



21 September 2018

Hon Kenneth Hayne AC QC
 Commissioner
 Royal Commission into Misconduct in the
 Banking, Superannuation and Financial Services Industry

Dear Commissioner

Thank you for the opportunity to provide a submission in relation to Phase 5 of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Preliminary

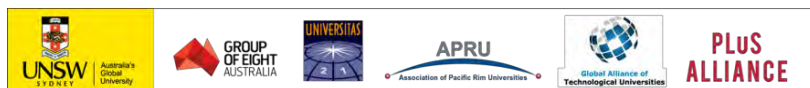
By way of introduction, I am Deputy Director of the Centre for Law, Markets and Regulation at UNSW Law. I am also retained on a part-time basis as an External Consultant by Herbert Smith Freehills. My PhD and subsequent research has been predominantly directed towards the regulation of the Australian superannuation industry.

Prior to entering academia in 2010, I worked for ipac (1986-1994) and Frank Russell Company (now Russell Investment Group) (1994-2009, including five years as Director of Research and four as Director of Product Development). Much of that time was spent actively involved in advising superannuation funds and their stakeholders on governance matters and in investment manager research and selection.

The views expressed in this submission are informed by my experience and research but they are my own and ought not be taken to reflect the views of UNSW or Herbert Smith Freehills, nor any of their clients, employees, interns or associates. I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction.

Submission

Counsel Assisting has identified a range of questions and issues on which input is sought. I choose to focus my submission on three. I address them sequentially below.





1. The enforcement role of regulators [825.25, 825.26 and 825.27]

The regulatory approach taken by ASIC and APRA differs markedly; adversarial and legalistic on the part of ASIC and responsive and risk-based on the part of APRA. Shortcomings in both have been identified in the course of the Royal Commission but, in my opinion, these stem from the way in which the two regulators have gone about implementing these regulatory styles rather than shortcomings in the approaches themselves.

I propose to limit my comments in this submission to the regulatory activities of APRA, as those are the activities with which I am most intimately acquainted as a result of my academic research over the past decade.

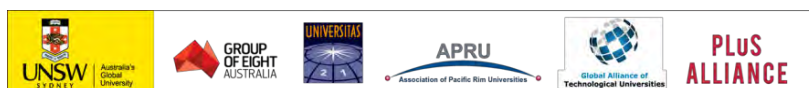
APRA has for some time espoused a risk and principles-based approach to supervision.¹ It aims for flexibility and a level of engagement with the regulated population that would be impossible for a broad-based regulator such as ASIC or the ACCC. This has some very powerful advantages, including the ability to deal with issues in a tailored and considered manner. There are however a number of less desirable consequences of this approach, some of which have been highlighted by the Public Hearings. In particular, APRA's preference for negotiated solutions:

- **has encouraged some in the industry to view regulatory issues as merely a cost of doing business** rather than legal requirements that need to be complied with. The low likelihood of any public awareness of the issues being addressed dramatically reduces the risk perceived by industry members in any transgression.
- **represents a problem for the rule of law.** The lack of transparency around the negotiations undertaken by APRA with transgressors undermines its accountability to the public.
- **is reflected in its structure and culture.** Its enforcement capacity in particular is profoundly undermined by its under-investment in legal resources. Lawyers are not well represented at senior levels and the culture of the organisation does not respect the perspective that their lawyers bring to issues. One good example of this lack of regard is the preparedness of APRA to accept 'management' rather than avoidance of conflicts of interests and conflicts of duty on the part of RSE Licensees.² The consequences of this departure from (and dilution of) the law are evident in many of the transgressions identified in the various Phases of the Royal Commission. Another example is the drafting of the Prudential Standards imposed upon the superannuation industry. The open-textured nature of the drafting renders them largely unenforceable in a court, undermining their effectiveness as a regulatory tool. (I note in that regard that APRA is currently undertaking a review of the effectiveness of its Prudential Standards regime.³)

¹ APRA, *The APRA Supervision Blueprint* (May 2015). For a prescient discussion of the way in which APRA's approach limits its political risk as an institution, see Julia Black, 'Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority' (2006) 28 *Law and Policy* 1.

² For a discussion see M Scott Donald, 'A servant of two masters? 'Managing' conflicts of duties in the Australian funds management industry' (2018) 12(1) *Journal of Equity* 1.

³ <https://www.apra.gov.au/post-implementation-review-apras-superannuation-prudential-framework>.





The Government has indicated a desire to enhance APRA's powers.⁴ However APRA has not always used the powers it has. The Royal Commission (and the Productivity Commission in its current Inquiry into the sector)⁵ has also uncovered a disinclination on the part of APRA to use its licensing powers effectively. In particular, APRA had a positive disposition towards granting MySuper licenses that has now been shown to be inappropriate.⁶ The policy objective behind the Stronger Super reform which introduced the MySuper products as a 'safe harbour' for default contributions was materially put at risk by APRA's failure to exercise this regulatory power effectively. That is not to argue that APRA ought to exclude all but large incumbent providers in this sector of the market – new entrants can bring innovation and competition – but it is to suggest that a licensing process in which almost all can get a licence is clearly undesirable. It has the potential to convey to the public a false sense of security and, even if 'light touch', imposes costs on the industry and the public purse. This same disinclination to vet carefully entrants to the industry is evident in APRA's application of its 'fit and proper' requirement in its RSE licensing process.⁷ To permit individuals and entities to self-certify as to their fitness and propriety, without an incisive and independent process at APRA to interrogate the fitness and propriety of those individual is self-evidently vulnerable to abuse.

Recommendations

APRA is ultimately a servant of the public, with its tactical priorities set by the Government of the day through the Statement of Expectations issued by the Government to its various agencies. The Government's rhetoric of active enforcement and prosecution against parties alleged by the Royal Commission to have contravened the law is not matched by its current Statement of Expectations for APRA.⁸ Absent formal prioritisation of enforcement in its Statement of Expectations it would be unreasonable to expect APRA to intensify its efforts in this regard to the extent that the Government now seems to expect.

I therefore submit that the Royal Commission ought to recommend that the Government's Statement of Expectations of APRA be redrafted to give greater priority to active enforcement of the laws APRA is empowered to oversee.

The introduction of the licensing regime for superannuation funds and their trustees in 2005 was directed towards ensuring that all trustees 'meet minimum standards of competence, possess adequate resourcing and have in place appropriate risk management procedures.'⁹

⁴ Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017.

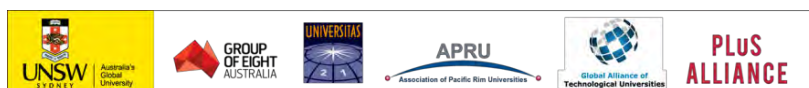
⁵ <https://www.pc.gov.au/inquiries/current/superannuation>.

⁶ Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, Draft Report (April 2018), at 27.

⁷ APRA, *Superannuation Prudential Standard SPS520: Fit and Proper* (July 2013).

⁸ <https://www.apra.gov.au/statement-expectations-2014>.

⁹ Minister's Second Reading Speech, *Superannuation Safety Amendment Act 2004* (Cth).





I therefore submit that the Royal Commission ought to recommend that APRA be required itself to conduct a fit and proper assessment of all RSE Licensees and their directors and senior officers.

2. Section 62 The sole purpose test [825.1 and 825.2]

Section 62 is somewhat enigmatic. Superficially it appears to have considerable substantive consequence; providing direction to the more generalised requirements on the trustee to act carefully and to exercise its powers in the best interests of members. However, as the *Explanatory Memorandum* to the *SIS Act* notes,¹⁰ the purposes articulated in the section are essentially the types of benefits to be provided to each member of the fund.¹¹ Moreover the section does not expressly address the sorts of issues to which it has historically been applied. Most of the cases on section 62 have involved variations on a theme: members deriving benefits from the fund prior to retirement,¹² and most have involved the Australian Taxation Office and the trustees of SMSFs.

Perhaps because of the expansiveness apparent in its wording, the section has inspired academic and other commentary on whether the sole purpose test might constrain superannuation fund trustees from making decisions perceived to have some public benefit, including sustainable investment¹³ and funding for social infrastructure.¹⁴ In these contexts the question is typically whether the proposed application of fund assets to those investments would compromise the returns from the investment portfolio generating the benefits for members. For instance, APRA's intervention in relation to Coles Myer Shareholder Discount Cards in 2001, in which a spokesperson for APRA noted 'It is the decision to forgo fund income that makes obtaining the card inconsistent with the "sole purpose test"',¹⁵ makes this connection. More recently, questions have been asked about whether activities such as the development of financial planning subsidiaries, or the launch of a newspaper, or promotional activity such as advertising or sponsorship, are consistent with the sole

¹⁰ At [104].

¹¹ It seems likely that the phrase was lifted from the early superannuation case *Scott v Commissioner of Taxation (No.2)* (1966) 40 ALJR 265, in which Windeyer J (at 278) defined a superannuation fund as a 'fund bona fide devoted as its *sole purpose* to providing for employees who are participants money benefits (or benefits having a monetary value) upon their reaching a prescribed age.' (emphasis added).

¹² See for instance *Sutherland v Woods* [2011] NSWSC 13; *Deputy Commissioner of Taxation v Lyons* [2014] FCA 1353; *Deputy Commissioner of Taxation (Superannuation) v Ryan* [2015] FCA 1037; *Aussiegolfa Pty Ltd (Trustee) v Federal Commissioner of Taxation* [2018] FCAFC 122. See also Super System Review, *Review into the Governance, Efficiency, Operation and Structure of the Superannuation System, Final Report - Part Two: Recommendation Packages* (July 2010), 246, in relation to the investment by SMSF trustees in coin and art collections.

¹³ See for instance Senate Select Committee on Superannuation, Parliament of Australia, *Investment of Australia's Superannuation Savings* (1996), Chapter 2; Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate responsibility: managing risk and creating value* (2006), [5.41]; Andrew Leigh, "'Caveat Investor': The Ethical Investment of Superannuation in Australia" (1997) 25 *ABLR* 341; Sarah Barker, Mark Baker-Jones, Emilie Barton and Emma Fagan, 'Climate change and the fiduciary duties of pension fund trustees – lessons from the Australian law' (2016) 6(3) *Journal of Sustainable Finance and Investment* 211; M Scott Donald 'Climate Change and fiduciary investors: weathering a disaster scenario' in Rosemary Lyster and Rob Verchick (eds.) *Climate Disaster Law: Barriers and Opportunities* (Edward Elgar, 2018).

¹⁴ See for instance Senate Select Committee, *ibid*; M Scott Donald, Jarod Ormiston and Kylie Charlton 'The potential for superannuation funds to make investments with a social impact' (2014) 32 *Companies and Securities Law Journal* 540.

¹⁵ Reported in Shaun Phillips, 'Battlers lose card benefits.' *Herald-Sun*, 2 November 2001, 17.





purpose test. Some of these issues have also surfaced in the Public Hearings of the Royal Commission.¹⁶ To the best of my knowledge the Coles Myer Shareholder Discount Card issue in 2011 is the only time APRA has intervened in respect of the sole purpose test.¹⁷

That said, APRA has announced an intention to assess the appropriateness of its current guidance on the sole purpose test.¹⁸ Its current guidance accommodates a range of practices that might appear to go beyond the strict wording of the section, including sponsoring member awareness, education and financial advice programs. It has in the past accepted the validity of trustees using fund assets to pay for advertising designed to retain members,¹⁹ albeit noting that ‘imposing marketing expenses on current members primarily to attract new members is difficult to justify; imposing marketing expenses on current members where the benefit of such expenses falls primarily to the trustee (by way of enhanced remuneration) or other parties would be inconsistent with the sole purpose test and may give rise to inequities among generations of members.’²⁰

Recommendation

I submit that it is unrealistic to expect APRA to regulate trustee decision-making using section 62 as currently drafted. The historical record demonstrates that APRA has failed to employ the sole purpose test to regulate fund investment and expenditure effectively. Part of this, I submit, reflects shortcomings in APRA’s enforcement strategies (see above) but part of the blame must also fall to the drafting of the section.

I therefore submit that section 62 ought to be redrafted to reflect either:

- *the narrower objective of policing preservation; or*
- *both the narrower objective and the broader objective of providing direction to the more general qualitative obligations on the trustees of superannuation funds.*

I further submit that some of the uses to which member money has been put by superannuation fund trustees that have been identified by the Royal Commission are inconsistent with the broader objective of ensuring that the assets of superannuation funds are invested pursuant to an investment strategy that is designed to provide financial benefits to members, including:

- information campaigns which go beyond the retention of current members, such as broad-based media campaigns;

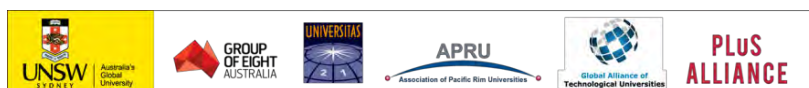
¹⁶ See Transcript, Ian Silk, 9 August 2018, [4526 – 4538, 4541 - 4554]; Transcript, David Elia, 14 August 2018, [4866 - 4873].

¹⁷ Contrary to the statement made to the Royal Commission by its Deputy Chair, at Transcript, Helen Rowell, 17 August 2018, 5180.

¹⁸ APRA, *Discussion Paper, Strengthening superannuation member outcomes*, (13 December 2017), 16.

¹⁹ Letter from Ross Jones, Deputy Chair of APRA, to APRA Regulated Superannuation Funds, 14 March 2005. The letter is no longer available on the APRA website but is quoted in full in APRA’s *Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Structure and Operation of the Superannuation System* (September 2006), available at https://www.apra.gov.au/sites/default/files/inquiry-into-structure-of-super-industry-Sep-2006_0.pdf.

²⁰ Ibid 11.





- the creation of specialist subsidiaries to undertake activities not permitted of the trustee itself, such as financial planning extending beyond superannuation matters; and
- corporate hospitality directed towards employer and union groups involved in the selection of default superannuation arrangements for new employees.

Whether these practices amount to justiciable contraventions of section 62 will inevitably depend on the circumstances of each case but that possibility cannot be ruled out. Redrafting section 62 ought to clarify its application to future examples of these types of conduct, providing certainty for industry participants, clarity for regulators and, ultimately, better outcomes for members.

3. Duty on Nominators of Directors to act in the best interests of the company when nominating individuals to a superannuation fund Board [825.14, 825.19]

It is a curious anomaly of the superannuation system that the directors of the companies acting as trustees of superannuation funds are often appointed by parties having only an indirect connection to the main stakeholders in the institution.²¹ (I note in passing that Counsel Assisting appears to believe that all nominators are shareholders, which is incorrect). In some cases, the Boards of these trustee companies have no legal means of resisting the nomination of a director to their Board by the external nominator, notwithstanding the regulatory requirement on the Board to ensure that collectively they are 'fit and proper' to manage the trustee.

Research I conducted in 2015-16 with Professor LeMire (University of Adelaide) found occasions when the impotence of the Board to resist inappropriate nominations, or to secure the nomination of individuals with a complementary skill-set to those already serving on a Board, were felt to be undesirable by serving Board members.²² In some, but not all, cases the situations were alleviated by informal methods, including direct representations from the Chair to the nominating entity.

Counsel Assisting has suggested that these circumstances could be avoided in the future by imposing upon nominators that they act in the best interests of members in making the appointment. I understand the factors that might encourage such an idea but I believe that suggestion should be resisted for the following reasons:

- it is naïve to think that a nominating body would not regard its nomination (however surprising and unsuitable it might appear to an independent observer) as in the best interests of the institution and its members. A regulator or member would therefore have to demonstrate that, on the balance of probabilities, the nomination (specifically and independent of any misconduct that might subsequently be found) was not objectively in the best interests of members. Given the historical experience of the regulators and

²¹ For a discussion of this issue, see M Scott Donald and Suzanne LeMire 'Independence in Practice: Superannuation Fund Governance through the Eyes of Fund Directors' *CLMR/CIFR Working Paper 16-3* (April 2016), 17; and 'Independence and the Governance of Superannuation Funds' *CLMR/CIFR Working Paper 16-1* (February 2016), 25.

²² Ibid.





members (not) holding trustees and their directors to account for actual documented misconduct, this seems unlikely to occur;

- **it diffuses accountability.** There already exists a well-designed (but perhaps not well executed) regime for ensuring that the directors of a superannuation fund trustee perform their duties skilfully, carefully and loyally. That regime starts with the fit and proper requirement; it then requires that directors demonstrate certain qualities in their actual decision-making;²³ and it concludes with a power vested in the Court upon application by APRA for the individual to be disqualified.²⁴ This focusing of accountability on the trustee and its officers was one of the key objectives of the *SIS Act*.²⁵ Diffusing that accountability simply because the regulator has not effectively fulfilled its mandate to enforce the existing law is, in my opinion, a backward step.
- although it may be possible to employ a mechanism such as that provided for in section 55(4A) of the *SIS Act*, **there is nevertheless a real risk that the bi-partisan politics** that have afflicted parts of the superannuation system for the past twenty five years would, if this duty were enforceable by the members, **be given another avenue for expression** as feuding factions on an equal representation board contest each other's nominations.
- **it is unclear what consequences would flow from breach of the duty.** How might damage or harm to the interests of members be measured, given that a connection between the nomination and any subsequent loss would have to be made out?

Recommendation

It is widely recognised that the appropriateness of an individual to a particular Board depends not just on the capabilities and characteristics of the individual but also on the composition of the Board as a whole. This is recognised in the recommendation by the Productivity Commission that all Boards be required develop a skills matrix to assess their joint capabilities.²⁶ It is entirely possible, therefore, that an entirely admirable individual might not be an appropriate choice for a Board, perhaps because his or her skill-set and experience were already over-represented on the Board. In my opinion this suggests that a privately administered process is preferable.

I therefore submit that the Royal Commission should recommend that the SIS Act be amended so that the Board of a superannuation fund be empowered to veto any nomination which would threaten its ability to meet the 'fit and proper' test administered by APRA, irrespective of the governing rules of the fund and the constitution of the trustee.

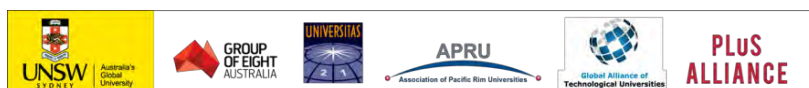
APRA's existing investigation powers under Part 25 of the *SIS Act* enable it to review how a power of veto was exercised in any particular set of circumstances if it suspected misuse.

²³ Part 6, *SIS Act*.

²⁴ Section 126H, *SIS Act*.

²⁵ John Dawkins, Treasurer of the Commonwealth of Australia, *Strengthening Super Security. New Prudential Arrangements for Superannuation* (AGPS, 1992), 3.

²⁶ Productivity Commission, above n 5, 39. APRA has expressed qualified support for this recommendation; APRA, *Submission on Productivity Commission draft report: Superannuation efficiency and competitiveness* (3 August 2018), 12-13.





Concluding comments

The Royal Commission has uncovered misconduct falling short of community expectations and the law in a wide range of organisations in the superannuation sector. In so doing it has brought into question the effectiveness of both the regulators and trustees in protecting adequately the interests of members. It has raised important questions and brought to light practices and attitudes that, in my opinion, have no place in the superannuation industry. That said, the rule of law is important and the fact that a practice falls short of community expectations does not, of itself, make the practice unlawful. Specifically in that regard, I note the pernicious effects of referring to the duty imposed on trustees ‘perform their duties and exercise their powers’ in the best interests of members as a duty ‘to act’ in the best interests’ of members. The desire to use the summarised form is understandable; the original is ungainly. The summarised form does however suggest that the duty on a trustee is much larger than it actually is.²⁷ That misapprehension is reinforced in the community by journalists and Counsel Assisting who mistakenly employ the summarised version. The law is clear: a trustee has a duty to give effect to the trust,²⁸ as defined by the governing rules, and the interests of members are defined as those, and only those, created by those rules²⁹ (which s9 of the *SIS Act* defines as including statutory provisions.) It is for this reason that the very important covenants in sections 52 and 52A, and the rules in sections 55A, 55B, 55C, 56, 57, 58, 58A, 58B and 59 are directed specifically towards regulating the governing rules of the fund – the governing rules are all-important. At law a trustee does not have an overarching pastoral duty to attend to the welfare of members, but rather a duty to give effect to the trust faithfully and in accordance with the law. Respectfully, I hope that the Royal Commission will respect these nuances of legal expression and not allow the desire for concision to inflame community expectations further.

Finally, I commend the Royal Commission for the work so far undertaken and look forward to seeing the Interim and Final Reports. Please do not hesitate to contact me if you have any questions or require any further information or elaboration.

Yours sincerely

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²⁷ I am indebted to David Pollard for his exhaustive treatment of the subject in his paper ‘The Shortform Best Interests Duty: Mad, Bad and Dangerous to Know’, available at <http://www.wilberforce.co.uk/people/david-pollard/>.

²⁸ In *Youyang v Minter Ellison*, the High Court noted that it is the duty of a trustee ‘to adhere to the terms of the trust in all things great and small, important, and seemingly unimportant’; *Youyang v Minter Ellison* (2003) 196 ALR 482, [33].

²⁹ *ACN 074 971 109 Pty Ltd (as trustee for the Argot Unit Trust) v National Mutual Life Association of Australasia Pty Ltd* (2013) 305 ALR 722; [2013] VSCA 241.

