red tape for superannuation funds

a) Trustees are likely to incur considerable cost in making application as part of Stage 1 of the process of determining the default fund list
b) Trustees may incur further costs in defending against criticism by their competitors during the Stage 1 process
c) Where a fund includes Tailored MySuper products in addition to the generic MySuper, if the generic MySuper is listed there is nothing to gain by also having the Tailored MySupers listed. However, as it will be uncertain as to whether or not the generic MySuper will be listed, applications will also need to be made by the fund/employers in relation to each Tailored MySuper. Such applications may later prove to have been unnecessary where the fund is listed in the relevant Modern Award due to its generic MySuper

d) Where a fund is not listed in an Award and as a result, employers can no longer use the fund as a default:
   - The number of inactive accounts will increase. This is likely to lead to increased lost member reporting
   - The fund may expect significant withdrawals of existing balances which may require changes to investments so appropriate liquidity can be maintained
   - The fund may require tax advice in relation to deferred tax credits and whether it is likely they can be eventually utilised (if not, this could have a detrimental impact on unit prices)
   - The fund may need to consider winding up

Red tape for employers

a) Employers will need to ensure they are using a default fund set out in the relevant Modern Award. Many may need legal advice to determine which Modern Award(s) are relevant to their staff as many employers do not have this information readily available
b) Where the employer's existing default fund can no longer be used as a default fund:
   - A new default fund or funds will need to be chosen
   - Where the workforce includes employees who are covered by different Awards, it may be necessary to choose more than one default fund as a particular fund may not be listed in all relevant Awards
   - Where an employer has more than one default fund, it may be necessary to change the default fund for a particular employee when the employee's role changes and he/she becomes covered by a different Award
   - Employees will need to be given a new Choice of Fund form and completed forms processed
   - Payroll instructions will need to be amended to reflect the new default fund and new funds chosen by employees
   - Employers may need to respond to complaints from employees who are concerned about having to complete paperwork and any adverse implications on their superannuation
   - Employers will need to consider whether they should make financial advice available to employees to highlight the differences in fees, insurance cover and investment strategies, the likely additional costs associated with maintaining two accounts and the additional costs which will be incurred to merge the accounts
c) Where a corporate fund or Tailored MySuper is being used as a default fund, the employer will need to become involved in the application to the FWC for approval to use the fund as a default fund. For Tailored MySuper products, the application and associated costs will need to be made before the Modern Award default fund lists are released. It may subsequently be found to have been a wasted expense where the parent fund (of which the Tailored product forms part) is listed in the relevant Award

In any case, superannuation is not well understood by employers. We expect there will be a high level of unintentional non-compliance by small employers in particular. This will potentially lead to even more red tape following any investigation of their non-compliance.

Red tape for employees

a) Where an employer is required to change default funds, the employee will need to complete a Choice of Fund form specifying their existing fund if they are to avoid having accounts in two funds with two sets of fees and insurance costs
b) Where the Choice of Fund form is not completed in time, the employee will then need to consider merging the accounts which will generally incur a withdrawal fee
c) The employee may need financial advice to assist in determining the most appropriate on-going arrangements, including the most appropriate insurance and investment strategies
d) The employee may need to provide evidence of health to maintain the same level of insurance cover in the new fund. Insurance cover may be lost entirely (for example if the employee was not at work at the time his/her membership of the new fund commenced)
e) Where the accumulated balance remains in the original fund and a new default fund is used for future contributions, there is an increased likelihood, the original account will eventually become “lost”, potentially being transferred to the ATO. This will create further difficulties and paperwork for the employee when they eventually attempt to claim their benefit.

Adverse impact on members

It is likely the new requirements, once introduced into Modern Awards (expected in 2015) will have a significant adverse impact on many employees currently in default funds which are not specifically listed in a Modern Award but which can be used under the current grandfathering provisions. The current grandfathered fund may have lower fees and more appropriate insurance arrangements than any default fund listed in the relevant modern award.

We have included more detail on how these members will be impacted in Attachment 4.

28. If not, is the model presented by the Productivity Commission the most appropriate one for governing the selection and ongoing assessment of default superannuation funds in modern awards or should MySuper authorisation alone be sufficient?

The model recommended by the Productivity Commission is significantly better than the existing model. In particular, the Commission recommended there should be no limit on the number of funds (which offer MySuper products) listed in each Modern Award.

> Extract from Productivity Commission RECOMMENDATION 8.4
>
> ***The number of default products listed in a given modern award should be at the discretion of the Default Superannuation Panel. The decision about whether or not to list a product should be based on an assessment of a fund's application against the factors for consideration identified by the Commission, and any other factors at the panel's discretion.***
>
> ***Where decisions about whether or not to list a product are marginal, the panel should err on the side of listing it even if this creates a longer list. Given the absence of grandfathering, a longer list will reduce the need for employers to change default funds. This will help ensure that the best interests of employees are not undermined by issues of market instability and the potential negative impact of having multiple accounts (unless employees exercise choice to consolidate their existing balances).***

We also note the amendments to the Fair Work Act were made before it was clear how many funds would offer a MySuper product. Originally it was anticipated that possibly in the region of 250 funds might obtain MySuper product authorisation. In fact, as at 1 January 2014 only 116 authorisations had been given. Of these, less than 90 will be eligible to apply for Stage 1 listing with the others being either Tailored MySuper products for large employers or corporate MySuper products for which a different application process is required.

The significant reduction in the expected number of MySuper products also raises the question as to why the FWC should be involved in the process at all. With a much more manageable number of MySupers, we consider all such funds should be eligible to be used as a default fund.

29. If the Productivity Commission's model is appropriate, which organisation is best placed to assess superannuation funds using a 'quality filter'? For example, should this be done by an expert panel in the Fair Work Commission or is there another more suitable process?

As indicated in our response to Q28, the number of MySupers is much lower than expected. This significantly reduces or removes the need for a second stage quality filter (after APRA's filter as part of the MySuper approval process). In any case, if a fund has successfully satisfied APRA to provide approval to offer a MySuper following APRA's review of the proposed MySuper product it appears superfluous for second stage filter to be applied. If the MySuper product was not an appropriate product, it would not have been approved in the first place. Hence we struggle to understand how a second filter could add anything to the process as we expect virtually all MySuper products would satisfy any testing criteria.

As a second stage filter is unnecessary, we have not considered who should conduct it. No matter who conducts the filter, any second stage filter will, to a large extent, be subjective. How much confidence could there be that funds ranked 5 to 10 would be "better" in future than the funds ranked 31-40 or indeed those ranked 81-90? This assumes of course that it is possible to produce a fair, objective and accurate ranking. In practice, this is likely to be impossible. There will necessarily be subjectivity in weighing up cost versus service range, quality versus investment performance versus insurance features. At the same time, the second stage filter process is hamstrung because it cannot take into account the specific circumstances of large employers who have negotiated discounted fees with their current default fund.

30. Would a model where modern awards allow employers to choose to make contributions to any fund offering a MySuper product, but an advisory list of high quality funds is also published to assist them in their choice, improve competition in the default superannuation market while still helping employers to make a choice? In this model, the advisory list of high quality funds could be chosen by the same organisation referred to in focus question 29.

Whilst this may appear a superficially attractive compromise, we have grave doubts about its practicality and effectiveness as well as concern with the likely considerable costs it will entail.

Clearly the most appropriate model would be to allow employers to choose to make contributions for default employees to any fund offering a MySuper product. Such an approach would also increase competition by allowing new players in to the market immediately and encouraging existing funds to update their products with more effective offerings.

31. If changes are made to the selection and assessment of default superannuation funds in modern awards, how should corporate funds be treated?

Under our recommended approach of removing default fund lists from Modern Awards, the employer sponsor of a corporate fund could use the corporate fund as its default fund provided a MySuper was offered. In other words, they would be treated no differently from any other fund offering a MySuper (with the subsequent reduction in red tape). A similar outcome would apply to Tailored MySuper products.

If a second stage filter is to be maintained (either by the FWC, APRA or some other body) the approach set out in the new legislation is broadly reasonable with the fund being assessed against the general criteria but with specific reference to the sponsoring employer's relevant employees. Approval of a corporate fund or Tailored MySuper as a default fund should be applied to all Modern Awards which impact on the employer.

ATTACHMENT 3: Specified criteria in relation to Stage 1 of the Application Process

Section 156F sets out the criteria to be used by the FWC in Stage 1 of the process.

(a) the appropriateness of the MySuper product's long term investment return target and risk profile;

These terms are not defined in the Fair Work Act and the FWC will need to determine what they mean.

Long term investment return target could be the Return Target adopted for the purpose of product dashboards (refer to SRS 700.0). This is a 10 year expected return in excess of CPI.

Risk profile is a more general term. It could be defined as the Level of Investment Risk as defined for the purposes of reporting to APRA (SRS 700.0).

We consider a more appropriate criterion would be the appropriateness of the investment product itself, taking into account the fund's membership profile as the return target and risk profile are the outcome of the product's investment strategy.

Clearly a fund should not be excluded from the Stage 1 list because it has a lower return target than its competitors because of a lower risk profile. The stage 2 process will become more difficult. Any decision as to whether such a fund should be on the default fund list in any Modern Award ahead of funds with higher return targets and higher risk profiles will effectively need to be made on an arbitrary basis taking into account the individual views of those making the decision.

(b) the superannuation fund's expected ability to deliver on the MySuper product's long term investment return target, given its risk profile;

If the return target is defined as above, this requirement is almost unnecessary as the return target is effectively the best estimate of the fund's performance. In broad terms, every fund should have around a 50% probability of achieving the return target. If this is not the case, then the return target has not been determined in accordance with the requirements. (Defining the return target in other ways will lead to confusion and further expense.)

(c) the appropriateness of the fees and costs associated with the MySuper product, given:
(i) its stated long term investment return target and risk profile; and
(ii) the quality and timeliness of services provided;

It is a concern there is no specific reference to the services provided with some funds providing a greater range of services to members. In some cases the fees may appear out of line with the market and may be a reason a fund is excluded from the Stage 1 list. However, any decision on this criterion during Stage 2 is likely to be made on a somewhat arbitrary basis as it will be extremely difficult for the FWC to compare the relative value of the quality and timeliness (and services provided) against the fees charged.

In any case, the FWC cannot take into account fee discounts which many funds provide to employees of large employers to reflect economies of scale

(d) the net returns on contributions invested in the MySuper product;

This is a difficult criterion for two reasons:

(i) Some funds have adopted a new investment strategy for their MySuper product. In particular, a life cycle investment strategy may have been introduced. In such cases, there will be no history of net returns. It would be inappropriate for the FWC to discount such funds because their product does not have an investment history. Where an existing product has been rebadged as a MySuper, net investment returns for the original product should be sought as part of the application.

(ii) Net return will need to be defined. One approach would be to adopt the same approach as adopted for SRS 700.0 based on a $50,000 account for the year so that the return can be net of both fixed dollar and percentage of asset based fees. However past net returns may not be a good comparator for funds which have changed their fee basis during the comparison period or on introducing their MySuper product.

(e) whether the superannuation fund's governance practices are consistent with meeting the best interests of members of the fund, including whether there are mechanisms in place to deal with conflict of interest;

This is a strange criterion bearing in mind it is a requirement for superannuation funds to have governance policies in place which are consistent with meeting the best interests of members and to have mechanisms in place to deal with conflicts of interest. Such issues would have been verified by APRA when considering the fund's application for approval to offer a MySuper product.

It is therefore difficult to see how this criterion will be useful to the FWC in deciding the default fund lists.

(f) the appropriateness of any insurance offered in relation to the MySuper product;

Appropriateness will depend on the fund's membership profile. It is a concern some funds may not be successful in being listed in a particular Modern Award because the Full Bench has a different view of its likely membership profile to that of the trustee.

(g) the quality of advice given to a member of the superannuation fund relating to the member's existing interest in the fund and products offered by the fund;

Quality of advice is a very subjective term.

(h) the administrative efficiency of the superannuation fund;

Administrative efficiency is a very subjective term.

(i) any other matters the FWC considers relevant.

ATTACHMENT 4: Adverse impact on members

Adverse consequences

Although the intention of the changes to the Fair Work Act is to provide greater assurance that the employer's superannuation contributions for default employees are paid to an appropriate fund, changing an employer's default superannuation fund can have adverse consequences for employees.

These adverse consequences which can arise as a result of changes to Modern Awards include:

Higher fees

1. In some cases, fees in the new default fund will be higher than those in the previous fund. (This could be particularly significant in relation to employees of a large employer which may have been able to negotiate significant "large employer" fee discounts in their existing fund.)

2. Unless an employee "chooses" their existing fund, future contributions will be paid to the new fund. Past contributions are unaffected and remain in the previous fund unless action is taken to merge the accounts. The employee will potentially become a member of two superannuation funds (the new default fund in respect of future contributions and the previous default fund in respect of past contributions) and incur two sets of administration fees (until the accounts are merged).

3. Merging the accounts will generally trigger the payment of a withdrawal or exit fee in the account being closed. Unless sufficient notice is provided, some contributions may be paid to the new default fund before the employee can advise they wish to choose their existing fund. The withdrawal fee could wipe out a considerable portion of these contributions.

Insurance

4. Insurance arrangements in the new default fund are likely to be different from the previous default fund. Premium levels and levels of cover may be higher or lower. Whether the new arrangements are more, or less, appropriate for an individual member will depend on the individual's particular circumstances. However, unless the employee's accounts are merged, there may be two sets of insurance premiums providing, in some cases, unnecessary insurance cover and a reduction in the amount of contributions financing the employee's retirement. Further, members may not be eligible for insurance in the new fund (for example if they were not at work on the day of joining) and may eventually lose their insurance cover in their existing fund if the account balance is no longer sufficient to pay premiums.

Other

5. If the accounts are not merged and one becomes inactive, after five years, such accounts (up to a threshold proposed to be $6,000) may be classified as an inactive account and transferred to the ATO (incurring a withdrawal fee). Following the transfer to the ATO, the account will only earn interest at the rate of CPI, potentially significantly lower than would have been earned if it had been retained in the superannuation fund. Once transferred to the ATO, members will also lose valuable death and disability insurance.

Lack of engagement

Most employees are not engaged with their superannuation. We expect many will not make any decisions and by default, could end up in two funds paying double fees etc.

ATTACHMENT 5: Who is Mercer?

Mercer (Australia) Pty Limited is an employer of over 1300 employees and the Mercer group is one of the largest providers of superannuation products and services to many of Australia's largest, mid-sized and small business employers.

Mercer Consulting (Australia) Pty Limited and Mercer Legal Pty Limited provide consulting and legal advice to a broad range of superannuation funds and employers in relation to superannuation.

Mercer Superannuation (Australia) Pty Limited is the trustee of the Mercer Super Trust (MST) that has approximately 225,000 members and 250 participating employers with approximately $17.5 billion in funds under management.

Many of these employers have selected the MST as the default fund for the superannuation guarantee (SG) contributions for their employees. The MST has a MySuper product available to its members who have not chosen a fund to receive their SG contributions. A number of those employers participate in the MST under the existing grandfathering provision in Modern Awards.