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APRA

Memorandum

14 June 2017

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From:	Juliette Lee - Principal Analyst, SID Anthony Davies - Senior Manager, Resolution & Enforcement
Subject:	IOOF PRUDENTIAL REVIEW GOVERNANCE & CONFLICTS MANAGEMENT - OBSERVATIONS & CONCERNS

Purpose

The purpose of this memorandum is to inform internal APRA discussions relating to IOOF on matters concerning governance, conflicts management and culture.

Matters for consideration

Supervision and R&E request that, as part of any internal discussions in relation to the approach to be taken in response to the concerns raised by IOOF, you consider:

1. Whether the [current supervisory strategy](#) remains appropriate given ongoing prudential issues relating to Questor Financial Services Limited and in relation to the concerns that have been raised from the Prudential Review (detailed below).
2. Whether consideration of director fitness and propriety is warranted given the apparent unwillingness of IOOF directors, in particular the Chair of the Board, to recognise and address ongoing prudential issues arising from the recognition and management of conflicts of interest.

Background

Prudential review on governance and conflicts management

Supervision, together with Resolution & Enforcement (R&E), conducted a Prudential Review of the following APRA regulated entities (collectively 'IOOF') on 29 and 30 May 2017:

- I.O.O.F. Investment Management Limited;
- Questor Financial Services Limited;
- IOOF Ltd; and
- Australian Executor Trustees Limited.

The review focussed on the adequacy and effective implementation of the governance and conflicts management framework(s) for the above APRA-regulated entities.

It also incorporated APRA's thematic review work on Board Governance and Related Party arrangements. To this end, it considered elements of board governance, management and risk governance.

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The agenda for the meeting can be found [here](#).

Supervision assessment

Summary

Following the Prudential Review of IOOF, and from engagement on ongoing matters of prudential concern, both Supervision and R&E have identified a number of concerns regarding the IOOF's approach and culture towards governance and conflicts. These concerns stem from:

- The continuing poor culture towards conflicts management, specifically the ongoing refusal from the Board and senior management to appropriately identify and manage the conflicts of interest that arise from their dual role as an RSEL and RE and to recognise the impact a failure to manage those conflicts could have on superannuation members;
- The tone from the Board, in particular from the Chair of the Board, towards governance and conflicts management lacks both maturity and sufficient focus on members' best interests, with Supervision's assessment being that the Board is focussed on form over substance; and
- Policies and attitudes at IOOF that in APRA's view conflict with sections 52(3)(a) and 52A(3)(a) of the SIS Act, which require the entity to manage these conflicts by giving priority to the duties to and interests of the superannuation beneficiaries.

Core drivers of this assessment, which are explained in further detail below, are:

- The IOOF Board has a fundamental misunderstanding of its duty to prioritise the duties to and interests of superannuation fund members, in particular its duties under the SIS Act.
- IOOF view themselves as an "advice business" rather than a superannuation trustee business, and therefore lack adequate focus on members' best interests.
- IOOF do not see a clear nexus between themselves and the member when it comes to investments, and appear to be of the view that having an advisor between the Trustee and the member removes the conflict arising from IOOF products on RSE platforms.
- IOOF directors have difficulty identifying conflicts in arrangements with related parties.
- IOOF directors are at risk of abrogating their obligations on conflicts management via delegation to Committee without appropriate oversight.
- The IOOF Board does not view compliance and conflicts management as areas that matter.
- Conflicts management considerations are not adequately documented and the Board appears resistant to detailed documentation.

Detailed assessment

The culture of IOOF's board towards governance and conflicts management is poor. Directors have failed to demonstrate that they appropriately understand or accept the conflicts inherent in IOOF's business (arising from either corporate structure or business offering). Rather, it has been evident through discussions during the Prudential Review, and via engagement on ongoing areas of prudential concern, that the IOOF directors have a fundamental misunderstanding of their fiduciary duties to members.

Current frameworks and structures in place to manage conflicts are considered appropriate for IOOF's business mix, structure and complexity. However, Supervision is of the view that

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the structures that IOOF has in place will remain ineffectual until the understanding, attitude and culture of the Board shifts in response to conflicts.

Supervision's impression from discussions during the Prudential Review is that staff below senior management remain focussed on 'doing the right thing' and are attempting to implement and embed the Conflicts Management Framework. However, it is clear that these efforts may amount to limited change to the way in which IOOF actually approaches conflicts management due to the culture and tone from the Board.

Drivers of Supervision's assessment are:

- The IOOF Board has a fundamental misunderstanding of its duty to prioritise the duties to and interests of superannuation fund members.

IOOF has formulated a guide for directors on conflicts which includes the following position:

The obligation of the trustee and director under the SIS Act overrides any conflicting obligation the director or trustee has under Part 2D.1 of the Corporations Act, including the duty of care and diligence (s180) and duty of good faith (s181). This has been codified in section 52(3)(a) and 52A(3)(a) of the SIS Act. However, caution should be taken as Part 2D.1 is not the only source of directors' duties and the SIS Act does not expressly permit other obligations to be overridden.

Therefore the requirement to act only for the benefit of members should not operate to the exclusion of all others, for example, the directors' duties to the company at common law and in its capacity as responsible entity of registered managed investment schemes.

APRA disagrees with this position and initial internal discussions have indicated that the provision to give priority to the interests of superannuation fund members was included within the legislation to deal with this specific situation where an entity was both RSE of super fund and RE of another entity. In APRA's view, whilst an entity may have other duties that are not expressly overridden (e.g. duties as RE of a connected entity), sections 52(2)(d) and 52A(2)(d) require the entity to manage these conflicts by giving priority to the duties to and interests of the superannuation members.

At the prudential review, when this legislative requirement was discussed, the Chairman stated that IOOF could not consider the interests of superannuation members to the "exclusion of all others" and that they could not "ignore their fiduciaries." He highlighted that IOOF's advisor platform was a "unique offering" and stated that IOOF consider superannuation members "to the extent we have to."

IOOF's fundamental misunderstanding of the express duty in the SIS Act is of significant concern to Supervision, and may drive decision-making which does not prioritise the interests of superannuation members (as demonstrated in the 'Reason for Concerns' section below).

- IOOF view themselves as an "advice business" rather than a superannuation trustee business.

IOOF demonstrated during discussions that they see characterise themselves as an "advice business," with the Chairman stating that that the "core role of IOOF is to provide advice." Discussion during the Prudential Review indicated to APRA that IOOF is concerned with servicing advisors, and offering choice to advisors via their investment offering and platforms. There was limited focus of directors on superannuation members and whether the offering to superannuation members was appropriate or in their best interests.

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Furthermore, IOOF directors indicated that their core role is to ensure that the process is appropriate and being followed. The directors did not appear to consider circumstances where the process was followed but the quality or outcome of decision-making was not in the interests of superannuation or friendly society members.

- IOOF do not see a clear nexus between themselves and the member when it comes to investments.

At several stages during discussions IOOF directors noted that, as advisors provide advice to members and are "subject matter experts" responsible for directing member investment, it is the advisors and not IOOF that should consider members best interests.

Given that the investment of IOOF superannuation members' funds is "advisor directed," the directors could not see how IOOF were placed in a position of conflict if an advisor makes a decision to invest an IOOF superannuation member's funds into a product for which IOOF act as an RE.

IOOF also felt that their conflict of interests in respect of IOOF products being on an IOOF superannuation platform were managed by the products being independently rated by a rating agency.

In setting out this view, IOOF opined that APRA should be more concerned with what advice is being provided to members by advisors given this relates directly to members' best interests. This commentary suggests to Supervision that IOOF does not see a clear nexus between themselves as Trustee and their members.

In relation to their own funds, IOOF view themselves as a 'manager of managers', rather than as a superannuation trustee. This attitude is particularly concerning given I.O.O.F. Investment Management Limited (IIML) act as RSE licensee of the IOOF Portfolio Service Retirement Fund, which offers a number of superannuation investments, including a MySuper product.

- IOOF directors have difficulty identifying conflicts in arrangements with related parties.

The major issues contemplated from a conflicts management perspective by the Board were around the successor fund transfer process, for which they have completed a number over recent years, or future acquisitions where there may be common directorships. The IOOF Board did not see any conflicts in operating a dual role as RE and RSE licensee.

IOOF directors do not understand the conflict that needs to be managed when an entity (i.e. IIML) acts as both RE and RSE licensee, where the RSE licensee makes a decision to invest in an investment offered by itself as RE. Efforts were made by Supervision to explain how conflicts would arise in these circumstances but IOOF directors maintained that they did not see how this relationship/transaction could give rise to a conflict.

Furthermore, when questioned on the above from a MySuper context, IOOF management could not adequately explain how this conflict is managed. Supervision is of the view that this occurred because IOOF had not, at any stage, considered this to be a conflict.

In this respect, Supervision notes that IIML as RSE licensee of the IOOF Portfolio Service Retirement Fund offers the following investments for which it also acts as RE:

- IOOF Multimix Funds (9 funds) - includes the IOOF Balanced Investor Trust, IOOF's MySuper option; and
- IOOF MultiSeries Funds (4 funds).

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Each of the above investments then on-invest into products for which IIML is the investment manager. Using a rough calculation, IIML invests approximately 18.06% (or \$1.39bn) of the above funds in IOOF-related products. Whilst this is not a precise indication of superannuation assets invested in IOOF-related products (as the relevant data is not available), Supervision would expect that the percentage of superannuation assets invested would be similar to that at a whole of MIS level.

However, both IOOF directors and management were of the view that, as the advisor or the member was responsible for directing into which specific investments members' superannuation monies would be invested, there was no conflict for the IOOF Trustee to manage.

As a live example of this, the Product Investment Committee (PIC) of IIML made a decision on 8 November 2016 to add a number of Mosaic Funds (for which IIML is the RE) to the IOOF Pursuit Select investment menu and IOOF Employer Super investment menu, which are both investment menus of the RSE for which IIML is RSE Licensee. No conflicts were declared at this meeting and minutes of the PIC make no reference to any considerations relating to conflicts of interest or duty. Furthermore, Committee papers supporting this decision also do not contemplate any conflicts of interest or duty, or any steps to be taken to manage same.

- IOOF directors are at risk of abrogating their obligations on conflicts management via delegation to Committee without appropriate oversight.

The IOOF Trustee Board delegates decision-making on investments to be offered to superannuation and friendly society members to its PIC, and there is little evidence to indicate the oversight that the Board has over the PIC.

Supervision has noted that no conflicts were declared at a meetings of the PIC where there was a decision to add an IOOF-related investment to the IOOF superannuation investment platform.

Furthermore, the Board advised that its full consideration regarding conflicts is contained in both the minutes and papers to both Board and Committee meetings. However, the only level of reporting which the Board receives from the PIC is via meeting minutes (which is therefore not a full insight into the discussion and considerations that have occurred).

Rather, the Chair of the Board had suggested during discussions that if papers had already been seen by another committee and the decision had already been made, then the Board should "move on".

- The IOOF Board does not view compliance and conflicts management as areas that matter.

The Chair of the Board indicated on a number of occasions during discussion that the Board has previously wrestled with the split between the amount of time spent on compliance versus the time spend on "things that really matter", such as strategy. The Chair shared his view that he was of the view that conflicts management was "getting too much airplay" and that provided everyone has the right intention and the organisation has the right culture, "it doesn't matter if you tick every box".

- Conflicts management considerations are not adequately documented and the Board appears resistant to detailed documentation.

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IOOF Board and Board Committees do not adequately document their conflicts management consideration. When this was raised with directors during prudential review discussions, the Chair of the Board advised that he did not believe that it was appropriate to document full discussions of the Board within its minutes as this could get an organisation into trouble should litigation later arise.

Fitness and propriety

Since December 2015, APRA has identified a number of instances where IOOF have failed to adequately identify conflicts and either avoid or appropriately manage them. These instances have led to inappropriate outcomes for superannuation members. These instances include:

1. On 27 May 2015, following a breach that resulted in a loss to investors resulting from a failure to reinvest distributions in accordance with member instructions, both the Questor and IIML Boards resolved that non-superannuation members were to be compensated by IOOF, whereas superannuation members were to be compensated from their own monies via the Operational Risk Financial Reserve. IOOF responded to APRA's concerns regarding the use of the Operational Risk Financial Reserve by noting the commercial reality of running a large group of companies means that issues may not necessarily be realistically actionable or indeed require action in order for compensation to be made.
2. IOOF's failure to appropriately respond to the CMT over-distribution issue. In October 2015, IOOF chose to compensate affected superannuation members using the superannuation fund's general reserve, rather than pursuing the RE (also IOOF), and then in December 2016 refused to replenish the general reserve when made aware of APRA's concerns regarding their consideration of members' best interests.
3. IOOF's failure to consider conflicts when it made the decision to defer the transfer of Accrued Default Amounts to its MySuper product (IIML Board, 25 February 2015). Minutes state that directors declared that they did not have a conflict of interest in relation to any matter to be discussed in that meeting. There is no indication that the Board considered how the move to MySuper would alter the fee arrangements nor how it managed the potential conflict arising whereby the fee revenue earned by IOOF would reduce once the Accrued Default Amounts were transferred to MySuper.
4. On 10 February 2015, the Managing Director's made a decision to refuse an initial SFT request of the Optus Plan and agreed to allow members to be given choice of fund. The Optus plan was IOOF's largest employer plan and represented approximately \$750m in FUM. The loss of this FUM would have impacted on revenue to the IOOF group and would also have been reflected in ASX reporting to the industry as the loss of this quantum of FUM would wipe out all growth in FUM of that relevant financial year. Given Mr Kelaher's role as CEO and his own personal interest in IOOF as a shareholder, he was heavily conflicted and the Board should not have allowed him to act as the delegate to refuse the SFT request. Furthermore, there is no documentary evidence of the decision being made or the basis on which the decision was made (despite this being requested via formal notice).
5. On 8 November 2016, the PIC made a decision to add investments for which IIML is RE to the superannuation platform for which IIML is RSE Licensee. No conflicts were declared at the PIC meeting, nor were any conflicts contemplated in either the minutes or the papers.

Should similar issues to those set out above arise again, decisions regarding those issues are likely to be made or overseen by the Board. It is therefore vital in such an instance that the Board act in accordance with legislation and prudential standards to recognise any conflicts and appropriately manage them to ensure superannuation members' interests are prioritised.

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Given the board's assessment that IOOF's dual roles as both RSEL and RE do not present a conflict of interest, and given the Chair's dismissive attitude to compliance and risk management, APRA does not have confidence that when similar issues arise in the future between the RE and RSEL businesses, IOOF will recognise and manage the inherent conflict to ensure the interests of its superannuation members are prioritised. Consequently, we have concerns regarding the Board's fitness and propriety as superannuation trustees which we think APRA should further consider.