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The Treasury

Financial Services Royal Commission

Submission

Hearings on superannuation

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INTRODUCTION

1. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Commission) held the fifth round of hearings from 6 August to 17 August 2018, which was focused on superannuation. This submission addresses policy questions posed by Counsel Assisting the Commission. Specifically, it covers five topics:

   - potential systemic or architectural changes to promote member interests;
   - structures that might raise inherent conflicts of interest for superannuation trustees in complying with fiduciary duties;
   - issues that Aboriginal and Torres Strait Islander members face in relation to their superannuation;
   - potential improvements to fund governance to encourage a culture that promotes members' best interests; and
   - the allocation of regulatory responsibilities.

2. This submission does not make policy recommendations, but rather outlines possible policy responses and their advantages and disadvantages. The Commission's future hearings and publications may present additional information and evidence that should be considered in further analysis.

3. This submission builds on Treasury's previous submissions to the Commission. *Background Paper 24: Submission on key policy issues* (Treasury's Policy Submission) covered culture and governance, the role of regulators and conflicts of interest.[1] Treasury's submission on the *Hearings on Financial Advice* provides further relevant context.[2]

1 Treasury, *Background Paper 24: Submission on key policy issues to the Commission* (2018) (*Treasury Policy Submission*).

2 Treasury, *Submission: Hearings on Financial Advice* (2018).

4. The superannuation market is unlike most markets; generally, consumers impose discipline on industry participants by choosing better products, which incentivises firms to improve performance. Several reviews, including the Financial System Inquiry (FSI) and the Productivity Commission's (PC) Superannuation Draft Report, have found that consumer-led competition in the superannuation market is weak due to a combination of compulsory superannuation contributions, generally disengaged members, complexity of the underlying decisions, and the lack of simple, relevant information to assist members.[3,4] Consequently, the PC found that there are few consequences for poor superannuation fund performance. Its findings suggest that other elements of system architecture, which would be expected to compensate for the lack of competitive pressure — the settings for allocating default products, existing product regulation and the regulation of trustee governance and conduct — do not always result in good outcomes for members.

5. Additional regulation is not the only way to strengthen the regulatory framework. Better enforcement of existing regulations and changes to system architecture are likely to be important parts of improving member outcomes. Ideally, regulation should only be imposed when it is clearly targeted at the underlying problem and where it generates the greatest net benefit of all policy options. The design of the regulatory framework needs to strike a balance between rules and flexibility, public enforcement and system stability, and innovation and compliance. It is also important to recognise that no single policy initiative alone can provide a perfect solution — a comprehensive and coherent regulatory approach is required.

6. Recent and proposed government policies (including bills currently before Parliament) seek to address a number of issues highlighted in the hearings. In addition, a large body of regulation has been imposed on the superannuation industry over recent years, which brings with it a cost to funds and members. It is important to note that these changes, which involve refining the enforcement approach and entrenching cultural shifts, can take years to be embedded into the system and have often involved negotiation and compromise in their passage through the Parliament. Treasury encourages the Commission to consider implementation issues, as well as how any recommendations would interact with existing and already proposed changes to the regulatory framework.

3 Commonwealth, *Financial System Inquiry*, Final Report (2014) *(FSI Final Report)*.

4 Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*: Draft Report (2018) *(PC Superannuation Draft Report).*

SECTION A: THE EFFECT OF SYSTEM ARCHITECTURE ON INCENTIVES TO ACT IN MEMBERS' BEST INTERESTS

7. Before examining specific regulatory measures, it is worth considering the role of the broader architecture of the superannuation system — that is, the process by which members are defaulted into products and the broader regulatory settings governing both default and choice products.

8. Ideally, the architecture would align the incentives of superannuation fund trustees with those of members. In an efficient market, competitive forces would facilitate this alignment.

9. Both the FSI and PC found a lack of member-driven competition in the superannuation system to be a major driver of poor member outcomes.[5,6] This applies to both the default segment of the market, where some members are defaulted into poor products, and the choice segment, where more 'active' members can end up in substandard products, often due to poor financial advice. For example, the PC found a large variation in the investment performance of default products, with a significant minority of products underperforming.[7] It also found just under half of all products, representing 40 per cent of assets in the choice sector, underperformed compared to benchmarks customised to those funds' asset allocations.[8] This underperformance leads to a significant reduction in superannuation savings at retirement for members of those funds.

10. The PC observed that while current default settings are aimed at addressing the problems caused by a lack of member engagement, they also contribute to these outcomes.[9] Members are not required to be engaged, as employers choose default funds on behalf of employees who do not make an active choice, and there is little competition for default status between funds. Employers are also not necessarily skilled in choosing superannuation funds. Other conduct presented in the evidence to the Commission, which is likely to be driven by the current default settings, includes inducements by trustees aimed at employers and the use of member funds to pay for political advertising.

11. We acknowledge the Counsel Assisting's focus on misconduct and the statement that default fund selection may be out of scope of the Commission.[10] However, some misconduct or poor outcomes may be dealt with more efficiently via systemic changes, rather than other tools that may impose more costs and may not change behaviour. Therefore, this section will examine options that address some of the drivers of the issues examined in the Commission, rather than options targeted at the specific cases raised.

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5 FSI Final Report, above n 3, 101–2.

6 PC Superannuation Draft Report, above n 4, 24.

7 Ibid, 13–14.

8 Estimate based on limited data of available choice products (just under half) and a limited segment by assets (13 per cent of choice segment). Ibid, 14.

9 Ibid, 456.

10 Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Module 5: Superannuation Closing Submissions*, 208 [785] (*Module 5 Closing Submissions*).

12. There is merit in examining the method by which individuals are allocated to default products to ensure that members end up in high performing funds rather than low performing ones. There are options which may reduce the underperformance of superannuation products, irrespective of whether this underperformance is driven by conflicts of interest, absence of scale, inappropriate fees, or other factors. These options include the PC's draft recommendation for the creation of a 'best in show list' or a variation on it, as well as a variant of the PC's recommendation on revoking MySuper authorisation for underperforming products.[11] Where possible, policy solutions should be directed at the root cause of issues instead of trying to regulate symptoms.

MySuper reauthorisation

13. The MySuper regime was designed to lift the standards that apply to default superannuation funds, including through imposing additional obligations on trustees around promoting the best financial interests of members. MySuper products were intended to be simple, standardised, cost-effective, suitable for disengaged default members and easily comparable. However, the PC found the original hurdle for authorisation was set too low and has proposed an elevated threshold for MySuper products.[12]

14. The Commission's hearings have highlighted improvements to the ongoing evaluation of the appropriateness and performance of MySuper products may be warranted.

15. The PC has argued a reauthorisation of trustees who are permitted to offer MySuper products against heightened criteria would help ensure members are no longer defaulted into products that would be expected to provide lower retirement incomes. The PC found that an underperforming MySuper product can lead to members having $375,000 (or 36 per cent) less savings in retirement than members in one of the top ten MySuper products (using the PC's assumptions).[13] To ensure that only adequately performing funds pass the reauthorisation process, there may be merit in assessing MySuper products using some objective criteria such as a combination of absolute net returns and returns relative to tailored benchmarks, possibly combined with subjective criteria. This one-off process could be conducted in conjunction with an ongoing outcomes test as discussed below, where the reauthorisation process would remove the tail end of underperforming products, whilst the outcomes test would place ongoing pressure on trustees around performance of their product.

16. While there are strong in-principle arguments for this option, there are also significant costs and risks. Reauthorisation is likely to be disruptive and impose regulatory costs on funds. These costs would ultimately be borne by members, including members of high performing funds that may not benefit from the process. However, this burden could be reduced by targeting the reauthorisation process at funds that fail an objective test.

17. The assessment process itself would be technically challenging, requiring a robust methodology and reliable performance data. The PC's inquiry illustrates these challenges, but also shows they are not insurmountable. The methodological work undertaken by the PC on comparing performance for its inquiry would provide the groundwork for future assessments.

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11 PC Superannuation Draft Report, above n 4, 459-467.
12 Ibid, 27.
13 Ibid, 14.

18. A reauthorisation process would likely lead to underperforming funds losing a future stream of default contributions, with adverse implications for scale and liquidity. The consequences for other members of the fund would need to be addressed. Thus, if this process was implemented, consideration should be given to how members of de-authorised funds should be assisted or protected.

19. However, this option would not improve outcomes for choice members, where the PC found there are greater issues with underperformance.

OUTCOMES TEST

20. Regulatory oversight of superannuation product quality can assist where there are barriers to consumer-led competition driving product quality. A legislated requirement for a more comprehensive assessment of products could make trustees more accountable and may enhance Australian Prudential Regulation Authority's (APRA) ability to intervene where the interests of members are not being promoted. As Counsel Assisting noted: 'One way of increasing external pressure in relation to MySuper products might be to require a putative MySuper product to meet an outcomes test in order to be authorised as, and to retain authorisation as, a MySuper product.'[14]

21. The 'outcomes test' is included in Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017 (Member Outcomes Bill), currently before Parliament.[15] This is designed to strengthen the obligation on trustees to consider the appropriateness of their MySuper product on an annual basis. Trustees would be required to assess the outcomes provided to their MySuper members against a number of criteria, and compared to outcomes provided in other equivalent MySuper products, before publicly reporting this assessment.

22. The outcomes test is designed to provide trustees with a framework for assessing their MySuper offering and is aimed at supporting trustees' existing obligation to promote the financial interests of their MySuper members, with particular regard to the net returns. The assessment should support the existing obligation on trustees to obtain sufficient information to make decisions in the interests of members. The regulator would also be able to examine the methodology and processes supporting trustees' application of the test to ensure that the conclusions of the test are robust.

23. The outcomes test could be undertaken in conjunction with a reauthorisation process. A MySuper reauthorisation process could be a one-off process that removes the tail of underperforming products, whilst the outcomes test would involve an ongoing obligation on trustees to assess performance.

14 Module 5 Closing Submissions, above n 10, 211 [795], 212 [798].

15 Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Bill 2017 (Cth) *(Member Outcomes Bill)*.

24. Extending the proposed outcomes test, or a like assessment tool, to choice products, would be one way to ensure trustees consider the appropriateness of the choice products they offer their members. APRA's recently announced consultation package 'Strengthening Superannuation Member Outcomes' goes some way to achieving this. The package includes a draft prudential standard that would require trustees to annually assess whether outcomes for members across MySuper and choice products could be improved through changes in business operations.[16] This approach could complement the recently introduced design and distribution obligations (DDOs) that apply to issuers and distributors of choice products, requiring them to identify target markets, determine the most appropriate distribution channels, and periodically review these arrangements.[17]

25. Extending the outcomes test to choice products could improve choice product design and promote consolidation of legacy products. Legacy products often involve high fees and drive costs up for the fund as a whole. Trustees would be expected to routinely consider whether maintaining legacy products meets their duty to look after their members' interests, assuming there are no legal impediments to closing the products.

26. However, there would also be practical implementation issues to work through, particularly if the outcomes test is extended to choice products, to ensure the test promotes an active consideration of member outcomes and does not become overly procedural. Consideration should be given to the trade-off between allowing members to prioritise different elements of a superannuation product (such as investment choice) and the extent to which trustees are held responsible for retirement outcomes.

FACILITATING MERGERS

27. As at June 2018 there were 221 large superannuation funds and 105 MySuper products.[18, 19] As more pressure is put on funds to perform, more funds will need to merge to maintain scale and deliver better outcomes for members.[20] However, evidence was heard at the Commission that even where a prospective merger had significant financial benefits for members, this was not sufficient for the merger to proceed.[21]

28. There may be a number of disincentives to merge, but these should be subsidiary to the need for trustees to act in the best interests of members. Trustees might be avoiding mergers for fear that directors of trustees lose their positions, or sponsoring organisations may lose their influence. In other cases, a beneficial merger might not proceed because of high upfront transition costs, which have not been adequately weighed up against longer term benefits.

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16 APRA, *Outcomes Assessment,* SPS 225, 13 December 2017 (*SPS 225*).

17 The DDOs will regulate the design, marketing and distribution of choice superannuation products, among other financial products. These obligations will require product issuers to identify target markets and select appropriate distribution channels for their products. Distributors will be required to take reasonable steps so that their promotion, sales and other distribution conduct is consistent with the distribution conditions in the target market determination.

18 APRA, *Quarterly Superannuation Performance* (June 2018 and reissued 31 August 2018), 10. APRA-regulated funds with more than five members, including APRA-related and exempt public sector schemes.

19 Ibid, 9. Key Statistics: MySuper products and accrued default amounts.

20 PC Superannuation Draft Report, above n 4, 24, 28, 40. There are high costs associated with being subscale; FSI Final Report, above n 3, ch 2. It is not always the case that the benefits of scale are passed on to members.

21 Module 5 Closing Submissions, above n 10, 67-70 [238-253].

29. On the other hand, some small funds might not be a commercially attractive merger target, for example, because of their small size, [22] or because they have a large portion of members in the drawdown phase. In such situations, the upfront costs of undertaking initial due diligence and the subsequent costs of the successor fund transfer might outweigh any benefits to the larger fund from increased scale. Submissions to the PC indicate merger transaction costs can amount to between $1 million and $10 million.[23] More broadly, in situations where a merger might benefit the underperforming small fund but not the recipient fund, there is no in-principle case for imposing the costs of the merger on the recipient fund with the effect of disadvantaging its existing members.

30. The PC argued that regulators should play a greater role in facilitating mergers between underperforming or subscale funds.[24] Under the Member Outcomes Bill, APRA would be given a directions power that would allow it to direct a trustee to merge its fund with another trustee.[25] Previous reviews have raised regulatory uncertainty around equivalency requirements when transferring member interests as another potential impediment to mergers.[26] However, APRA has updated its prudential guidance on successor fund transfers and wind-ups to provide greater clarity, which may address this impediment without the need for a change to the law. In addition, trustees currently can approach APRA where clarity is needed in relation to a specific set of circumstances.

31. Finally, trustees may be more inclined to pursue mergers and to overcome some of the barriers listed above, should there be greater consequences for fund underperformance.

DUPLICATE ACCOUNTS AND STAPLING

32. Multiple accounts lead to lost savings for members and inefficiencies in the superannuation system. The PC found unintended multiple accounts are a consequence of structural flaws within the superannuation system and they regressively harm a significant number of members. Approximately one-third of all superannuation accounts are unintended multiple accounts, eroding $2.6 billion in unnecessary fees and insurance each year from member balances.[27] Unintended multiple accounts often end up as lost or unclaimed accounts.

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22 Alice Uribe, 'ASFA CEO Martin Fahy says 'orderly mechanism' for fund mergers needed', *The Australian Financial Review* (online) 17 June 2018 < https://www.afr.com/business/banking-and-finance/financial-services/asfa-ceo-martin-fahy-says-orderly-mechanism-for-fund-mergers-needed-20180613-h11d1z>.

23 Productivity Commission Hearings on Superannuation, Sydney, 20 June 2018, 34 [15] (Adam Gee, KPMG). https://www.pc.gov.au/__data/assets/pdf_file/0018/229113/20180620-sydney-superannuation-assessment-transcript.pdf.

24 PC Superannuation Draft Report, above n 4, 40.

25 Member Outcomes Bill, above n 15, sch 2 item 1; Evidence to Royal Commission, Melbourne, 17 August 2018, 5198 (Helen Rowell, APRA). *(Helen Rowell evidence).*

26 Productivity Commission, *Superannuation: How to Assess Competitiveness and Efficiency*, Final Report (2016) 98, 291.

27 PC Superannuation Draft Report, above n 4, 247.

33. To help address the stock of unintended multiple accounts, under the Government's Protecting Your Super Package, accounts which do not have insurance cover, have balances below $6,000 and which have not received a contribution or rollover for 13 months, would be transferred to the Australian Taxation Office (ATO) to protect them from further erosion to balances. [28] The ATO would be able to reunite these accounts proactively, alongside lost superannuation it already holds, with a member's active account where possible, boosting their balances at retirement.[29]

34. The PC made a draft recommendation that members should only have a default account created once, upon entry into the superannuation system.[30] In principle, this could resolve the future creation of unintended multiple accounts. However, the net benefit of this proposal is contingent on the product to which a member is 'stapled' being a good product, and remaining a good product in the future.

35. When fully implemented, the Single Touch Payroll onboarding reforms will go some way to reducing instances of new employees creating an unintended new account, by streamlining the process for new employees to nominate existing superannuation accounts when they commence employment.

EMPLOYER INDUCEMENTS

36. The Commission heard evidence of a trustee using member funds to pay for entertainment in order to manage relationships with employers.[31] Section 68A of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) prohibits the trustee of a superannuation fund, or an associate of the trustee, from providing or withholding a good or a service to a person on the condition that one or more of their employees becomes a member of the superannuation fund, subject to certain exceptions.[32]

37. However, the high threshold implicit in the wording 'on the condition that' and the fact the provision can only be enforced by those suffering loss or damage (and not by the regulators) limit the effectiveness of this provision. An option is to amend the provision to facilitate enforcement. Ultimately, however, even if a prohibition on employer inducements is strengthened, it would only be addressing the symptom of the problem. The underlying cause of the issue is a default mechanism that involves employers who may not be skilled in selecting a default fund, or have a strong incentive to make a decision solely in the interests of their employees.

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28 Explanatory Memorandum, Treasury Laws Amendment (Protecting Your Superannuation Package) Bill (2018) (Cth) [1.24-25] (*Protecting Your Superannuation Bill*).

29 Ibid [1.14, 1.26]. The ATO will proactively reunite to an active account where the balance upon reuniting would be greater than $6,000.

30 PC Superannuation Draft Report, above n 4, 459.

31 Module 5 Closing Submissions, above n 10, 87–88 [313–16].

32 However, see Module 5 Closing Submissions, above n 10, 91 [326-29]. Counsel Assisting questioned the effectiveness of s68A of the SIS Act.

SECTION B: CONFLICTS OF INTEREST ARISING OUT OF STRUCTURES OF SUPERANNUATION ENTITIES

38. Counsel Assisting posed questions about whether there are structures that raise inherent problems for a superannuation trustee being able to comply with its fiduciary duties, and whether structural change of entities is desirable.[33]

39. The Commission's hearings have highlighted a number of business structures which can give rise to conflicts of interest that can result in poor outcomes for members of superannuation funds. These structures include trustees':

    - reliance on, or integration with, advice businesses; and
    - use of integrated providers or related parties for service provision.

40. As discussed in Section A, trustees and related parties may be able to exploit conflicts of interest because, as the PC identified, there are insufficient consequences for trustees of funds that underperform and deliver poor member outcomes.[34] Policies that introduce greater consequences for underperformance and that stimulate member-driven competition (see Section A) could also mitigate risks associated with conflicts of interest, as products that underperform due to high fees or fees-for-no-service, or products with low investment returns, would attract fewer members. Policies that improve governance, discussed in Section D, also go to managing conflicts of interest.

41. Currently, regulations addressing conflicts of interest are largely directed at trustees, who are subject to a duty to act in the best interests of members and prioritise the interest of members over any other person.[35] This obligation does not always extend to related entities that may have obligations to their own shareholders. Specific practices raised in the hearings are considered below.

CONFLICTS OF INTEREST CAUSED BY TRUSTEES' RELATIONSHIPS WITH ADVISERS

42. The Commission's fifth round of hearings heard evidence of fees-for-no-service, commissions paid with members' funds and conflicted financial advice arrangements. This evidence built on evidence presented in the second round of hearings on financial advice.

33 Module 5 Closing Submissions, above n 10, 222 [825.17-18].
34 PC Superannuation Draft Report, above n 4, 27.
35 SIS Act s52.

43. Treasury's Policy Submission considered conflicts of interest in financial advice from an overall advice perspective.[36] This submission revisits conflicts of interest in financial advice from the perspective of superannuation trustees and the impact on member outcomes.

44. There are a variety of corporate structures, which can present a range of possible conflicts of interest. Generally, retail funds' business models are largely reliant on financial advisers to attract members.[37] Advisers also have an incentive to switch members out of default products, even where those products deliver higher net returns, when they receive ongoing advice fees linked to non-default products.[38]

45. Paying grandfathered commissions to advisers encourages those advisers to continue to recommend that members stay in the trustee's products. In board papers presented to some trustees' directors, this practice has been justified as being in members' interest, as it increases fund scale and, therefore, benefits existing members.[39] However, this practice results in conflicted advice with its attendant negative consequences. The continuance of grandfathered commissions can also lead to higher member costs and, therefore, lower retirement outcomes.

46. Counsel Assisting raised the following options to reduce the risks of conflicted advice arising from the ongoing relationship between advisers and trustees:

- a ban on commissions (removing grandfathering) for superannuation products; and
- direct invoicing (charging advice fees to clients directly) and banning the use of superannuation assets to pay ongoing personal advice fees.[40]

Removing grandfathering

47. The Royal Commission's fifth round of hearings heard further evidence of the continued payment of grandfathered commissions. This evidence brought out again that grandfathered arrangements have not ceased as quickly as expected and that, in some cases at least, trustees and advisers have acted to keep their clients in grandfathered arrangements.[41] For example, the Commission heard evidence of financial advisers switching their clients into choice superannuation products so they could continue receiving trailing commissions in respect of the clients' superannuation investment.[42]

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36 Treasury Policy Submission, above n 1, 36. Which noted that recent structural changes in the advice industry, recently introduced or soon to be introduced reforms, other potential reforms the Commission could recommend, and heightened attention by firms and ASIC, should be sufficient to mitigate the systemic risks involved — subject to further ongoing scrutiny by regulators.

37 Module 5 Closing Submissions, above n 10, 38, 96.

38 ASIC, *Report 562: Financial advice: Vertically integrated institutions and conflicts of interest* (2018).

39 Module 5 Closing Submissions, above n 10, 38 [121-122].

40 Ibid*,* 202-203.

41 Evidence to the Royal Commission, Melbourne, 6 August 2018, 4219-20 (Paul Carter, NAB); Module 5 Closing Submissions, above n 10, 98.

42 Module 5 Closing Submissions, above n 10, 96, 175.

48. In its Policy Submission, Treasury identified the conflicts of interest and degree of potential harm associated with grandfathered payments, but noted removing grandfathering was not straightforward.[43] The submission also noted an abrupt end to grandfathering could impact the viability of some financial advice practices, with implications for their owners, employees and customers.[44]

49. The issues and conclusions in that previous submission apply equally when considering removing grandfathered commissions from superannuation products. There are no in-principle reasons for drawing a distinction between superannuation and other financial products, and in practice such a distinction could be difficult to implement in specific cases. The impact of remaining in poor-performing products is, however, particularly acute in superannuation, where poor performance over a long period can significantly impact a person's retirement balance.

50. Since the Commission's second round of hearings, some financial firms have taken steps to unilaterally remove grandfathered payments in certain circumstances, including payments made by trustees.[45] In general, these firms have committed to stopping grandfathered payments to employed advisers and have committed to pass benefits through to customers. However, the value of payments covered by these announcements appears to represent only a small proportion of estimated total grandfathered payments.[46] Evidence from the fifth round of hearings suggests that some trustees may be reluctant to remove grandfathering unilaterally, because they rely on financial advisers to distribute their products and they might find it more difficult to compete with other superannuation entities that retain conflicted remuneration.[47] There are also difficulties with varying contracts with unrelated parties in the absence of legislative change to remove grandfathering. Therefore, an end to grandfathered payments in the foreseeable future is likely to require legislative intervention.

51. When considering legislative intervention, it is worth recognising that under the Future of Financial Advice (FoFA) laws, a number of different arrangements were grandfathered.[48]

52. Some of these grandfathering arrangements are broader than others in terms of the commissions that can be paid. For example, a client may obtain products using a platform account established before FoFA, and commissions from the platform operator for these new products can be paid to Australian Financial Service (AFS) licensees because the grandfathering relates to the account as a whole.[49]

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43 Treasury Policy Submission, above n 1, 40.

44 Ibid, 39–40.

45 National Australia Bank 'NAB moves on grandfathered commissions' (Media Release, 3 September 2018) <https://news.nab.com.au/nab-moves-on-grandfathered-commissions/>; BT Financial Group, 'BT Financial Advice announces removal of grandfathered payments' (Media release, 20 June 2018) <https://www.bt.com.au/about-bt/media-centre/media-releases/archives/2018/media-release.html>; Stephen Letts, 'Macquarie joins rush to ban grandfathered commissions to financial advisers', *ABC News* (online), 3 July 2018. <http://www.abc.net.au/news/2018-07-03/macquarie-joins-the-rush-to-ban-grandfathered-commissions/9935994>.

46 National Australia Bank announced that customers will benefit through fee rebates and reductions of approximately $11 million; BT Financial Group announced that the financial impact of its changes would have represented $14 million of its first half year cash earnings of the 2018 financial year.

47 Evidence to the Royal Commission, Melbourne, 8 August 2018, P-4391-6 (Nicole Smith, NULIS).

48 *Corporations Amendment (Future of Financial Advice) Act 2012* (Cth) and *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth).

49 *Corporations Regulations 2001* (Cth) regs 7.7A.16, 7.7A.16A(2).

53. Submissions to the Commission have indicated that legislative intervention would be complex and potentially give rise to constitutional issues.[50] While Treasury's Policy Submission noted such concerns, their strength varies across the many types of grandfathered arrangements. For example, removing grandfathering for when a business is sold may raise different issues than ending grandfathered payments between platform operators and AFS licensees.[51]

54. If the Commission was to recommend an end to grandfathered payments, an important design issue is the time parties would be given to transition. Factors which may need to be considered against the benefit to consumers of earlier termination include:

- the degree of disruption to financial firms, particularly those who rely more heavily on commission payments (but bearing in mind the expectation when grandfathering was enacted was that grandfathered commissions would have a short natural life);
- the length of time to draft, consult and pass a potentially complex piece of legislation; and
- the potential benefits of allowing firms to end grandfathered payments through renegotiating existing contracts in an orderly manner and ahead of a ban taking place.

Directly charging clients

55. Counsel Assisting has also asked whether it would be appropriate to remove ongoing financial advice fees from superannuation accounts and charge clients directly for financial advice.[52]

56. Under the current framework, one-off advice and ongoing advice related to superannuation can be paid out of a member's superannuation account. Advice that does not relate to superannuation must not be paid out of a member's superannuation account, though this prohibition can be difficult to enforce in practice.

57. The evidence presented during the hearings highlighted issues arising in the context of ongoing financial advice arrangements where adviser fees are deducted directly from a member's superannuation account. As the fees are not paid directly out of the member's own pocket, the member is less likely to make an active assessment of the value of the advice and may not be aware that they are not receiving financial services for which they have paid.

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50 AMP, Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 7 May 2018, [30(b)]; ANZ, submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, [8]; Treasury Policy Submission, above n 1, 40.

51 *Corporations Regulations 2001* (Cth) regs 7.7A.15B(2), 7.7A.16(2)(b)(ii), 7.7A.16BA. A grandfathered benefit will continue if it is redirected under a later arrangement entered into after 1 July 2013, or transferred as part of the sale of a business.

52 Module 5 Closing Submissions, above n 10, 202–03.

58. One option raised by Counsel Assisting involves requiring financial advisers to directly charge members rather than deducting ongoing advice fees from members' superannuation accounts. It would require a member's explicit consent for payment, rather than allowing an employer to accept charges on the member's behalf. This would make the cost of advice transparent to the member, facilitating an informed decision on whether to establish or continue an ongoing advice arrangement. Stopping advice fees from being deducted from superannuation accounts would also remove the risk of financial advice that is not related to superannuation being paid for with superannuation assets. An extension of this option could be to require one-off advice to be directly charged, but further consideration of the costs and benefits of this option would be required.

59. The potential downside of direct charging is that it could act as a barrier to some members who wish to receive ongoing advice, but can only afford to pay for it by using their superannuation savings. It is not clear, however, the extent to which this is a significant problem, compared to the benefits to members of transparency around the cost of advice. In addition, members who could not afford to directly pay for advice would still have access to intrafund advice (for limited advice about a member's own account with their superannuation fund).

Superannuation selling practices

60. There was evidence presented to the Commission regarding the selling of superannuation products in bank branches in circumstances that created a risk of customers believing they were receiving personal financial advice when the bank's representatives were not licensed to provide it.[53]

61. The application of the existing regulatory framework may be sufficient to prohibit the practices that amount to customers being provided with unlawful personal advice. The Australian Securities and Investments Commission (ASIC) has used enforceable undertakings with the Commonwealth Bank and ANZ to stop these practices.[54] While facts need to be considered on a case-by-case basis, further clarity around whether the sales practices constitute personal or general advice may be provided by the case currently being litigated against Westpac.[55]

62. Counsel Assisting has asked whether it is appropriate that superannuation be sold through bank branches and whether this is likely to produce an outcome that is in members' best interests.[56] This question relates to the different consumer protections afforded to purchases of superannuation products depending on the channel through which the product is acquired. Consumer protections vary depending on whether the product is acquired through:

- general advice or without any advice;

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53 Module 5 Closing Submissions, above n 10, 104, 127-8; ASIC, 18-206MR 'ASIC accepts court enforceable undertakings from CBA and ANZ over superannuation product distribution' (Media Release, 6 July 2018) <https://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-206mr-asic-accepts-court-enforceable-undertakings-from-cba-and-anz-over-superannuation-product-distribution/>.

54 Module 5 Closing Submissions, above n 10, 107, 129.

55 ASIC, '16-460MR ASIC takes action against Westpac entities in relation to the "best interests duty" and superannuation customers' (Media Release, 22 December 2016) <https://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-460mr-asic-takes-action-against-westpac-entities-in-relation-to-the-best-interests-duty-and-superannuation-customers/>.

56 Module 5 Closing Submissions, above n 10, 220.

- a financial adviser (which can attract personal advice protections); or
- the default allocation system (which attracts protections attached to MySuper products).

63. If the Commission finds a prohibition on the sale of superannuation products through bank branches is appropriate, such a prohibition could:

    - increase efforts by financial entities that offer superannuation products to sell those products through alternative channels, such as call centres or white-labelled products, which present their own risks;
    - decrease competitive pressure on the non-bank sector of the superannuation market to the extent customers are unwilling to pay for personal financial advice; and
    - impose a cost on consumers that value the convenience of accessing information on the bank's products in the bank branch, further reducing consumer-led competition.

64. On the other hand, even without a prohibition, reforms committed to by the Government could affect the way in which the products are marketed and sold. For example:

    - DDOs are expected to result in more careful consideration of how and where sales are made, and what disclosure and promotional efforts are adopted in relation to choice superannuation products;[57] and
    - re-labelling general advice as sales or marketing or similar to increase customer awareness of the nature of the sales service they are receiving and make it clearer that it is not advice.[58]

65. While these reforms would provide some additional protections, they are unlikely to provide an equivalent level of protection to some of the other distribution channels, including protections associated with personal advice and default superannuation products. However, measures to increase product quality would reduce the negative impact of this practice.

66. One of the challenges in enhancing protections in relation to general advice is the breadth of the existing definition. Reforms in this area would benefit from considering the merits of having a more graduated definition of general advice and the different types of advice that consumers need.

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57 The Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (Cth) was introduced to Parliament on 20 September 2018. Also see O'Dwyer, K (Minister for Revenue and Financial Services) 2018, 'Turnbull Government seeks further comment on law to improve outcomes for financial consumers' (Media Release, 20 July 2018). The proposed Design and Distribution Obligations do not apply to MySuper products.

58 Productivity Commission, *Competition in the Australian Financial System:* Inquiry Report (2018), 279 (*PC Financial System Competition Report*).

CONFLICTS OF INTEREST ARISING FROM RELATED PARTIES

67. The PC noted superannuation funds outsource extensively, especially for key expense items such as investment management and administration.[59] The PC also found that available data and industry research suggest funds that outsource administration to related parties pay more for the service, although the poor quality of the data made this difficult to assess.[60] APRA's thematic review on related party arrangements showed there are gaps in dealing with conflicts and highlighted cases where trustees were unable to demonstrate that arrangements were arm's length or in the best interests of members.[61] These issues were demonstrated further in the Commission's hearing.[62] However, APRA's thematic review has also found an improvement in the governance and management of related party arrangements since 2014.[63]

68. It should be noted there may be some benefits to members from using related party service providers. Efficiencies may be derived from a number of sources, including economies of scale and scope, reduced transaction costs, or other unquantifiable factors, such as reduced information asymmetries.[64] Integration may even be a source of competitive pressure on wholesale investment managers.[65] These efficiencies could lead to lower costs for members. However, it is not clear whether it is members, related parties or sponsoring entities that benefit from these efficiencies.

Inherent problems of trustees using related party arrangements

69. Reliance on related parties, such as wealth management businesses, to provide services relating to advice, management and operations, can lead to trustees not seeking out the appropriate information to make informed decisions.[66] In general, outsourcing to related parties can also lead to a lack of transparency around related party arrangements, pricing, and conflict management in ensuring that members' outcomes are prioritised over related parties' interests.

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59 About 80 per cent of funds' reported service expenses were attributed to external service providers in 2016. PC Superannuation Draft Report, above n 4, 278. 2017b; APRA *Annual Superannuation Bulletin June 2016*, Sydney.

60 PC Superannuation Draft Report, above n 4, 301-302.

61 APRA letter to RSE licensees, 29 May 2018.

62 Some examples include delaying remediation of members who had paid fees for no service as these needed to be paid by a related party, related entities retaining the margins of the trustees' super business as payment for servicing the fund, trustee boards facing information asymmetries with management and being unable to make decisions in respect of the funds where performance was poor.

63 These improvements were owing to a number of APRA reviewed trustees demonstrating effective approaches to managing related party service provider arrangements, such as having acceptable standards in terms of legal enforceability, clearly defined services, specified prices, and better practices in decision making and contract management.

64 For example, in the case of group insurance, related party arrangements can reduce insurance premiums and facilitate claims handling due to ease of information sharing.

65 PC Superannuation Draft Report, above n 4, 282.

66 Module 5 Closing Submissions, above n 10, 31, 99 and 135 respectively provide examples of reliance on a related party wealth management arm regarding remediation; reliance on the group's strategic position with respect to trailing commissions prior to the trustee considering whether to remove trailing commissions; and arrangements through which the trustee outsourced the entirety of the administration and operation of its funds to related entities within the conglomerate group.

70. Moreover, the trustee may have difficulty complying with its obligations to put superannuation members' interests first, especially where a trustee is part of a conglomerate group with different competing interests. Where a superannuation fund is related to an entity offering other financial products (such as managed investment schemes (MIS) or insurance products) there may be expectations on the trustee to invest in those products. In the case where a trustee is also the responsible entity of a MIS (referred to as a dual regulated entity (DRE)) there may be a conflict between acting in the best interests of members of the superannuation fund and the members of the MIS.

Options to address conflicts from related party arrangements

71. There is existing regulation that seeks to mitigate risks arising from conflicts of interest. This includes requirements for trustees to:

    - have a conflicts management framework;
    - demonstrate to the regulator that agreements on outsourcing are made on an arms-length basis and with the benefit of a 'tender or other process'; and
    - notify the regulator when an agreement is entered into, ceased or changed.[67]

72. However, some of the behaviour evidenced in the hearings — including the use of a related party as an insurance provider,[68] contracting for services with businesses with close family ties,[69] and related entities charging fees for no service[70] — suggests that these requirements are not always achieving their objective of prioritising the interests of members where a conflict arises. The PC has recommended that the regulator strengthen prudential standards requiring trustees to conduct due diligence on related party outsourcing arrangements every three years, to ensure arrangements provide value for money. The PC has also found that the regulator can more effectively review these arrangements, and recommended that funds be required to disclose publicly to current and prospective members the proportion of total costs paid to related party service providers.[71]

73. The proposed outcomes test (discussed above)[72] would also allow the regulator to inquire further where the performance of MySuper products is unsatisfactory and would help to target particularly problematic entities without imposing costs on the sector as a whole.

74. Better enforcement of the trustee's best interests duty and conflicts management processes would also assist. Importantly, it is still incumbent upon trustees to overcome information asymmetries (regardless of who provides the services) by requesting relevant information, prior to making decisions. Independent trustee directors can improve outcomes for members where some of these structural issues exist (discussed further in Section D), provided they are motivated and empowered to question board decision-making.

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67 APRA Prudential Standards SPS 521, 231 and CPS 231. PC Superannuation Draft Report, above n 4, 366.
68 Module 5 Closing Submissions, above n 10, 116 [399].
69 Ibid, 119-122 [416-427, 437]
70 Ibid, 42 [134–149].
71 PC Superannuation Draft Report, above n 4, 40.
72 Member Outcomes Bill, above n 15.

STRUCTURAL SEPARATION OF SUPERANNUATION TRUSTEES FROM RELATED PARTIES

75. Counsel Assisting questioned whether it is desirable to mandate structural change of entities.[73]

76. Structural separation has the benefit of removing some of the risks of conflicts of interest caused by horizontal or vertical integration, such as inflated margins charged by related parties for services provided, higher premiums charged by related party insurers, and related parties' influence over the investment decisions of superannuation trustees (see above). However, this option would be complex and disruptive, and could have unintended consequences, including increasing costs to members through the removal of efficiencies.

77. Treasury's Policy Submission considered the separation of financial product issuers from financial advice provision.[74] This submission builds on the previous submission with a focus on structural separation in a superannuation context, including separating superannuation trustees from other entities and the functional separation of boards in the case of DREs. Many of the issues and considerations remain the same as those discussed in the previous submission.

78. A mandated structural separation would eliminate the efficiencies associated with integration, such as economies of scale, reduced transaction costs and reduced information asymmetries. These efficiencies would otherwise be expected to flow through to members if the funds face sufficient market or regulatory consequences for underperformance.

79. The costs and benefits of structural separation would vary on a case by case basis and would depend on many factors. For example, the implications of vertical separation would differ from that of horizontal separation. However, any forced separation would impose costs on industry and would need to be justified by net benefits to members. The PC's analysis of the case for mandated structural separation in the financial sector concluded that forced separation would do little to improve member outcomes.[75]

80. The transition costs associated with separating the superannuation entity from other parts of the business could be significant. However, it is difficult to assess the magnitude of the transitional costs as there are few, if any, precedents for structural separation along the lines outlined by Counsel Assisting.

81. Given structural separation alone does not resolve all conflicts, such as those conflicts created through contractual arrangements, it may be prudent to consider any structural issues after the impacts of other options have crystallised. This includes any recommendations to ban grandfathered commissions, remove advice fees from superannuation and strengthen conflict management practices. Finally, it should be noted that structural changes do not solve the underlying issue of underperforming products, as discussed in Section A.

73 Module 5 Closing Submissions, above n 10, 222 [825.18].
74 Treasury Policy Submission, above n 1, 36 [159].
75 PC Financial System Competition Report, above n 58, 269–271.

Functional separation of dual regulated entities

82. As raised in the hearings, concerns about conflicts of interest may arise when a board is both a trustee of a superannuation fund and a responsible entity of a MIS.[76] There are a small and declining number of these entities.[77] Under this arrangement, the board has duties to both the superannuation members and the investors in the MIS, but must prioritise the interests of the members. Currently, the regulator may revoke a trustee's registrable superannuation entity (RSE) licence where a trustee has breached the law, including this duty to prioritise superannuation members.

83. An option posed by Counsel Assisting is to legislate functional separation of the responsible entity and superannuation trustee.[78] This would be expected to improve conflict management practices, as the same board would no longer be required to consider multiple interests. However, consideration would be needed to ensure that there were net benefits to members from this approach. For example, it may not remove all conflicts, especially where both the trustee and the responsible entity remain under the same parent company. There is also a question of allocation of resources amongst the two boards, and a risk of detriment to superannuation members if the fund trustee is insufficiently resourced.

76 Module 5 Closing Submissions, above n 10, 206.

77 The number of dual regulated entities has dropped significantly since the law was amended to require two sets of regulatory requirements to this structure.

78 Module 5, above n 10, 222 [825.17-18] and Evidence to Royal Commission, Melbourne, 17 August 2018, 5218.

SECTION C: ISSUES FACED BY ABORIGINAL AND TORRES STRAIT ISLANDER MEMBERS

84. Many Aboriginal and Torres Strait Islander people face barriers when interacting with the Australian financial system. Issues include language barriers and lower levels of financial literacy. These difficulties can be further compounded in regards to superannuation. As the Commission heard, Aboriginal and Torres Strait Islander members may face a number of challenges in engaging with superannuation funds and services, including identification and certification requirements, and access to technology.[79]

85. The measures discussed in other parts of this submission are designed to improve the baseline safeguards of the superannuation system, including the quality of default products, to ensure that members are not adversely affected if they are unable or choose not to engage with the superannuation system.

IMPROVING ACCESS AND ENGAGEMENT

86. Even with baseline safeguards, the issues faced by Aboriginal and Torres Strait Islander members (as well as other vulnerable people) merit further attention.

87. There has been increasing industry recognition of challenges faced by some Aboriginal and Torres Strait Islander members and initiatives are being developed to address these. For example, the Indigenous Superannuation Working Group is a cross-industry initiative that seeks to improve superannuation outcomes for Aboriginal and Torres Strait Islander members.

88. Separately, the Australian Transaction Reports and Analysis Centre (AUSTRAC) released updated guidelines in July 2016 to assist entities in taking a flexible approach to identification and verification procedures for Aboriginal and Torres Strait Islander people. Trustees would be expected to train staff to use these procedures. There might be room for the superannuation industry to improve identification practices, access and engagement for their Aboriginal and Torres Strait Islander members.

PRESERVATION AGE AND EARLY RELEASE OF SUPERANNUATION

89. Counsel Assisting questioned whether life expectancy should be taken into account for superannuation early release mechanisms,[80] given Aboriginal and Torres Strait Islander people have lower life expectancies on average.[81] The Commission heard that this approach would be preferred to lowering the preservation age for Aboriginal and Torres Strait Islander members.[82]

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79 Evidence to the Royal Commission, Melbourne, 13 August 2018, (Lynette Melcer, QSuper), 4714-6 *(Lynette Melcer Evidence)*.

80 Module 5 Closing Submissions, above n 10, 221 [825.11-2].

81 Productivity Commission, *Overcoming Indigenous Disadvantage: Key Indicators 2016* (2016), 4.5. Aboriginal and Torres Strait Islander males born between 2010 and 2012 have an estimated life expectancy of 69.1 years, 10.6 years less than non-Indigenous males. Aboriginal and Torres Strait Islander females have an estimated life expectancy of 73.7 years, 9.5 years less than non-Indigenous females.

82 Lynette Melcer Evidence, above n 79, 4727-8.

90. The retirement income system has a number of significant 'milestone' ages, including preservation age, which is the age at which people can access their superannuation savings (between 55 and 60 years of age depending on date of birth). With the exception of date of birth, the preservation age applies uniformly and does not vary depending on the characteristics of particular groups of members.

91. This reflects the universal nature of the system and the fact that ultimately the case for early access to superannuation depends on individual circumstances, rather than group characteristics. There are practical difficulties with varying the preservation age for different life expectancies. However, the system provides a mechanism for early release of superannuation benefits prior to preservation age for individuals in certain circumstances. Concerns regarding early access to superannuation by particular individuals can be dealt with through this mechanism, rather than through universal changes to the preservation age.

92. Individuals who have a lower life expectancy may be more likely to qualify for access to benefits through early release mechanisms, including to pay for medical treatment, or because they are unable to work or undergoing severe financial hardship.

93. However, the discretion to allow release under compassionate or severe financial hardship grounds rests with the trustees, and they may choose not to offer early release. In such circumstances, a member may choose to move to a superannuation fund that does offer this option. The Government is currently reviewing the early release of superannuation rules on severe financial hardship and compassionate grounds.[83]

BROADENING BINDING DEATH BENEFIT NOMINATIONS

94. Counsel Assisting asked whether the law regarding binding death benefit nominations should be changed to reflect Aboriginal and Torres Strait Islander kinship structures.[84] Superannuation trustees are responsible for the distribution of superannuation death benefits. Subject to a superannuation fund's governing rules, a member may make a non-binding or binding death benefit nomination concerning the distribution of their superannuation benefits.

95. A binding death benefit nomination allows a member to direct the trustee of their superannuation fund to pay their superannuation benefits upon their death to their legal personal representative (the executor of the deceased estate) or their dependants. A dependant can include a spouse, child of the person or a person with whom the deceased had an interdependency relationship.

83 Commonwealth, *Early release of superannuation benefits: Under compassionate and financial hardship grounds and for victims of crime compensation*; Discussion Paper (2017).

84 Module 5 Closing Submissions, above n 10, 221 [825.13].

96. An interdependency relationship can exist between two people, whether or not they are related, in circumstances where there is a close personal relationship. The legislation is likely broad enough to cover most dependant relationships and there are other means to influence to whom superannuation benefits are distributed. Nonetheless, Treasury considers there is merit in exploring the interaction between the current legislation and kinship structures. It is important that consideration of the framework for binding death benefit nominations is done in consultation with key Aboriginal and Torres Strait Islander stakeholders, such as traditional owner groups, local Aboriginal or Torres Strait Islander organisations, land councils, and other affected communities.

SECTION D: ENCOURAGING GOVERNANCE PRACTICES THAT ARE IN MEMBERS' BEST INTERESTS

97. The evidence from the Commission about conflicts of interests, failed mergers and inappropriate expenditure by trustees underscores the importance of strong fund governance and adherence to the requirement to act in members' best interests. Importantly, the regulatory settings on governance should be viewed together with the other policy options discussed in this submission, including the changes to system architecture, better management of conflicts of interest arising from funds' structures, and improvements to regulator effectiveness.

98. Trustees (and their directors) have fiduciary obligations to members and beneficiaries that require trustees to take ultimate responsibility for the fund and to manage the assets of the fund with competence, diligence, prudence and honesty. There are also covenants in the SIS Act that require trustees to act in the best interests of members. APRA Prudential Standards also require trustees to disclose and manage conflicts of interests, ensure that trustee directors are fit and proper, and have an appropriate mix of skills and experience on their boards.

99. As discussed in Section A, the proposed outcomes test would impose significant new obligations on trustees, and may improve regulator scrutiny of trustee decisions. Treasury's Policy Submission discusses a further option to extend the Banking Executive Accountability Regime (BEAR) to superannuation, to improve accountability and impose additional obligations on senior managers.[85] However, the superannuation industry is structured in a different way to the banking sector, and careful consideration would need to be given to how the BEAR could apply.

EXTENDING THE BEST INTERESTS DUTY AND PENALTIES

100. In the context of managing conflicts of interest, Counsel Assisting asked about extending the reach of the trustee best interests duty and penalties.[86]

101. The Member Outcomes Bill aims to hold superannuation directors accountable for their conduct in the same way as directors of a MIS by subjecting them to criminal or civil penalties in relation to their duty to act in the best interests of members.[87]

85 Treasury Policy Submission, above n 1, 15-16.
86 Module 5 Closing Submissions, above n 10, 222 [825.19(i)-(ii)].
87 Member Outcomes Bill, above n 15, sch 3.

102. More broadly, there is a question of whether the best interests duty and associated penalties should be extended beyond the trustee of the fund to cover shareholders of the trustee.[88] An argument for this approach is that responsibility for good governance should not be limited to directors but should equally lie with the trustee company or shareholder — given the power some shareholders have under many company constitutions for nominating, appointing and removing directors from boards.

103. On the other hand, this policy approach might dilute the responsibility of directors, and could potentially create inefficient decision-making structures. For example, if a shareholder is responsible, they would become involved in more decision-making processes, where previously they would have been satisfied with directors acting independently. This approach would also likely exacerbate the conflicts arising out of the current business structures (discussed in Section B), as the same entity would be required to reconcile potentially competing obligations.

Superannuation trustee board composition and skills

104. Several reviews have focussed on methods to ensure that trustees are accountable to their members and that the settings governing them are current and fit-for-purpose. The Cooper Review, FSI and PC all identified independent directors as a feature of best practice fund governance.[89,90,91] The existing representative board composition requirements in the SIS Act differ from those of other corporate sectors, including listed companies, banks, and general insurers that all, at a minimum, recommend a majority of independent directors with an independent chair.

105. The Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017 proposes that boards be comprised of at least one-third independent directors including an independent chair.[92] It also proposes a stronger definition of 'independent'.[93]

106. Independent directors should bring to boards an external, dispassionate perspective, provide a diversity of views and a check on management recommendations. In contrast to directors who may be executives of a related business or who represent employers or employees, independent directors are more likely to be free of the types of conflicts that may cause them to (either intentionally or unintentionally) serve the interests of the employer sponsors, a related party or a subset of members, rather than the fund's entire membership.[94]

107. Notwithstanding the in-principle arguments for including independent directors on boards, overall board skills and accountability are also important. However, there are challenges in improving governance standards in these areas, which are discussed below.

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88 That is, the ownership arrangements of the trustee company.

89 Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, *Super System Review Final Report* (2010), 12 (*Cooper Review*).

90 FSI Final Report, above n 3, 134.

91 PC Superannuation Draft Report, above n 4, 362.

92 Explanatory Memorandum, Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017 (Cth) [2.24].

93 Ibid [2.2-3].

94 Ibid [2.10].

108. Superannuation members have a right to expect that the people entrusted with the management of their retirement savings have the requisite skills and qualifications to discharge their duties. In its draft report on superannuation, the PC noted that some trustee boards lack sufficient skills, expertise or independence.[95] The PC and Australian Institute of Company Directors have also proposed that funds should be required to publish a skills matrix for each director.[96,97]

109. In principle, regulations targeting skills on boards could lift both board quality and confidence in the system and potentially refresh board membership. However, there would be a number of issues to work through with stakeholders in order to determine the right mix of skills required and the appropriate skills standard, particularly given these might change over time. Constraints on board appointments in trustee constitutions are a further challenge that would need to be overcome.

110. As suggested by the PC, engaging an external third party to evaluate the performance of the board and capability against the skills matrix might be required to ensure that the skills have been assessed and reported correctly by the trustee.[98] However, this would invariably impose costs on the funds (and hence members). Furthermore, to be effective there would need to be some real consequences when an audit revealed poor practices. There is also a risk that the audit would become a 'tick the box' compliance exercise and not take into account the true culture of the board or foster a change in board recruitment practices.

111. Currently, under APRA's Superannuation Prudential Standard: *SPS 510 Governance*, boards do not have to make their performance processes public and are not required to submit their approach to APRA. A further suggestion by the PC is to require trustees to have and disclose a process to assess their board's performance.[99] In principle, this could increase accountability and transparency. However, there would be significant implementation challenges in ensuring that such disclosure delivers a material change in governance practices. For example, determining the criteria for assessment and disentangling the short term performance of the board from external factors (for example, broader economic and market factors) would be difficult.

Sole purpose test

112. Section 62 of the SIS Act (the sole purpose test) requires that regulated superannuation funds are maintained for retirement income purposes. In general, the sole purpose test requires there should be a reasonable, direct and transparent connection between trustee action and the core or ancillary purpose of superannuation.

113. Counsel Assisting asked about the connection between the sole purpose test in the SIS Act and political advertising by superannuation funds.[100]

95 PC Superannuation Draft Report, above n 4, 43, 361.
96 Ibid, 39.
97 Australian Institute of Company Directors, Submission No DR164 to Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, 13 July 2018, 2.
98 PC Superannuation Draft Report, above n 4, 40, 60.
99 Ibid, 39, 60.
100 Module 5 Closing Submissions, above n 10, 220 [825.1-2].

114. In undertaking advertising in compliance with the sole purpose test, trustees should be able to demonstrate that the advertising provides value for money and an underlying benefit for members. However, in practice, there is a degree of ambiguity around the sole purpose test, making it difficult to administer. The more tenuous the connection between an action and the core or ancillary purpose, the more difficult it would be for the fund to meet the sole purpose test. There is significant overlap between the objectives of the best interests duty and the requirements of the sole purpose test.

115. Further clarification through legislation or regulatory guidance by APRA on the requirements of the sole purpose test would likely provide greater certainty to trustees on what type of advertising is appropriate. A legislated ban on certain forms of advertising, including political advertising may warrant consideration.

SECTION E: THE ALLOCATION OF REGULATORY RESPONSIBILITIES

116. Counsel Assisting has sought submissions on whether the present allocation of regulatory roles is appropriate to achieve specific and general deterrence of misconduct and whether the roles of APRA and the ASIC should be restructured or significantly altered in order to achieve this.[101]

117. Counsel Assisting has also sought submissions on what could be done to encourage the regulators to act promptly on misconduct or potential misconduct.[102] This reflects concerns raised by Counsel Assisting that there has been a lack of enforcement action by the regulators, and that consequently they may be failing to generally deter misconduct.[103]

118. This section sets out the key considerations that have shaped the evolution of the current regulatory arrangement and allocation of regulatory responsibilities. The submission then outlines potential options for reform and the considerations that may be relevant to the Commission in developing its recommendations. This section focuses on the regulation governing APRA-regulated funds with more than five members and does not explicitly consider the regulation of Self-Managed Superannuation Funds (SMSFs).

119. Additionally, Treasury's Policy Submission sought to outline considerations relevant to effectiveness of the regulators, including regulatory culture and use of public enforcement as a regulatory tool.[104] This section does not seek to repeat Treasury's earlier submission. Instead, it considers issues specific to superannuation and relevant to enhancing regulators' willingness and ability to take action and deter misconduct.

120. Regulatory architecture, and its impact on regulator effectiveness, must be considered within a broader context. As previously identified, responsibility for compliance fundamentally rests with those to whom the obligations apply. Government and regulators cannot ultimately set culture within entities.[105] In addition, the system creates incentives for funds and other actors, which have an impact on their conduct (see Section A). Finally, the legislative settings are also relevant; for example, the extent to which there are clear standards of behaviour, powers available to regulators to deal with failures to meet those standards, and consequences of failure that reflect its seriousness.

121. Nonetheless, it is clear that regulators have a critical role to play in ensuring compliance with the regulatory framework. Strong, independent and accountable regulators help maintain trust and confidence in the system.[106]

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101 Module 5 Closing Submissions, above n 10, 223 [825.26–27].
102 Ibid, 223 [825.25].
103 Ibid, 217 [814].
104 Treasury Policy Submission, above n 1, 18.
105 Ibid.
106 Ibid, 18 [74].

THE EVOLUTION OF REGULATORY RESPONSIBILITIES

122. The twin peaks model was designed so that, generally, APRA is responsible for prudential regulation and ASIC for regulation of conduct and disclosure.

123. The regulatory framework governing the superannuation system modifies the twin peaks model to take into account additional regulatory functions that target member outcomes. This includes compliance with best interests obligations, the sole purpose test, authorisation and regulation of MySuper products, and regulation of the delivery of quality outcomes to members on an ongoing basis. Consequentially, APRA, in addition to its prudential role, takes on responsibility for ensuring compliance with these broader outcomes regulations. ASIC's role in superannuation regulation is largely focussed on disclosure, advice and dispute resolution.[107]

124. The regulatory requirements for member outcomes in superannuation differ from other financial services sectors — neither ASIC nor APRA have these functions for other industries. However, some aspects of the member outcomes functions bear similarities with other functions carried out by ASIC. For example, ASIC is responsible for ensuring compliance with best interests duties in financial advice and MISs, responsible lending requirements in credit, and has a role in relation to the proposed Product Intervention Powers.[108]

125. The current regulatory framework stems from the recommendations of the 1997 Financial System Inquiry (Wallis), which established the twin peaks model for financial system regulation. Wallis concluded that the fast paced and evolving nature of the financial services sector required responsive regulators. It found that this would be best delivered by two separate regulators for prudential and conduct regulation that cover the whole of the financial sector — that is, regulatory responsibility should be split across functions rather than products, sectors or institutions.[109]

126. Splitting regulatory responsibilities in this way allows the regulators to leverage synergies across functions and exploit economies of scale in expertise and resources, which cannot be achieved by specialised regulators that each focus on a different sector. It also allows a consistent regulatory approach across the financial sector.

127. In addition, Wallis found that the compulsory and long-term nature of superannuation necessitated an enhanced regulatory framework beyond conduct (which for Wallis involved a focus on disclosure) and core prudential issues. This resulted in the remit of the prudential regulator including compliance with government retirement income policies and ensuring that appropriate risk management practices be adopted.[110]

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107 ASIC grants Australian Financial Service Licences (AFSL) to trustees making public offers of superannuation products or providing other financial services, such as financial advice. ASIC is responsible for AFLS requirements (focused on ensuring businesses operate efficiently, honestly and fairly and deliver appropriate consumer outcomes) in relation to the provision of financial services.

108 Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018 (Cth), sch 2. The proposed 'product intervention power' will enable ASIC to take temporary action in relation to products (or classes of products) which may pose significant harm to consumers, but does not give ASIC a role in the authorisation of these products.

109 Commonwealth, *Financial System Inquiry*, Final Report (1997), 242-3.

110 Ibid, 305.

128. Following Wallis, and particularly as a consequence of the Cooper Review, there have been substantial changes to the regulatory framework for superannuation. These include an increased focus on strengthening obligations to ensure superannuation products deliver appropriate outcomes for members, rather than simply disclosure and risk management. The regulation of member outcomes can be seen as having elements of both conduct and prudential concerns, and thus lacks a natural home within either regulator.[111]

129. In recommending the MySuper regime, the Cooper Review recommended that APRA (as the regulator with the primary responsibility for administration of the SIS Act) should have its remit extended to include a role that is more focused on improving member outcomes.[112] This allocation of regulatory responsibilities stemmed in part from concerns about the regulatory costs and inefficiencies arising from overlaps in functions across regulators.[113] Cooper envisioned APRA's additional role should be 'directed primarily towards overseeing and promoting the overall efficiency and transparency of the superannuation system, to the ultimate benefit of members.'[114] Cooper acknowledged that APRA having a broader range of regulatory functions would call for new skills, resources and perspectives.[115] The FSI considered the appropriateness of the regulatory systems and concluded that the twin peaks architecture did not need major change. However, it made recommendations to refine the system by improving the accountability framework governing the regulators, ensuring the regulators have sufficient resources and directing regulatory focus towards competition.[116]

131. Most recently, the PC found that 'conduct regulation arrangements for the superannuation system are confusing and opaque, with significant overlap and no clear delineation between the roles of APRA and ASIC'.[117] The PC raised concerns that there was a 'very real and ongoing risk' that regulatory breaches could 'fall through the cracks' as a result of divided responsibilities.[118] To improve outcomes, the PC suggested that APRA and ASIC's respective roles need to be more clearly delineated and better align with their distinct 'regulatory DNA'.[119]

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111 Counsel Assisting, consistent with the PC Draft Report, has used the umbrella term of 'conduct regulation' to also refer to aspects of regulatory obligations focused on member outcomes. While regulation that is focused on member outcomes seeks to enhance the protections offered to consumers, it does so in a manner distinct to other conduct regulations – that is, it seeks to ensure that the financial product is of a specific quality, not just that it is suitable.

112 Cooper Review, above n 89, 309. The panel recommended that APRA be given a broader mandate, with an additional role directed primarily towards overseeing and promoting the overall efficiency and transparency of the superannuation system, to the ultimate benefit of members.

113 Ibid, 308. For example, the review noted concerns by trustees about the duplication and significant costs in time and administration arising from the collection of similar data from the same entity by different agencies.

114 Ibid, 309.

115 Ibid, 311.

116 FSI Final Report, above n 3, 234–37.

117 PC Superannuation Draft Report, above n 4, 383.

118 Ibid, 396.

119 Ibid, 397.

OPTIONS FOR REFORM TO REGULATORY RESPONSIBILITIES

Strengthening current regulatory arrangements

132. Improvements to the current regulatory arrangements could be achieved through changes to the regulators' powers, their approach to enforcement and improving coordination between regulators. A focus on strengthening the current arrangements would limit the disruption that could arise from a more significant reallocation of regulator responsibilities, and help to ensure a stronger focus on regulatory work that might be a higher priority, including the implementation of other recommendations that may arise from the Royal Commission and the PC superannuation inquiry.

133. However, consideration needs to be given to whether this is the most effective way of ensuring there is adequate focus on conduct regulation for superannuation.

Improving powers

134. It is important that the regulators, whether individually or jointly, have appropriate and clear powers to effectively address misconduct. Having the right powers will also assist regulators to act promptly.

135. There are limits on APRA's current enforcement powers, which restrict its ability to address potential misconduct promptly. APRA's current directions power is limited to issuing directions only after a contravention of the law has been identified, meaning that APRA may not have the power to resolve or address concerns before they result in significant detriment to members.

136. The new directions power in the Member Outcomes Bill would allow APRA to issue directions where it has reason to believe that the licensee is likely to contravene its obligations. The Bill would also expand the scope of the power to allow APRA to issue directions if there are risks to the beneficiaries of an entity or to the financial system more generally. It also allows APRA to issue directions in respect of a connected entity to a trustee. APRA has expressed its strong support for the directions power and notes that the power would allow it to require a trustee to take specified action to address prudential concerns or direct a merger with another fund.[120]

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120 Helen Rowell evidence, above n 25,5197–99.

137. An adjunct to directions powers is enforcement powers. ASIC has a relatively narrow range of enforcement powers under the SIS framework.[121] The Government has already committed to a number of reforms that would expand ASIC's tool kit. For example, the Product Intervention Power and DDOs would 'enhance [ASIC's] ability to achieve market wide improvements' (although not for MySuper products).[122] Further, the Government has agreed, or agreed in principle, to all 50 of the recommendations of the ASIC Enforcement Review and will prioritise the implementation of 30 of the recommendations. The remaining recommendations, including those relating to self-reporting of breaches and ASIC's directions powers, will be considered alongside the final report of the Commission.[123]

138. While ASIC's role in superannuation is limited, these reforms should enhance ASIC's effectiveness within the scope of its current regulatory remit.

Enforcement approach

139. Additional enforcement powers are only effective if appropriately used. Counsel Assisting has raised concerns, shared by the PC, that APRA's regulatory approach preferences working collaboratively with industry and that its closed door method for regulatory interventions may not be appropriate or sufficient to deter misconduct more broadly.[124]

140. As the Commission heard, APRA is concerned that public action against trustees may cause reputational damage or other issues that would make the problem worse and negatively impact fund members, including by causing liquidity and assets valuation issues.[125]

141. APRA's regulatory approach focuses on working collaboratively with institutions to address its concerns when issues are identified.[126] APRA uses a range of techniques to identify emerging issues, which often become the focus of thematic reviews. While APRA's regulatory model focuses on supervision, APRA will need to consider its enforcement approach and resourcing in light of the issues raised in the hearings.

142. Counsel Assisting has also raised concerns regarding ASIC's approach to enforcement during the hearings.[127] As noted above, the Government has committed to significantly increasing ASIC's powers in relation to enforcement. The Government has also provided ASIC with additional funding to expand its enforcement and supervisory work including an increased focus on superannuation. Furthermore, two new Commissioners with superannuation expertise and a new deputy chair with experience in enforcement were recently appointed to ASIC.

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121 ASIC can exercise statutory powers for provisions it administers under the SIS Act (including the keeping of reports and disclosure). ASIC can also exercise specific information disclosure and consumer protection powers under the Corporations Act and ASIC Act, including taking action in relation to AFSLs and disclosure – for example, imposing and enforcing licence conditions.

122 Evidence to the Royal Commission, Witness Statement of Peter Kell (ASIC) 17 August 2018, 48 [171] *(Peter Kell Witness Statement)*.

123 Scott Morrison and Kelly O'Dwyer, 'Boosting penalties to protect Australian consumers from corporate and financial misconduct (Media Release, 20 April 2018) <http://sjm.ministers.treasury.gov.au/media-release/boosting-penalties-to-protect-australian-consumers-from-corporate-and-financial-misconduct/>.

124 Module 5 Closing Submissions, above n 10, 217 [814].

125 Helen Rowell evidence, above n 25, 5179.

126 Ibid, 5177-8.

127 Module 5 Closing Submissions, above n 10, 217-18 [815–17].

Better coordination

143. Regardless of changes in regulatory responsibility, improvements to informal and formal communication, cooperation and collaboration between the two regulators are critical. This should include efficiently sharing information and intelligence and working together on enforcement and investigation activities.

144. Existing arrangements could be reviewed to ensure there are no unnecessary limits on the regulators sharing information or working together. International comparisons of similar regulatory relationships, including between the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) in the UK, might highlight other features that may assist with better co-ordination, including statutory obligations to cooperate. For example, the *Financial Services and Markets Act 2000 (UK)* places a duty on the FCA and PRA to ensure co-ordinated exercise of their functions.[128]

145. The expectations for APRA and ASIC's working relationship are set out under the Memorandum of Understanding (MoU) between the two agencies. [129] A specific collaboration and individual responsibilities matrix could be issued under the MoU.

Giving ASIC greater responsibilities for conduct and other functions

146. As discussed above, the PC has suggested that APRA and ASIC's respective roles should be more clearly delineated and better aligned with their distinct 'regulatory DNA': APRA should be more focussed on 'prudential health' (ensuring high standards and fund performance over the long term) and ASIC on the behaviour of the system (that is, conduct of the trustees, advisors and the appropriateness of products).[130] Such an approach would be consistent with Wallis' view that there are considerable advantages to APRA and ASIC specialising in prudential and conduct regulation respectively.

147. On one hand, it is appealing to minimise regulatory overlap by clearly delineating regulatory functions as relating either to conduct or prudential regulation. However, this approach would be complex and difficult to implement. While further consideration could be given to shifting some functions (for example, regulation of fees) from APRA to ASIC, disentangling prudential matters from conduct in other legislative provisions related to superannuation is difficult. In particular, the requirement to act in members' best interest may merit regulatory oversight from both a conduct and prudential perspective. In addition, a focus on clear delineation of legislative functions between conduct and prudential is unlikely to address existing gaps in oversight and could create new gaps.

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128 *Financial Services and Markets Act 2000* (UK) c 8, pt 1A ch 3 s 3D.

129 ASIC and APRA, *MoU: Australian Securities and Investments Commission (ASIC) and APRA relationship statement*, 18 May 2018.

130 PC Superannuation Draft Report, above n 4, 383.

148. Accordingly, consideration could instead be given to improving alignment with the general twin peaks model by creating shared responsibility by the regulators for administration of certain obligations (for example the best interests duty), and clarifying by legislative or other means, the roles of each regulator. This would increase the scope of responsibilities for ASIC (in particular in respect of conduct) and would require each regulator to approach their functions from their respective conduct and prudential lenses. It would also allow the regulators to play to their strengths. For example, APRA's behind the scenes, collaborative, ex-ante approach may be more suited to prudentially-focussed regulation and some elements of functions that target member outcomes.

149. Shared responsibility for administration of regulatory obligations is not unique — for example, in the UK the PRA and FCA jointly administer the Senior Managers and Certification Regime. The FCA and PRA undertook shared consultation in order to develop the regime and have clearly set out their respective roles.

150. While this approach would increase the level of overlap in regulatory responsibilities, this is likely to be a second-order problem compared to the risk of gaps. Issues arise where there is overlap without sufficient clarity in relation to respective roles and/or a lack of coordination resulting in duplication and increased regulatory costs. In this context, effective collaboration and coordination between regulators, and appropriate accountability mechanisms, is essential and a shared responsibility model would make these needs more explicit and unavoidable.

151. Extending ASIC's remit would address concerns that ASIC cannot, under the current arrangements, adequately address systemic conduct issues. For example, ASIC has noted that its ability to pursue member outcomes under the SIS Act is currently relatively limited. ASIC notes that, because its 'tool kit' is very heavily focussed on disclosure, it faces 'significant limitations when addressing market problems associated with a complex, long-term, compulsory product.'[131]

152. Counsel Assisting has noted concerns with the breadth of ASIC's existing remit, and whether this suggested it would be preferable that another regulator be tasked with conduct regulation in superannuation.[132] As noted in Treasury's Policy Submission, the effectiveness of a regulator is dependent on a combination of factors including its remit, powers, leadership, culture and resources.[133] It is not necessarily the case that a broad regulatory remit undermines effectiveness if matched appropriately with powers, leadership, culture and resources, and if there are synergies between the matters covered.

153. In looking at the merits of possible adjustments of remit, careful consideration of each legislative provision would be needed to assess whether the cost of change is justified against an assessment of long-term benefits. Overall, however, this option is likely to be significantly less disruptive and more straightforward to achieve than the option for a standalone regulator.

131 Peter Kell Witness Statement, above n 122, 48 [172].
132 Module 5 Closing Submissions, above n 10, 219 [824].
133 Treasury Policy Submission, above n 1, 18–9.

A separate superannuation regulator

154. A more fundamental shift in regulatory architecture would be considering a new standalone regulator for superannuation, amalgamating functions across APRA and ASIC.

155. A separate superannuation regulator would be a move back to the sectoral model that existed prior to the twin peaks approach — with the Insurance and Superannuation Commission — and was at the time judged to be inadequate by the Wallis Inquiry.

156. The Cooper Review in its consideration of regulatory responsibilities noted that, in the longer term, it might be possible to completely integrate APRA and ASIC's jurisdiction for defined contribution superannuation funds into a single superannuation regulator (leaving defined benefit funds with APRA in its traditional prudential capacity). However, the Cooper Review did not find sufficient justification at the time for such a change.[134]

157. Under this option, the new boundaries between a separate regulator, APRA and ASIC would need to be clearly articulated, particularly for closely related financial sectors (including advice and insurance) and across functions (such as regulation of disclosure and dispute resolution). New overlaps and gaps between the financial service regulators would no doubt emerge.

158. The new regulator would also need staff with a diverse skill set to deal with prudential, outcome and conduct matters. Initially, in practice, such staff would come from APRA and ASIC. In the long run, splintering the limited pool of people with such skills between multiple regulators would potentially reduce the depth of expertise in each. The new regulator would also need to adopt different approaches to manage prudential, conduct and outcomes regulation. The tensions between those regulatory roles would still need to be addressed, and this is likely to be more difficult to do within a single body. In addition, the relationship between the functions of the new regulator and the Australian Tax Office's (ATO) role in superannuation would need consideration to ensure there is an appropriate approach across the industry.[135]

159. Any net benefits of introducing a standalone regulator would also need to be weighed against the substantial disruption and costs of establishment and ongoing maintenance. Transitional problems, including potential gaps in oversight during the transition, would need to be carefully managed. It is also likely that it would take considerable time for a new regulator to bed down its processes and become fully operational.

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134 Cooper Review, above n 89, 318.

135 For example, the ATO's role in regulating SMSFs, data collection and the management of the SuperStream framework. Consideration would need to be given to consistency, efficiency, compliance costs and the client experience for SMSFs.