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[redacted]
Financial Services Council

3 May 2021
By Email

Dear [redacted]

You have asked us to consider the following hypothetical scenarios that may arise for an RSE licensee:

1 Using operational reserves or trust assets to pay for customer remediation where the trustee(s) has acted unlawfully;

2 Using operational reserves or trust assets to pay for remediation where the trustee(s) have not acted unlawfully, but it is caused by an external factor, such as an ATO error during the early release scheme; and

3 Using operational reserves or trust assets to pay for insurance that indemnifies the trustee(s) for different types of conduct, both legitimate and unlawful conduct.

The regulatory regime applied to RSE licensees and their funds does not of itself provide a clear answer to the questions you ask. There is moreover only sparse case law specifically on the questions. Our answers are therefore derived from analysis of the interaction between the case law on trustees' rights of indemnity and exoneration generally, the SIS Act and Regulations, and the relevant Prudential Standards. How these would apply to any specific fund or any specific set of circumstances will depend crucially on the entirety of those circumstances. It is important to note however that in the context of the matters under consideration in this letter, the express provisions of the trust instrument may not be definitive of the legal position as there are both statutory and general law rules that cannot be excluded by the trust instrument.

Analysis of any specific set of circumstances must therefore have regard for a number of intersecting factors, including:

- Who caused the loss in respect of which remediation to members or ex-members is payable;
- The nature of the 'unlawful' conduct that gave rise to the loss; and
- The source of the money to be used for the remediation.

A detailed exegesis of these issues is contained in the Appendix attached to this letter. However, in summary we find:

1 Where the money comes from matters. For instance:

(a) It will be inappropriate to apply assets from specific reserves to customer remediation unless the purpose of those reserves specifically encompasses such payments;

(b) It may be appropriate to apply assets from the ORFR to customer remediation where the loss giving rise to the need for remediation is caused by the realisation specifically of an 'operational risk;

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(c) It may be appropriate to apply assets from a general reserve to customer remediation so long as unless the general purpose of those reserves is not inconsistent with such payments; and

(d) In some cases it will be inappropriate for an RSE licensee to apply trust assets that are not part of a reserve to customer remediation. In particular the RSE licensee must ensure that they deal fairly as between members.

2 When using assets of a reserve to pay compensation, a distinction must be made between the payment of compensation and the strategy employed by the RSE licensee to replenish the reserve once the compensation payments have been made.

3 Who caused the loss matters. For instance:

(a) An RSE licensee will not be entitled to be indemnified from trust assets for certain types of loss caused by that RSE licensee, and cannot apply trust assets (including those in reserves) in satisfaction of claims made against the trustee by members in respect of such losses. Crucially, the SIS Act influences which types of loss are indemnifiable; and

(b) Where the need for customer remediation derives from an actionable default by another party, it may be proper to pay for that remediation out of an appropriately purposed reserve. That said, the trustee will have an obligation to consider carefully and in good faith action against that party to recover the loss and thereby replenish the reserve. Although the RSE licensee may properly conclude on the circumstances before it that such action would not be in the best interest of members, an RSE licensee who does not expressly consider such action, or who exercises that discretion inappropriately, may find itself personally in breach and facing a liability to replenish the reserve personally.

4 The nature of the 'unlawful' conduct matters:

(a) Payments made to members to remediate losses resulting from breach by the RSE licensee of one or more of the statutory covenants in section 52 of the SIS Act is unlikely to be indemnifiable (on the current somewhat unsatisfactory nature of the law);

(b) Payments made to members to remediate losses resulting from criminal conduct on the part of the RSE licensee is not likely to be indemnifiable;

(c) Payments made to members to remediate losses resulting from a breach of trust that does not constitute a breach of a section 52 covenant may be indemnifiable; and

(d) Payments made to members to remediate losses resulting from conduct that is not a breach of a statutory covenant nor a criminal act, nor a breach of trust, may be indemnifiable so long as it is within power.

(e) The payment of premiums by the trustee out of trust assets for insurance against liabilities in respect of which a trustee would enjoy a right of indemnity is not prohibited under either the *SIS Act* nor the general law. The exception would be payments from a reserve allocated to a specific purpose (such as the ORFR) not accommodating such payments, which are prohibited.

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(f) The payment of premiums by the trustee out of trust assets for insurance against liabilities in respect of which a trustee would not enjoy a right of indemnity is not permitted. Such liabilities include, as Jago J made clear in *APRA v Keleher*, breaches of the statutory covenants.

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Appendix

The nature of customer remediation

We take 'remediation' here to refer to a requirement enforceable in court to make payments to identified individuals (typically current or former members) to compensate them for some loss suffered. The obligation to remediate could arise from a unilateral decision of the trustee, an enforceable undertaking entered into with a regulator or a decision of the court. It is to be distinguished from compensation paid to the fund (and hence benefitting current members generally).

Note unlawful conduct could give rise to other regulatory consequences, such as monetary penalties, which result in amounts being paid to the Commonwealth and are consequently not strictly 'remediation'. They are therefore not considered here.

The nature of 'unlawful' conduct

It is necessary to recognise that there are a variety of types of 'unlawful' conduct that could give rise to need for remediation. Examples are:

- Conduct by the trustee of the Registrable Superannuation Entity (**RSE licensee**) that is inconsistent with its duties under the trust instrument (as shaped by any exclusion of liability clauses) or the general law. These would include actions based on the section 52 covenants pursuant to section 55(3) of the Superannuation Industry (Supervision) Act 1993 (**SIS Act**) and are often termed 'breaches of trust.'
- Conduct by the RSE licensee that is inconsistent with a statutory obligation and is actionable directly by a member, such as civil actions pursuant to section 1014I of the Corporations Act 2001.
- Conduct by the RSE licensee that is inconsistent with a statutory obligation or rule and is actionable by the relevant regulator, but which would result in an order that the RSE pay compensation under section 215 of the SIS Act.

That is to say, it is not necessarily the case that an unlawful act will constitute a breach of trust, although often it will be possible to identify some taint of dishonesty, disloyalty or a deficiency in care on the part of the trustee that enabled the unlawful act to occur.

It is also important to recognise that a need for remediation may arise from conduct that was not strictly a breach of trust or otherwise unlawful, for instance where the event was arose from factors involving no deficiency on the part of the trustee or where the deficiency causing the loss is excused by a valid exoneration or exculpation clause.

The use of reserves

Summary

As a general principle, reserves are used as a source of money to replenish member accounts that have suffered some relevant loss. The RSE licensee then needs to deploy its strategy for replenishing the loss. In the first instance this is likely to be by recourse to the party responsible for causing the loss, directly or as a result of a claim against an insurance or guarantee arrangement.[1] Where that proves inadequate or unobtainable, it will typically be replenished be out of the fund's investment earnings over some period

[1] This is not to contend that a reserve such as the ORFR is only available if the other avenues for compensation are exhausted, as was unsuccessfully contended by the regulator in *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521.

into the future. This latter situation means that, in effect, the members bear the cost of the loss, albeit spread over time.

It is customary for RSE licensees to maintain a variety of reserves within their funds. The assets in those reserves can only be used for the purposes for which the reserve was established, although in some cases that purpose may be quite broad. Moreover, because the assets in the reserve are assets of the trust, familiar trust law and regulatory rules apply. Key amongst these are the duties of impartiality and loyalty imposed on the RSE licensee by the SIS Act.

Status of reserves

The assets held in a fund's reserve are trust assets[2] the value of which has not been allocated to individual member accounts. This nuanced status inspired Jago J in *APRA v Kelaher*[3] to find that the amounts held in reserve were not strictly "members' money" in the sense suggested by the regulator in its submissions in that case.[4] Notwithstanding that characterisation, her Honour was nevertheless clear that members hold an undivided equitable interests in the assets held in a reserve even though members can have no expectation of receiving those assets (other than when the trust comes to be terminated). As a consequence, the RSE licensee must comply with the obligations created by the covenants in section 52 of the SIS Act and by other provisions of the SIS Act in respect of those assets. The RSE licensee must also comply with any regulatory rules specific to reserves in the SIS Act, Superannuation Industry (Supervision) Regulations 1994 (**SIS Regulations**), the relevant Prudential Standards and with any general law rules (to the extent that those general law rules are able to apply concurrently with the SIS Act).

There is a second important corollary to be drawn from the judgment of Jago J. Her Honour did not accept APRA's submission that the RSE licensee had a strict duty to pursue the (related) parties responsible for the loss to trust assets. Rather, her Honour recognised that trustees must have regard to the likely costs and success of any litigation in making such a decision.[5] In so doing, she implicitly affirmed that an RSE licensee does have a duty to consider pursuing the party responsible for the loss, and that the reserve was merely a means of ensuring that the value of member accounts was not affected in the interim. Only where replenishment of the reserve from the party responsible for the loss (or from insurance) was insufficient[6] would the replenishment of the reserve by way of imposts against the returns credited to members in future years be acceptable. (Her Honour noted that the latter approach would effectively distribute the loss across different generations of member).

Use of assets held in different types of reserves

Reserves dedicated to a specific purpose

Section 115 of the SIS Act provides that RSE licensees can establish reserves within their funds for 'particular' purposes unless the fund's rules prohibit reserves for that purpose. This connection of a reserve to a specific purpose is echoed in APRA's approach. APRA expects to see a 'clear definition of the purpose, or purposes, of each reserve and the sources from which the reserve will be drawn or accumulated.'[7] This connection matters because, as a matter of trust law, amounts held in these types of reserves can only be applied by RSE licensees in a manner that is consistent with the

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2 *Ibid*, [119].

3 *Ibid*.

4 Ibid [119].

5 Ibid [124].

6 On the facts before her Honor, this was at least partly because of the exoneration clauses present in the service contracts negotiated by the RSE licensee; ibid [109].

7 APRA, *SPG 515 - Strategic and Business Planning* (August 2019), [60].

purpose of the relevant reserve. Use beyond those purposes would in the first instance be voidable at the instance of the beneficiaries as a fraud on the power.[8]

The Operational Financial Risk Reserve (ORFR)

APRA specifically requires that RSE Licensees maintain either capital or an Operational Financial Risk Reserve (ORFR) (or a combination) in order 'to address losses arising from operational risks that may affect registrable superannuation entities within its (sic) business operations.'[9] Operational risks are defined broadly in SPS 114 as 'the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.'[10] The definition 'includes legal risk but excludes strategic and reputational risk.'[11] The assets in the ORFR may only be used to meet an 'operational risk event' or to pay for the operation of the ORFR. An operational risk event is defined as an operational risk that has 'materialised and caused one or more beneficiaries in an RSE to sustain a loss, or to be deprived of a gain to which they otherwise would have been entitled, in relation to their benefits in that RSE.'[12] This definition notably excludes the possibility of insurance premiums being paid from this reserve, although, as noted below, such proscription may be moot.

General reserves

On its face, section 115 would not seem to authorise RSE Licensees to maintain general reserves. However, neither does it prohibit general reserves, leading to the conclusion that individual fund rules may provide for them so long as no other regulatory restrictions would thereby be infringed. The range of purposes to which such reserves might be applied would clearly be wider than those anticipated by section 115. That said, in *re VBN and APRA (No 5)*[13] the Administrative Appeals Tribunal found that the term 'reserves' in section 115 conveyed the notion of funds and assets being 'put aside to meet future contingencies and demands.' That description suggests that the catalyst for use of the reserve will be outside the normal operation of the fund, but it would be unwise to rely too heavily on that impression given the tribunal in that matter was considering the use of a 'Crediting Rate Reserve', the name of which demonstrates that the reserve was established for a defined purpose, which purpose was moreover an ongoing one (the smoothing of crediting rates over time).

Where the reserve is of a more general nature it may be more difficult to demonstrate that a particular use by the RSE licensee was proper (or not).

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8 *Re Courage Group Pension Scheme* [1987] 1 WLR 495; *Hillsdown Holdings plc v Pensions Ombudsman* [1997] 1 All ER 862.

9 APRA, *SPS 114 - Operational Risk Financial Requirement* (July 2013).

10 Ibid, [6].

11 Ibid.

12 Ibid, [7].

13 [2006] AATA 710 at [442-3].

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Relevance of the section 52 covenants and section 62

Both section 62 and the covenants in section 52(2) are expressed in terms that encompass decisions taken by an RSE licensee in respect of any reserves in the fund. These include the requirements to act with honestly[14] and with care and diligence,[15] to prioritise the interests of members[16] and to exercise all powers and perform all duties in the best interests of the beneficiaries.[17] Of particular relevance in the context of compensation is the requirement that the RSE licensee act fairly in dealing with classes of beneficiary and in dealing with beneficiaries within a class.[18] Although there has been no detailed judicial consideration of these provisions, it is likely that the older authorities relating to the trustee's duty of impartiality will be relevant. If compensation were to be paid only to certain members (and/or former members) from trust assets generally, or from a general reserve, the RSE licensee will have to ensure that such payments did not 'unfairly' impose the burden of the loss originally suffered by the recipients of the compensation on other members.

Right of indemnity

A trustee ordinarily enjoys a right of indemnity out of the assets of the trust for all expenses properly incurred in the administration of the trust. As a matter of principle, such expenses cannot include:

- Liabilities owed by the trustee for breach of trust;[19] and
- Paying for indemnity insurance for the trustee in circumstances where the trustee would not enjoy a right of indemnity for the liabilities covered by the insurance.

As such, even express provisions in a trust instrument purporting to permit indemnities for such liabilities cannot at general law enable the trustee to be relieved of liability for conduct that was not undertaken honestly and in good faith.[20]

Special rules in the superannuation context.

Section 56(1) of the SIS Act voids any provision in the governing rules of the fund that purports to preclude or limit an RSE licensee from being indemnified out of the assets of the fund. It is however subject to section 56(2) which voids any provision in the governing rules of the fund in so far as the provision purports to exempt the trustee from liability, or indemnify the RSE licensee out of trust assets, for:

- liability for a breach of trust where the RSE licensee acts dishonestly or intentionally or recklessly fails to exercise the degree of care and diligence required of it; or
- liability for certain nominated regulatory measures (the list of which was recently extended).[21]

For most funds, then, section 56(1) broadens dramatically the right of indemnity that would otherwise be enjoyed by the RSE licensee under the general law, only for section 56(2) to narrow that right somewhat. The combined effect of the expansion in section

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14 Section 52(2)(a), *SIS Act*.

15 Section 52(2)(b), *SIS Act*.

16 Section 52(2)(d), *SIS Act*.

17 Section 52(2)(c), *SIS Act*.

18 Section 52(2)(e) and (f), SIS Act. See also regulations 5.02(3) and 5.03(2) of the SIS Regulations.

19 Note conduct that would constitute a breach were it not for an exclusion or exculpation clause does not give rise to a liability, so losses flowing from such conduct would be indemnifiable.

20 *Armitage v Nurse* [1998] Ch 241.

21 *APRA v Keleher*, above n 1, [20].

56(1) and the narrowing in section 56(2) is overall to broaden the right of indemnity that pertains in the general law and, arguably, in state Trustee Acts.

Until *APRA v Keleher* it was therefore assumed that exoneration and indemnity clauses which did not purport to excuse or indemnify RSE licensees in the ways described by section 56(2) would be enforceable. However, in *APRA v Kelaher*, Jago J held that section 7 of the SIS Act has the effect of entrenching the section 52 covenants against erosion by section 56. That is to say, an RSE licensee will not enjoy a right of indemnity, or the benefit of an exclusion clause, in relation to breaches of those covenants.

Finally, we note that it is common for trust deeds in the superannuation context to include references that purport to subject provisions to compliance with other laws, including the SIS Act, state Trustee Acts and the general law, as a means of averting inadvertent invalidity. In this context, however, such a reference can have a perverse effect, imposing the strictest of the rules regarding indemnification on the trustee and thereby undermining the somewhat more permissive rule provided by section 56 of the SIS Act.