



UNSW  
SYDNEY

16 February 2022

[REDACTED]  
Executive Director  
Australian Prudential Regulation Authority

By email: [REDACTED]

Dear Ms [REDACTED]

**Consultation on SPS 530 Investment Governance**

Thank you for the opportunity to provide a submission in relation to *Superannuation Prudential Standard SPS 530 Investment Governance*.

**Preliminary**

By way of introduction, I am an Associate Professor in the School of Private and Commercial Law in the Faculty of Law and Justice at UNSW Sydney. 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. In the past decade I have consulted to a number of industry associations in the superannuation field, to RSE licensees and to The Treasury in matters related to the governance of superannuation entities.

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

I have a number of observations about SPS 530. For the most part they are not criticisms of what already appears in the re-draft of the instrument. Rather, they are inspired by what I regard as limitations in the scope of the instrument as re-drafted and its engagement with the current structure and operation of the superannuation system.

### 1. Differentiated operational models

SPS 530 implicitly assumes that RSE licensees conform to a single operating model (Model 1, below). Two other models (Models 2 and 3) have become important in the industry over the past fifteen years. The models are:

- Model 1: traditional member investment choice ('MIC'), in which there are a small number pre-packaged options and some narrower investment options from which members can build a bespoke strategy. Most industry and corporate funds conform to this model;
- Model 2: investment platforms, in which the trustee compiles a large list of alternative investment products to facilitate implementation of an investment strategy formulated by the member (or more commonly, the member's adviser). Large retail funds commonly conform to this model; and
- Model 3: 'trustee for hire', in which the trustee's role is circumscribed by the governing rules of the fund, and most key decisions are taken by an investment manager or fund distributor. Smaller retail funds commonly conform to this model.

By my estimates, approximately 52% of the industry (by assets under management) currently conforms to Model 1, 43% to Model 2 and 5% to Model 3.<sup>1</sup> Given that Model 1 represents only slightly more than 50% of the industry, it seems to me that SPS 530 must accommodate and engage constructively with the diverse issues arising from all three models.

I raise this here because, as I noted in a submission I made to the 2018 Post-implementation review of the Prudential Standards, some of the investment governance issues arising in these three models are quite distinct.<sup>2</sup> In particular, the hollowed-out role played by the trustee in respect of the second and third models undermines much of the substance of SPS 530. The most obvious example of this surrounds the requirement for the RSE licensee to formulate, review regularly and give effect to an investment strategy, pursuant to the covenant articulated in section 52(6). This requirement is ill-suited to Models 2 and 3 in which the RSE licensee has little practical control day-to-day over the way the investments are managed. Importantly, I am not recommending that RSE licensees using those second and third models be forced to demonstrate the level of involvement in investment governance necessarily present in Model 1. Rather, I believe it is desirable for the requirements imposed by a Prudential Standard to be tailored so that they are fit-for-purpose. In saying that, I recognise that the operating models chosen by RSE licensees are in part a response to the regulatory regime imposed upon them (it is an 'adaptive' system), so structures and practices would no doubt evolve in response to any finetuning of SPS 530 that APRA may undertake, however deft when introduced.

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<sup>1</sup> Based on analysis of APRA, *Annual fund-level superannuation statistics* (June 2021), Table 1.

<sup>2</sup> M Scott Donald, Submission to APRA's *Post-implementation review of APRA's superannuation prudential framework* (Sept 2018).

2. **In-house management of assets.** It has become increasingly common for RSE licensees to undertake some or all of the investment management tasks involved in the management of the fund's investment portfolio in-house. I have in the past recommended that APRA develop a Prudential Standard specifically in relation to the governance and other issues that arise in respect of in-house investment management to address the myriad of practical governance issues that arise when a RSE licensee undertakes investment itself.<sup>3</sup> There are, for instances, issues of conflicting interests, risk management, transparency and disclosure, fitness and propriety, and liquidity management that are peculiar to institutions which mix external and internal asset management capabilities. In the absence of a separate Prudential Standard for in-house management, in my opinion the issues catalysed by mixing in-house and outsourced investment management ought to be addressed specifically in SPS 530.

3. **Co-investment vehicles.** RSE licensees in both the industry and retail sectors routinely co-invest with other large scale investors (including entities from the same corporate group, in the case of retail RSE licensees) in unregistered managed investment schemes and other bespoke investment structures. These can be a very effective and efficient way to achieve certain types of investment exposures. They do however generate unique investment governance challenges. As with the in-house management of assets, SPS 530 would be enhanced if it engaged in a more tailored way with this important investment practice.

4. **Independent valuations.** The proposed changes to SPS 530 include changes to valuation policies and procedures. In my opinion, they do not go far enough. Like Accounting Standard AASB 1056 *Superannuation Entities*, SPS 530 leaves considerable discretion in relation to valuations.<sup>4</sup> Similarly, *Superannuation Prudential Guide SPG 531 Valuation* (November 2013) is not prescriptive on the actual methodology and process, nor is it directly enforceable. In light of that, I believe that SPS 530 ought to require that:

- All valuations ought to be derived from sources independent of the RSE licensee, related parties of the RSE licensee and the issuer of the interests in the investment.
- Where no active secondary market for the asset is available, each revaluation, including interim revaluations, ought to be formally signed off by independent experts because even interim valuations have 'real' effects - members make irrevocable transactions (switches, contributions and redemptions) on the basis of those valuations.

It is common to hear current valuation practices justified on the basis that the funds in question would miss out on access to the investments if these valuation requirements were imposed. With respect, that misses the point. If valuation processes are not present in respect of a potential investment, it cannot be prudent from a legal nor practical perspective for a trustee to use trust monies to purchase the investment because the information available for the trustee to consider in coming to its decision is not of a quality that can be relied upon.<sup>5</sup> It would in my opinion be preferable for APRA to head-off this problem by specifying some minimum standards in an unambiguous and enforceable form in SPS 530, rather than having to pursue sanctions and remedies after the event when problems occur.

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<sup>3</sup> Ibid. Also David Gallagher, Timothy Gapes, and Geoffrey Warren, 'In-House Asset Management in the Australian Superannuation Industry' (2017) 59 *Accounting and Finance* 615.

<sup>4</sup> AASB 1053 relies on AASB 13 (September 2011), and specifically on the concept of Level 3 inputs.

<sup>5</sup> This observation is not new, see M Scott Donald, 'Prudence under Pressure' (2010) 4 *Journal of Equity* 44.

5. **Abuse of the investment power.** It is long-standing practice that RSE licensees have employed trust assets to fund business operations, such as member benefit administration and financial advice, that they prefer not to house within the trust company. There is a disconcertingly long list of failures of such ventures, and the quantum of assets involved in a number of cases has been quite considerable. Moreover, in many cases the legal foundation for this practice is questionable, as the investment power granted to a trustee has to be used purely for the purpose of investing<sup>6</sup> and there is no other power in the deeds of many funds that would empower the RSE licensee to purchase, or inject capital into, such an asset. It seems to me that APRA ought to have a process to ensure that an RSE licensee's use of the investment power is not abused and is only applied to genuine acts of investment. Failing that, in circumstances where the RSE licensee is legitimately relying on an investment power granted by its deed to justify its purchase and funding of the enterprise, at the very least, it seems to me that APRA's Prudential Standard in relation to Investment Governance ought to ensure that the RSE licensee:

- maintains a level of governance oversight over such enterprises appropriate to an investment, and not treat the enterprise as simply a subsidiary of the RSE licensee;
- expressly incorporates the holding into its stated investment strategy; and
- ensures (consistent with the recommendation in relation to valuation above) that it has a reliable and independent basis for valuing the holding on an ongoing basis.

### Concluding Comments

APRA has a crucial role to play in regulating the superannuation industry in Australia. It does many things well and deserves its reputation as one of the foremost financial regulators globally. It clearly recognises the danger to industry innovation and efficiency of being overly prescriptive. I do however continue to believe that greater prescription is sometimes warranted. Moreover, it is crucial that prudential rules engage constructively with the actual industry processes and structures as those processes and structures evolve if SPS 530 is to have the traction it requires to be effective. I therefore encourage APRA to consider a more comprehensive review of SPS 530, including, but not necessarily limited to, the issues raised in this submission.

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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<sup>6</sup> The concept of investing is traditionally understood to be the 'laying out of money in anticipation of a profitable capital or income return'; *Cook v Medway Housing Society* [1997] STC 90.