21 September 2018

ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

The Financial Services Council welcomes the opportunity to make a submission on the policy issues relating to the superannuation industry raised in Counsel Assisting's closing submissions for Round 5 of hearings.

The Financial Services Council (FSC) is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely,

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1. AUSTRALIA'S SUPERANNUATION SYSTEM

1.1 The evolution of superannuation

Australia has a world-leading superannuation system.

Compulsory superannuation is one of the three pillars of Australia's retirement income system, with 70% of individuals over the age of 15 and 90% of employed people now covered by the superannuation system.[1]

A compulsory superannuation system requires stronger oversight and regulation than a voluntary system to ensure all individuals, and their savings, are appropriately protected.

Governance and regulation of the superannuation system has evolved significantly since the introduction of the Superannuation Guarantee in 1992 and the *Superannuation Industry (Supervision) Act 1993* (the SIS Act). The scale of assets in the superannuation system has also grown exponentially over this time, with over $2.6 trillion invested by almost 15 million members.[2]

As the system has matured, changes have been required to improve and safeguard customer outcomes, by ensuring a competitive system that balances choice for engaged consumers and safeguards for those who are disengaged.

In 2005, changes were made to allow most employees to choose the superannuation fund that would receive their contributions, transfer accumulated benefits to other funds and consolidate multiple accounts.[3]

As noted by Treasury, these measures were designed to increase engagement, competition and efficiency in the superannuation sector.[4] Further reviews and reforms in the time since have continued to focus on these three goals.

The Stronger Super reforms introduced following the Super System Review in 2009 also sought to improve efficiency and consumer outcomes. They included:

- the introduction of MySuper products, which seek to address the lack of consumer engagement in superannuation by ensuring disengaged default customers are placed in a low-cost product meeting certain minimum standards; and,
- the development and implementation of SuperStream technology to increase administrative efficiency.

The Super System Review also recommended governance changes for funds, noting that a critical mass of independent directors would improve fund governance and member outcomes. The *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017*, which has been before the Senate since September 2017, would require all trustee boards to have at least one third independent directors.

The FSC and its members have also committed to governance standards for superannuation funds. FSC Standard No. 20 *Superannuation Governance Policy* sets minimum governance requirements including requiring trustee boards to include a majority of independent directors and an independent chair.

In 2014, the Financial System Inquiry commented further on efficiency during the accumulation phase, however it found significant inefficiencies in the retirement phase.

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[1] Productivity Commission *How to Assess the Competitiveness and Efficiency of the Superannuation System*
[2] Productivity Commission *Superannuation: Assessing Efficiency and Competitiveness Draft Report*
[3] Choice is still restricted for up to one million Australians who currently have a fund specified in their enterprise agreement.
[4] The Treasury, *Overview of key regulatory reforms in superannuation*

As the superannuation system matures and potentially disengaged default customers retire with higher balances, it is more important than ever to ensure that it is as simple as possible to achieve good outcomes in retirement.

Most recently, the Productivity Commission's *Superannuation: Assessing Efficiency and Competitiveness* Draft Report noted that the superannuation system is delivering good outcomes for most members, but suggested further improvements to the default system to protect disengaged customers.

The FSC and its members have supported ongoing reforms that have progressively strengthened the superannuation system and ensured it is equipped to deliver good retirement outcomes for customers.

1.2 Issues identified by the Commission

In Round 5, the Royal Commission identified a range of issues relating to conduct of superannuation trustees.

The policy questions raised in the Closing Submissions attempt to draw out the circumstances that have led to the conduct identified in the hearings.

Taken individually, the policy questions speak to specific policy settings and behaviours that may result in poor outcomes for consumers. Viewed as a whole, a majority of the policy questions relates to the central issue of conflict management.

However, the conduct issues raised by Counsel Assisting are not inherently tied to any business model or corporate structure.

Different corporate structures will create different kinds of conflicts, and these should be addressed.

The FSC supports ongoing improvements to superannuation to ensure that the system continues to operate to a high standard and meets the needs of members into the future, and there are important improvements to be made in the way conflicts are managed within organisations to improve outcomes for fund members.

Any discussions of structural changes to superannuation must retain a system-level focus on ensuring the superannuation system can deliver high quality retirement outcomes for Australians.

1.3 Member outcomes in the current system

Trustees are subject to a range of duties that are intended to ensure decisions are made with regard to the interests of members and of the fund, rather than the interests of the trustee or a corporate entity.

In addition to the general principles of trust law, trustees must comply with statutory requirements.

These include the following:[5]

- the best interests duty under Section 52(2)(c) of SIS Act
- the sole purpose test under Section 62(1) of SIS Act
- fiduciary duty (addressed in section 2)

These complementary requirements, when properly applied by trustees and consistently enforced, provide significant protection for consumers. They form an important part of the framework for managing conflicts in superannuation.

Best interests

[5] See details in Section 4 of Pamela Hanrahan, Background Paper 25.

The best interest duty creates an obligation for trustees to make decisions with regard to the best interests of members. Counsel Assisting has proposed that the obligation to act in members' best interests could be broadened in various ways, including to related parties.

As noted in the Royal Commission's Background Paper 25, it is important to note that this statutory duty does not require trustees to secure the best possible *outcome* for members. However, it does require them to make decisions with sole regard to what is in the best interests of members.[6]

It also applies to members as a whole, rather than requiring the best possible outcome for any individual member. For this reason, it may not always be appropriate to apply the best interest test to the impact of a trustee's decisions on a particular member. For example, default investment strategies are developed for the membership as a whole, and may not provide the best outcome for an individual member. Trustees must manage the tension between the interests of individuals and managing the trust as a whole.

The FSC supports enhancing penalties for directors who do not comply with the best interests duty. The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017, currently before the Senate, would achieve this.

However, we are cautious about other proposals to broaden the best interests duty.

This duty in current law requires the trustee to consider the interests of members of the fund as a whole, rather than on an individual basis. As a result, it can at times be difficult for trustees to balance decisions where the interests of different members are in conflict.

Creating duties on additional parties and attaching onerous penalties to these complex decisions may result in overly conservative decision-making that will not benefit the long-term member outcomes.

A change that would benefit many members, such as investment in online services, may not be made because of concerns that some members may not benefit (for example, those without internet access).

Broadening this duty to shareholders of trustees and related parties would further complicate the application of the duty, introducing the possibility for conflicting interpretations of the subjective test. It could also create confusion around ultimate ownership of responsibility.

Rather than adding additional complexity to the best interests duty, the same policy goals can be achieved by enhancing conflict management frameworks with additional regulatory guidance and direction (see section 2).

Sole purpose test

The sole purpose test has the practical effect of limiting the scope of activities the trustee can undertake using members' money.

This is an objective test, unlike the best interests duty, and requires trustees to use member money only for the purpose of providing benefits to members.

As noted by Counsel Assisting, there are questions regarding whether some activities currently undertaken by trustees meet this test.

Trustees should be able to show that the benefit to members from any advertising activity, including advertising of particular funds, a sector of funds, or political advertising, directly outweighs the cost. In theory, advertising may create a benefit to existing members. For example:

- existing members gaining more benefit from their existing fund (including through improved understanding of their fund), and
- advertising resulting in more members, which may in turn reduce costs to existing members.

[6] Pamela Hanrahan, Background Paper 25

It is difficult to see how political advertising meets the sole purpose test in most circumstances, particularly where the connection to the interests of members is weak and unquantifiable.

More broadly, any payment that directly supports any form of political activity should be carefully considered in terms of compliance with the duties of the trustee and adherence to conflict frameworks.

The FSC considers APRA should provide additional guidance on this issue, discuss this issue in detail with funds that do advertise or spend monies in support of political activity, and take necessary enforcement action in relation to funds that are not complying with the law.

2. MANAGING CONFLICTS IN SUPERANNUATION

2.1 The existing framework

Participants in the financial services industry are required to be licensed, and as a requirement of that licensing, are required by legislation and regulatory direction to identify and manage conflicts of interest. Fiduciary duty is a major reason why conflicts of interest frameworks are regulated and implemented.

Trustees are considered fiduciaries at law. All trustees of APRA regulated funds are required to be licenced as registrable superannuation entities (RSE). RSE Licensees are specifically required to adhere to the APRA Prudential Standard SPS 521 and Section 912A(1)(aa) of the Corporations Act where conflicts of interest are required to be managed.

Both APRA and ASIC have Practice and Regulatory Guides respectively detail requirements around conflicts of interest management. ASIC has also released discussion papers detailing specific case studies explaining how they expect conflicts to be managed in certain scenarios.[7]

As a result, each organisation in the financial services industry, as part of their risk management and compliance framework, should have a conflicts of interest policy, code of ethics, or similar document outlining how they manage risks. This document will be approved by the trustee board, particularly as required by SPS 521.

We support measures to ensure that governance standards are consistently high across the industry.

Notwithstanding this, the closing submissions made in respect of Round 5 of the Royal Commission hearings have raised concerns as to adequacy of conflict management in some organisations.

To address these issues, current conflict management frameworks could be strengthened through:

- evolving regulatory guidance on managing conflicts of interest, in particular to provide more detail or regulatory views as to “best practice” relating to compliance expectations;
- better alignment of interests and resultant incentive structures within firms to ensure members’ primacy; and
- better enforcement of conflicts management frameworks by regulators.

2.2 Enhancing the regulatory framework

Conflicts of interest frameworks appear within the regulatory landscape in many developed markets, including the UK, US and Canada. While many of these frameworks require that conflicts are to be first identified, and then avoided, managed or disclosed as appropriate, they are generally more detailed than those governed by Australian regulators.

[7] See http://download.asic.gov.au/media/1327370/Conflicts_discussion_paper_April_2006.pdf

- In the UK, both the Financial Conduct Authority and The Pensions Regulator have detailed guidance on conflicts management. The Pensions Regulator in particular outlines a process for identifying conflicts and declaring them.
- In the USA, according to the Securities and Exchange Commission (SEC), the purpose for enacting the Investment Advisers Act of 1940 was to "eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously *or unconsciously* — to render advice which was not disinterested"[8]. In addition, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and in the pensions landscape the ERISA Act were all enacted to address conflicts management of industry participants. In addition, self-regulatory bodies like FINRA have enacted and enforced their own conflicts of interest management framework.
- After extensive review and collaboration, the Canadian Securities Administrators recently introduced their Client Relationship Model regulatory framework to the industry. The model is underpinned by the notion that all client and finance industry participant interaction is to be adequately explained and disclosed, with a significant portion of this dedicated to implementing a conflicts of interest framework beyond simply disclosing conflicts.

Without necessarily implementing new legislative requirements, practical guidance around conflicts of interest management needs to be enhanced in the Australian regulatory landscape. Regulators offering practical examples of "adequate arrangements" tailored to specific situations would be most beneficial to assist industry participants in managing conflicts.

Regulatory guidance needs to be routinely reviewed and updated in response to changing markets, consumer expectations and identified systemic issues.

More detail on regulatory expectations of industry participants would assist financial service providers in better understanding the practical nature of their obligations. At law currently, financial services licensees are required to have "adequate arrangements to manage " conflicts[9]. This is a rule that properly recognizes that conflicts of interest are inherent in a system that permits and encourages private sector management of superannuation schemes as the most innovative, competitive and efficient alternative to a government managed system.

Once industry participants have more meaningful regulatory guidance and best practice regulatory advice to draw on, they will be better able to create tailored organisational policies and procedures which are implementable and sustainable.

2.3 Improving alignment of interests within organisations

Effective conflicts management should ensure that all parties are working explicitly toward aligning broad stakeholder interests with member interests.

ASIC, in its *Regulatory Guide 181*, explains that Licensees should ensure that their internal structures and reporting lines and even physical layouts enable them to effectively manage conflicts of interest.

There needs to be further guidance provided to financial services firms to help them understand what practical steps they can take to ensure that RSE Licensees are adequately empowered and incentivised to make decisions solely for members.

[8] See Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement's Speech entitled "Conflicts, conflicts everywhere" to the 17th Annual IA Compliance Conference, on 26 February 2015.
[9] See Michelle Levy, *Unravelled: conflicts of interest and the duty to manage them*, 9 August 2016 https://www.allens.com.au/pubs/fsr/160809-unravelled-02.htm

2.4 Regulation and enforcement

The Australian financial system regulation framework adopts the "twin peaks" model of a prudential regulator in APRA, and a markets and conduct regulator in ASIC. Since the global financial crisis, the twin peaks model of regulation is widely regarded as being effective in ensuring stability of the financial system. It is considered superior to other models that either focus on a single regulator, or one where multiple individual entities exist but do not coordinate activities.

The "twin peaks" model

There is a significant amount of academic literature on the effectiveness of the twin peaks model, as well as the flaws such a model can bring.[10] Most of that literature focuses on the model as it relates to banking and broader aspects of financial stability, without specific regard to the unique situation that superannuation regulation presents in Australia.

When considering APRA's role as a prudential regulator, it is important to note what prudential regulation is. The Wallis Inquiry, which gave rise to the adoption of the twin peaks model, explained prudential regulation as being the regulation for safety purposes and of regulating "intense financial promises". Financial promises as defined by Wallis generally exist "among those products and services which incorporate risk, including the risk that the promise will not be kept".

While the general notion of what a financial promise is measures true for banking, insurance and defined benefit superannuation, it is important to note that unlike many other pension systems in developed economies, over 95% of the Australian superannuation environment is defined contribution. The major difference here is that there is no financial promise to the member, as the member bears the investment risk.[11] Traditional prudential regulation does not adequately regulate for members in such an environment and is also the reason that managed investment schemes in general do not come under prudential regulation. In an environment where retirement savings are mandated by law, it is of paramount importance that prudential oversight is stronger than if savings were voluntary.

At the other end of the twin peaks model, ASIC is a markets and conduct regulator and it also protects consumers of financial products. This is a wide remit that covers both the regulation of financial markets structure, behaviour and integrity at a macro level, but also the licensing and conduct of individuals, directors, listed and unlisted companies and other entities, both in financial services and beyond.

ASIC is not expressly charged with protecting retirement savings of members and does not treat superannuation any differently to any other financial product as recognised by Corporations Law.

Role clarity for regulators

The scandals of HIH and Trio Capital in recent decades have already given rise to questions on overlap and the respective roles of each regulator.

The memorandum of understanding that exists between ASIC and APRA is generally high level and outcomes focused. It doesn't contemplate practical ideas on the actual nature of the cooperation between the two regulators.

The Council of Financial Regulators, which attempts to facilitate cooperation and collaboration between all the regulators, seems to focus on broader financial market stability, and not specifically superannuation.

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[10] See more recently *Godwin, Andrew and Kourabas, Steve and Ramsay, Ian, Twin Peaks and Financial Regulation: The Challenges of Increasing Regulatory Overlap and Expanding Responsibilities (December 23, 2016). The International Lawyer, Vol. 49, No. 3, pp. 273-297, 2016. Available at SSRN: https://ssrn.com/abstract=2889536*

[11] Wallis does note that "Financial arrangements which take the form of trust relationships also involve promises - promises to manage assets in the best interests of beneficiaries", however much more air time is given to the financial promises that exist in other areas such as banking and insurance.

It is worth noting that both the Super System Review and the Financial Services Inquiry (FSI) suggested changes to the regulator model.

The Super System Review recommended specific actions such as:

- A memorandum of understanding specifically for superannuation
- An "operational merger" of the superannuation capabilities at both regulators, which may or may not include co-locating them.
- Delegation of powers between staff of both agencies

The FSI, meanwhile, identified weaknesses in funding arrangements and enforcement tools for each of the regulators, particularly ASIC, and recommended more generally that the government ensured "regulators have the funding, skills and regulatory tools to deliver their mandates effectively".

Further consideration should be given to determining the best approach to ensure regulators with responsibility for the superannuation sector are able to effectively fulfil their responsibilities.

2.5 Managing conflicts across business structures

There has been considerable focus on the impact of certain business structures on the superannuation environment.

Counsel Assisting's closing submissions indicate that certain business structures lend themselves to inherent conflicts of interest. In particular, vertically integrated structures, where multiple lines of business exist within a company to provide products and services along the entire supply chain, have been suggested to be to raise inherent problems for trustees in meeting their fiduciary duties.

Vertical integration exists in most industries. Available evidence does not show that vertically integrated structures inherently result in adverse outcomes for members. Vertical integration is part of multiple types of business models within the Australian financial services sector, including profit making commercial enterprises and profit for member models.

Businesses that provide more than one product or service in the financial services value chain (regardless of whether they are vertically integrated or not) provide benefits to customers by reducing costs, ensuring supply and improving coordination of products and services.

It is important to note that underlying business structures are not the source of misconduct. Regardless of the business model within which a superannuation fund operates, it is the culture and the management of the conflicts of interest at any business, which will dictate whether members' needs are being put first.

Specific areas that require heightened focus for vertically integrated business structures include:

- related party transactions processes e.g. independent benchmarking of services;
- realigning incentive structures through the value chain, such as commissions; and
- improved disclosure of corporate relationships so that members understand who is providing their products and services.

3. SYSTEMIC AND STRUCTURAL ISSUES

3.1 Enhancing MySuper

MySuper products are designed for disengaged consumers. In a compulsory system, it is important to provide stronger consumer protections for these individuals in default products who do not make an active choice of fund. As proposed by the current legislative changes, the outcomes of default members should result in higher standards for MySuper products.

The FSC supports raising the bar for MySuper products through an improved member outcomes test under Section 29VN of the SIS Act, as proposed in the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017*. This Bill has been before the Senate since November 2017.

We also note that APRA is currently strengthening its prudential standards to include a similar member outcomes test under SPS 225. The FSC supports this process.

Collectively these measures should improve consumer protection by ensuring that both MySuper and choice products and continually assessed with the objective of continuous quality improvement.

Member outcomes testing complements APRA's prudential role and priorities. For example, a more stringent MySuper authorisation process could drive industry consolidation through the merger of underperforming funds.

Under the proposed changes, APRA would have an obligation to work collaboratively with a trustee to improve outcomes if they demonstrate underperformance against any of the criteria. APRA would also have the authority to cancel a MySuper authorisation where a trustee fails to improve performance.

It is vital that APRA has appropriate powers to take action in relation to trustees who are unwilling or unable to act in the best interest of their members, particularly in the case of MySuper products where members may have ceded their decisions to the trustee.

3.2 Improving default fund selection

Addressing account proliferation

The FSC supports the measures aimed at reducing the number of duplicate, inactive and low-balance accounts already in the system.

This includes the Protecting Your Super measures in the 2018 Federal Budget, which closely reflect draft recommendations in the Productivity Commission's recent *Superannuation: Assessing Efficiency and Competitiveness* Draft Report.

Untying default superannuation from the employment relationship would also significantly reduce the account proliferation noted by Counsel Assisting in question 23.

In practical terms, the Single Touch Payroll employee onboarding system for new employees, currently being developed by the ATO, is the best mechanism to introduce a 'stapling' mechanism.

When an individual changes employer, they should be invited to specify whether they wish to transfer their superannuation benefits to another fund. Where a member does not choose a new fund, default contributions should continue to be made to the member's existing account. This differs from current arrangements, where not making an active choice would result in the creation of a new account for default contributions.

The FSC also supports further consideration of the Productivity Commission's recommendations for reforming the default superannuation market, to better understand the consumer benefits of 'stapling' and alternate models for the allocation of default customers to MySuper products.

Conflicts in default fund selection

Inherent conflicts in the current default system arise through the current Fair Work Commission (FWC) process for selecting default funds in Modern Awards.

The current process allows trade unions and employers, but not superannuation funds themselves, to appear before the FWC to make submissions on which MySuper products should be listed in each award. This raises concerns when unions and employer associations with connections to a particular fund advocate for that same fund to be listed in an Award.

A more competitive default selection process, particularly with enhanced MySuper products as per section 3.1 above, would improve outcomes for default consumers by increasing scrutiny on trustees in the default market and ensuring they were constantly focused on member outcomes.

Prohibitions on choice of fund

The current default system also allows enterprise agreements to prohibit choice of fund. This means that individuals subject to a particular enterprise agreement may only have their superannuation contributions paid into a nominated fund, even if they have another fund they would prefer to contribute to.

This exacerbates the conflicts noted above, as the stakes are extremely high: the decision by employers and unions determines the super fund for all employees, regardless of the employee's preferred super fund. It also increases the likelihood for duplicate accounts. Stapling or defaulting only once cannot work while choice of fund is prohibited for some individuals.

Legislation has been introduced to Parliament to ensure all employees have choice of fund. The FSC supports the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 2) Bill 2017* which has been before the Senate since November 2017.

4. POLICY QUESTIONS

Advertising

1. Is political advertising consistent with the intention behind section 62 of the SIS Act? Is any amendment to the SIS Act warranted, and if so, why?

2. Is there identifiable detriment to consumers from advertising by super funds or particular advertising (such as Fox and Henhouse)? Is there identifiable benefit to consumers from advertising by super funds or particular advertising?

Like any use of member funds, political advertising paid for by trustees should be subject to the sole purpose test and best interests duty (see section 1.3). It is difficult to see how political advertising meets the sole purpose test in most circumstances, particularly where the connection to the interests of members is weak and unquantifiable.

Trustees should be able to show that the benefit to members from any advertising activity, including advertising of particular funds, a sector of funds, or political advertising, directly outweighs the cost. In theory, advertising may create a benefit to existing members. For example:

- existing members gaining more benefit from their existing fund (including through improved understanding of their fund); and
- advertising resulting in more members, which may in turn reduce costs to existing members.

More broadly, any payment that directly supports any form of political activity should be carefully considered in terms of compliance with the duties of the trustee and adherence to conflict frameworks.

Additional regulator guidance on this point would be welcomed.

Section 68A of the SIS Act

3. Is it appropriate, as a response to conduct of superannuation trustees that seeks to induce employers to select funds, or affect their decisions as to default funds, to make alterations to section 68A of the SIS Act to widen the prohibition?

4. How wide should the prohibition be – should it extend to prohibiting providing benefits to employers for the purpose or with the intention of inducing the selection of the fund as the default fund for employees, or affecting the decision, or being likely to induce or affect?

5. Are there matters of principle that would justify such a change? Are there problems that would arise in the application of the law?

ASIC already provides explicit guidance for employers that states "Inducements may cover a range of things including corporate hospitality and tickets to sporting events…Many of these inducements are prohibited under s68A of the Superannuation Industry (Supervision) Act 1993."[12]

Additional guidance around expectations for funds offering entertainment and gifts may be useful.

However, we note that only individual consumers can take action in relation to potential breaches of s68A. If benefits provided to employers are resulting in poor outcomes for members, additional regulator powers should be granted to undertake direct enforcement action.

Untying default superannuation arrangements from employment (see section 3.1) would make these issues less relevant, as it would place the onus on funds to engage members, in contrast to the

[12] 16-038MR ASIC guidance to employers about super https://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-038mr-asic-guidance-to-employers-about-super/

current system of disengaged members creating new default accounts. This would encourage employers to choose funds with their employees in mind, rather than being influenced by relationships or hospitality.

Payments from external responsible entities of managed investment schemes

6. Is it appropriate for the trustee of a superannuation funds to retain payments from the responsible entity of a managed investment scheme where that payment is derived from the investment of members' money?

The FSC believes the superannuation fund trustees should use funds received from the RE of a managed investment scheme for the benefit of members.

This may include rebating fees directly to member accounts or using the funds for other services which meet the sole purpose test and best interest duty.

Selling of superannuation

7. Is it appropriate that superannuation be sold through bank branches? Is it reasonable to think that there is any prospect that this is likely to produce an outcome that is in the best interests of consumers?

8. Are there statutory reforms that are required to address this problem (if it is a problem) or are the existing laws with respect to personal financial advice and general financial advice sufficient? What is the nature of the "advice" that a customer of a bank receives when told by a bank branch staff member about the availability of a superannuation product offered by a bank?

While instances of poor consumer outcomes have been identified where superannuation is "sold" through bank branches, the FSC does not believe there is anything inherent to a bank branch that prevents the sale from meeting the best interests of consumers.

Superannuation products can be generally made available to consumers without them receiving financial advice. However if a superannuation product is actively sold, it must be done through someone authorised to provide advice.

Instead, broader analysis is required of "selling" of superannuation wherever it occurs.

Any situation where an individual is "sold" a superannuation product without appropriate, licensed advice, whether this is in a bank branch or through an employer or union official at their place of employment, should be examined to ensure conflicts are appropriately managed and appropriate consideration is given to the interests of consumers and requirements of FoFA.

Engagement by superannuation funds with Aboriginal and Torres Strait Islander people

9. Are the identification procedures used by superannuation funds appropriate for their Aboriginal and Torres Strait Islander members?

(i) If those procedures are appropriate, are those identification procedures sufficiently understood and implemented by staff on the ground?

(ii) If those procedures are not appropriate, what should be changed?

The FSC has previously worked with First Nations Foundation to improve AUSTRAC's guidelines in order to allow members to use more appropriate identification processes when engaging with Aboriginal and Torres Strait Islander members.

We are aware that implementation of these processes could be improved to ensure all customers are able to comply with identification procedures. The FSC will work with our members to support these improvements.

10. Should superannuation funds be required to record whether their members identify as Aboriginal or Torres Strait Islander people?

The FSC and its members have some concerns about accurately and consistently capturing this data if it is voluntarily provided by members.

The FSC and its members will work with relevant stakeholders to determine whether there is a better approach to capturing and utilising meaningful data to improve outcomes for Aboriginal and Torres Strait Islander members. We note the Productivity Commission has recommended a whole of industry approach to improving the data collection and use relating to the superannuation industry.[13]

11. Should those superannuation funds who do not currently permit the early release of superannuation on the basis of severe financial hardship do so?

Superannuation benefits should generally be preserved to provide income in retirement. Early access to superannuation for other purposes is inconsistent with the preservation principle.

However, there will be circumstances where the benefits of early access to superannuation for an individual will exceed the benefits of preserving balances until retirement, such as in cases of genuine financial hardship.

In these cases, the FSC supports early release of superannuation funds.

The rules for early release should be able to be administered fairly and effectively.

One approach would be for the government (or an agency of government such as the Department of Human Services) to process assessment of hardship claims, as it already does for releases on compassionate grounds.

We note the Government has been conducting a review of the rules for early release of superannuation, covering a wide range of issues including many relating to financial hardship.

12. Should the lower life expectancy of Aboriginal and Torres Strait Islander people be taken into account in the decision-making processes of superannuation funds when considering how to administer or release the funds of Aboriginal and Torres Strait Islander people? If so, how?

There is currently a lack of flexibility in the legislation governing superannuation, which makes it difficult for trustees to choose to administer benefits or release funds differently based on an individual or cohort's life expectancy (with limited exceptions such as terminal illness benefits).

This lack of consideration disproportionately impacts Aboriginal and Torres Strait Islander people.

Further work should be undertaken to determine the best approach to improving superannuation and retirement outcomes for Aboriginal and Torres Strait Islander people including retirement income outcomes, which could align with the current policies in place designed to improve life expectancy for indigenous Australians.

If there is a change in relation to this issue, there is an argument that the Government (or agency of Government) should complete assessment of claims to ensure consistency of approach.

[13] Draft Recommendation 22 in Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness Draft Report*.

13. Should the categories of person permitted by legislation to be the subject of a binding nomination be changed to reflect Aboriginal and Torres Strait Islander kinship structures? If so, how should the categories be broadened?

The FSC supports this proposal.

Appropriate consultation should be undertaken to develop the updated categories.

Discretion to appoint and remove directors

14. Is it appropriate for shareholders of RSE Licensees to retain a broad discretion to appoint and remove directors? Or should there be an obligation imposed on shareholders to exercise such powers in the best interests of the members?

In practice, the best interests of members are served when appropriate governance and conflict management processes are in place to guide the appointment process. This helps to ensure shareholders are making appropriate board appointments with sufficient skills and experience to fulfil their duties.

The FSC notes that APRA's Prudential Standard SPS 510 requires all RSEs to have in place "a governance framework which includes, at a minimum, the Board's charter (or equivalent document) and policies and processes that achieve appropriate skills, structure and composition of the Board."[14]

The FSC's Standard 20 imposes further requirements for independent directors on trustee boards of our member companies.

Where effective governance and conflict management frameworks are present, it should not be necessary to formally extend the best interest duty to shareholders.

Relationship between trustees and financial advisers

15. Are legislative interventions to remove grandfathered commissions and ongoing service fees from superannuation accounts appropriate? If so, why? If not, why not?

16. Are there possible detrimental effects on the provision of high quality financial advice by such changes? If it is said that there are such detrimental effects, then the detriments and the reasons for the detriments should be precisely identified. For example, if it is said that it is unlikely that consumers will be willing to pay for the true value of financial advice then, amongst other things, it ought to be explained how the "true value" of financial advice is to be determined, why consumers will pay for the true value of other services but not for financial advice and why it is not sufficient to allow consumers to make an informed choice as to the specific price that is to be paid for a specific service.

Grandfathered commissions

The FSC notes that some of its members have ceased paying grandfathered commissions to their employed adviser network.

Many AFSL holders have contractual arrangements which legally oblige them to pay grandfathered commissions to unrelated third parties (such as aligned or external advisers and lenders).

[14] Prudential Standard SPS 510 https://www.legislation.gov.au/Details/F2016L01707

If the Commission chooses to recommend the removal of grandfathered commissions, careful consideration should be given to an appropriate mechanism and transition timetable. This should be the subject of specific consultation.

The FSC intends to make further comment on this issue in its submission to the Interim Report.

Ongoing service fees

It is appropriate for financial advice relating to superannuation to be paid from superannuation balances.

If advice funded from superannuation accounts was prohibited, fund members would need to meet the costs of superannuation financial advice out of pocket. In addition to upfront payments making advice less accessible for many individuals, this would also be likely to increase the costs of advice, as the tax advantage for advice paid from superannuation funds would be lost. Scale economies resulting from advice provided by funds may also be lost.

Where funds and licensees can show that providing an ongoing service arrangement (OSA) is consistent with the best interest duty, the OSA should not be prohibited. Superannuation trustees should have robust controls and monitoring in place to ensure such fees are discontinued where the trustee is made aware that the service is no longer being provided (such as where a member opts out of advice or the Trustee is notified of the death of a member).

Legislative protections introduced as part of the Future of Financial Advice reforms are also designed to ensure transparency and safeguard consumer outcomes. These include the obligation on advisers to ensure clients 'opt-in' every two years, and annual provision of a Fee Disclosure Statement.

If regulators have concerns that funds or advice licensees are not complying with their legal obligations including the best interests duty or sole purpose test in relation to advice funded from super accounts, then they may take appropriate action.

The FSC intends to make further comment on this issue in its submission to the Interim Report.

Managing conflicts

17. Are there structures that raise inherent problems for a superannuation trustee being able to comply with its fiduciary duties. For example, where a trustee is a dual-regulated entity, that would seem to raise an inherent conflict of interest, or the potential of a conflict of interest. Are there other structures such as investment of funds in insurance policies issued by related party insurers or the integration of a superannuation trustee into an advice business that also raise inherent problems? Is it possible to say that these conflicts are ever manageable?

18. If certain structures do raise inherent problems, is structural change of entities, mandated by legislation or otherwise, something that is desirable?

The FSC does not see any evidence that a particular structure has inherent conflicts that are unable to be managed. See section 2.

There are a range of different possible structures for different superannuation funds, some of which are vertically integrated financial institutions, and others that are stand-alone businesses that do not have related parties. The common factor to each of these businesses is that they compete with one another for market share.

Provided conflicts can be identified and appropriately managed and the market remains competitive, the FSC does not support mandated structural changes to entities.

The FSC and its members welcome additional scrutiny to ensure that members are being prioritised by their superannuation fund, whatever the structure of the business, and to ensure conflicts of interest are managed in a way that puts members first.

19. Would it be preferable to extend the obligation to act in the best interests of members of a superannuation fund so that:

(i) contravention of the obligation attracts a civil penalty; and

(ii) the obligation (and the civil penalty for breach) extends to shareholders of trustees and any related bodies corporate (within the meaning of the *Corporations Act*) of the trustee in respect of any conduct that will affect the interests of the members of the superannuation fund?

20. Are there unforeseen consequences of such a legislative intervention that would make it undesirable to strengthen the SIS Act in this way?

The FSC supports enhanced director penalties for failure to act in the best interests of members, as contained in the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017.*

However, extending the best interest duty to shareholders of trustees and related bodies corporate could create unnecessary complexity, and it is not clear how this would be administered or enforced.

Conflicts that exist within a corporate group or entities owned by beneficiaries of the trustee, can be managed by the trustee without expanding the best interests duty. Methods for managing these conflicts may include engaging related parties on arm's length terms, having processes in place for review of these arrangements, and effectively monitoring the performance of related party suppliers. APRA, in May 2018 provided guidance on conflict management in relation to outsourcing, the impacts of which have yet to be measured but reflect practical guidance on this aspect of conflicts management.

It is also not clear that this approach would lead to better outcomes for members. Extending best interest duties may stall decision-making within organisations, so that a change which would benefit many members is not made because of concerns that it could negatively impact a small group of members (see Section 1.3).

System changes

21. Is one way of addressing and discouraging misconduct on the part of superannuation trustees to seek to encourage improvements to outcomes for members whose contributions are made to MySuper products or is the link too tenuous to justify recommending any system changes to the default system?

The FSC considers that improving member outcomes for default (or MySuper) contributions will help address and discourage misconduct. An improved outcomes test will enhance trustees' focus on member outcomes; assisting the prevention of misconduct and addressing any misconduct that may occur.

The FSC recommends the Commission support the passage of the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017* which has been before the Senate for some time (see Section 3.1).

The FSC also supports measures to increase competition in the default system, which would subject increase scrutiny of trustees. The current default system, based on default funds being approved by

the Fair Work Commission (FWC), raises conflicts of interest that may exacerbate potential misconduct (see section 3.2).

22. Is it appropriate, as a response to misconduct of superannuation trustees, to apply an additional filter to MySuper authorisations so as to require outcome assessments? If so, what are the general parameters for such a system change and who is appropriate to apply the test?

The FSC agrees with this approach.

The FSC supports the proposal of outcomes assessments for MySuper products as set out in the current Bill (referred to in 24) as an important mechanism to ensure trustees have clear direction in acting in members' best interests when the members have defaulted their decisions to the trustee. Further, this may have other beneficial impacts such as driving consolidation.

The FSC considers the existing APRA administrative filter for MySuper authorisation should be amended to become a multifactor 'member outcomes' assessment.

The details of the FSC's proposed approach is in Section 3.1.

23. Is it appropriate, as a response to the conduct of superannuation trustees that might inhibit the consolidation of multiple superannuation accounts of a person, to introduce some form of "stapling" so that a person's account for receipt of default contributions is linked to the person and travels with the person when she or he changes job? Is this is a practical method of addressing this type of conduct noting that it is not suggested to be misconduct?

Untying default superannuation from the employment relationship would significantly reduce the account proliferation noted by Counsel Assisting.

In practical terms, the Single Touch Payroll employee onboarding system for new employees, currently being developed by the ATO, is the best mechanism to introduce a 'stapling' mechanism.

The FSC also supports further consideration of the Productivity Commission's recommendations for reforming the default superannuation market, to better understand the consumer benefits of 'stapling' and alternate models for the allocation of default customers to MySuper products.

See Section 3.2.

24. Are there other system changes that might be appropriately tailored responses to misconduct or conduct falling below community standards and expectations of superannuation trustees? If so, what are the general parameters for such a system change?

The FSC supports a number of reforms relating to product rationalisation and fund mergers. These reforms will help super trustees to act in the best interests of members and enable regulators to know when failure to act in best interest occurs. The FSC notes that there are several bills currently before the Senate that would introduce reforms beneficial to member outcomes. These include:

- Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018. The FSC supports the superannuation elements of this Bill, including the ban on exit fees, the consolidation of inactive low balance accounts, and the capping of fees on low balance accounts.
- Treasury Laws Amendment (2018 Measures No 4) Bill 2018 – which provides for additional powers in relation to non-payment of Super Guarantee and extends the operation of Single Touch Payroll.
- Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 – which provides for an annual MySuper outcomes assessment (see section 3.1), increased penalties for directors relating to best

interests test (see response to questions 19 and 20), strengthening APRA powers and requiring annual member meetings.

- Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 2) Bill 2017 – which provides for choice of fund for employees (see section3.2) and increases the integrity of SG in relation to salary sacrifice
- Treasury Laws Amendment (2018 Superannuation Measures No 1) Bill 2018 – provides for a one-off amnesty for the non-payment of super guarantee amounts.
- Superannuation Laws Amendment (Strengthening Trustee arrangements) Bill 2017, which would require one third independent trustees on superannuation boards.

The FSC supports passage of these bills as soon as possible.

Deterrence and insight

25. What can be done to encourage the regulators to act promptly on misconduct or potential misconduct?

26. Is the present allocation of regulatory roles appropriate to achieve specific and general deterrence from misconduct?

27. Given that what we are fundamentally concerned with is conduct that in subtle but ongoing ways negatively affects the retirement outcomes of consumers, are either of the regulators best placed to carry the responsibility to protect consumers should the balance between them be restructured or significantly altered?

The FSC believes that role clarity, transparency and appropriate resourcing are key to ensuring regulators can appropriately monitor the industry and manage instances of potential misconduct. See section 2.4.