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## Financial Services Royal Commission

### Written Submissions of the Australian Prudential Regulation Authority (APRA)

#### Round 5: Superannuation - Policy and General Questions

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1. The Closing Submissions pose three General and Policy questions regarding APRA's role in responding to misconduct, or potential misconduct, by superannuation providers:

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

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*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 or should the balance between them be restructured or significantly altered?*

**825.25**

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

2. In summary, APRA's answers to these three questions are:

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The present allocation of regulatory roles does not require major redesign to achieve specific and general deterrence from misconduct. However, legislative changes to sharpen and better focus the prudential and conduct mandates of APRA and ASIC respectively would, in APRA's view, improve the effectiveness of the current regulatory structure. This would include expanded powers for ASIC, as the primary conduct regulator in the Australian regulatory architecture, to pursue and enforce conduct-

related matters in superannuation. For its own role, there is also a need to strengthen APRA's powers in some areas (including to regulate and enforce the best interests of members covenant and sole purpose test). APRA's regulatory and enforcement practices could also be revised to give greater weight to general deterrence.

#### **825.27**

In identifying the relevant persons as "consumers", the question potentially presupposes an answer in relation to regulatory responsibilities. In the superannuation sector, consumers are also fund members. APRA's view is that the general philosophy behind the allocation of prudential and conduct regulatory roles between APRA and ASIC remains broadly appropriate. Subject to improving its powers (as noted below), ASIC is best placed to have responsibility for consumer protection, as this is a central aspect of ASIC's role in relation to each of the superannuation, banking and insurance sectors. APRA is best placed to have responsibility for protecting the collective best interests of fund members. This is central to APRA's role as prudential regulator of (most of) the superannuation industry, and is consistent with APRA's role in protecting depositors and policyholders through its regulation of the banking and insurance sectors respectively. APRA and ASIC, focusing on their respective domains and working together, are well placed to undertake their respective responsibilities, although as noted below changes could be made to enhance the ability of both to do this effectively.

#### **825.25**

APRA does not accept the premise that it has not generally acted promptly on misconduct or potential misconduct. Consistent with APRA's principles-based prudential supervision approach, APRA exercises its supervisory judgement in determining its actions and response in relation to identified issues and concerns. Using this approach, APRA has taken a range of supervisory actions over many years to achieve appropriate prudential outcomes and enhanced outcomes for superannuation members. However, there are steps that could be taken to improve the ability of both APRA and ASIC to take prompt and effective action in cases of misconduct or potential misconduct, including:

- a) APRA giving greater weight to the strategic use of formal enforcement powers, and in particular litigation, to achieve general deterrence across the industry. In light of the issues raised in the course of the Commission, APRA is commencing a review

of its enforcement strategy and related procedures and internal governance structures regarding issue escalation and the use of formal enforcement powers in all the industries it regulates, including superannuation. APRA has also recently decided to split and realign its internal supervision and enforcement committees, to provide more focus on the escalation of prudential concerns through the enforcement process. Given its broader set of prudential responsibilities and the range of supervisory and enforcement tools that APRA has at its disposal as a supervision-led agency, APRA is not dependent on formal enforcement actions to achieve appropriate outcomes. Hence the use of formal enforcement action such as litigation is not likely to be the primary means through which APRA achieves its desired outcomes;

- b) Continuation of APRA's member outcomes work. This will increase the focus by trustees on assessing their fund offerings and performance based on a variety of metrics. APRA's expectation is that this will operate to drive improved offerings, performance and outcomes for members (collectively). By providing a more structured framework through which such judgements can be made, it will also better enable APRA to identify and take action in cases where trustees appear to be delivering poor outcomes for their members, continuing the work already undertaken by APRA in this regard over 2017 and 2018;
  - c) Empowering APRA to direct superannuation entities to take action to address identified concerns before serious breaches arise, and to intervene in relation to concerns about ownership or control, as proposed in the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill currently before Parliament (**Member Outcomes Bill**);
  - d) Reviewing the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* to provide enhanced scope and powers for ASIC to act on misconduct and potential misconduct within ASIC's regulatory remit; and
  - e) APRA and ASIC continuing to strengthen their collaboration and coordination on regulation and supervision of the financial services industry, including managing potential overlap, and where possible eliminating impediments to cooperation.
3. A theme which ran throughout Counsel Assisting's submissions and questioning of witnesses was the idea that enforcement of the obligations in section 52(c) ('best interests of members covenant') and section 62 ('sole purpose test') should have been

undertaken by APRA by way of commencing court proceedings against those who had potentially breached those obligations. APRA addresses the content and application of these obligations below but submits here at the outset that:

- a) s 52(c) is a covenant that must be included in the governing rules of a registrable superannuation entity (**RSE**). It is not a civil penalty provision, nor does it provide for APRA to bring proceedings for compensation to be paid to fund members.<sup>1</sup> APRA cannot simply bring proceedings against an RSE for breaches of s 52. Rather, APRA would need to rely on the breach of s 52(c) as a breach of the condition imposed by s 29E(1) on all RSE licenses that the RSE Licensee must comply with the RSE Licensee law, which is defined to include the SIS Act itself. APRA could then rely on the breach of s 29E(1) to take action against the trustee, such as:
- (i) directing the RSE Licensee to comply with its licence conditions<sup>2</sup> (APRA could only commence proceedings if the RSE Licensee subsequently failed to comply with the direction within the time specified);<sup>3</sup>
  - (ii) placing additional conditions on<sup>4</sup>, or cancelling, the RSE license;<sup>5</sup>
  - (iii) applying to the court to have individuals disqualified from being able to hold positions as responsible officers of RSE Licensees on the basis that the person has breached the RSE license law.<sup>6</sup>
- b) of the actions referred to above, only (iii) requires an application to the court;
- c) where the breach of s 52(c) is not a significant breach or is not a continuing breach, the use of the above powers may well be disproportionate; and
- d) in contrast to s 52, s 62(1) is a civil penalty provision.<sup>7</sup> If APRA brought court proceedings in respect of an alleged breach of s 62(1), it could also seek compensation orders against the RSE Licensee.<sup>8</sup> As noted above, APRA accepts that it could give greater weight to the strategic benefits of taking such action.

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<sup>1</sup> Although APRA has a separate power under s 298 of the SIS Act to bring proceedings, in certain circumstances, in the name of an individual, if the individual consents.

<sup>2</sup> SIS Act, s 29EB.

<sup>3</sup> SIS Act, s 29JB.

<sup>4</sup> SIS Act, s 29EA(1).

<sup>5</sup> SIS Act, s 29G(1).

<sup>6</sup> SIS Act, s 126(1).

<sup>7</sup> SIS Act, s 193.

<sup>8</sup> SIS Act, s 215.

## **A. Structure of these submissions**

4. These submissions address the three questions set out at paragraph 1 above in the following manner.
  - a) First, the regulatory architecture for superannuation, based on the 'twin peaks' model dating back to the 1997 Wallis Inquiry, and its application to the division of roles between APRA and ASIC is discussed.
  - b) Secondly, some particular complexities of application of the twin peaks model in the superannuation context are set out and APRA outlines:
    - (i) its strong support for proposed legislation that will strengthen APRA's ability to take appropriate and timely action, for example by issuing directions to RSE Licensees or connected entities;
    - (ii) support for the proposition that ASIC be granted extended powers, including to take enforcement action in respect of breaches relevant to ASIC's conduct mandate, while APRA retains its powers to take enforcement action in respect of breaches where the breach concerns APRA's prudential mandate.
  - c) Thirdly, APRA makes submissions regarding:
    - (i) its enforcement of the best interests of members covenant, including through its Prudential Standards; and
    - (ii) its application of the sole purpose test.
  - d) Fourthly, APRA addresses the question of whether it has acted promptly on misconduct or potential misconduct and what can be done to assist it to do so.
  - e) Fifthly, APRA turns to the appropriate allocation of regulatory roles to achieve specific and general deterrence.
  - f) Sixthly, APRA responds to the suggestion that its objective of ensuring financial system stability is not readily reconciled with being an effective conduct regulator.

5. The submissions then go on to address in lesser detail other general and policy questions posed by Counsel Assisting in relation to:
  - a) managing conflicts;
  - b) suggested system changes;
  - c) section 68A of the SIS Act;
  - d) payments from external responsible entities of managed investment schemes;
  - e) discretion to appoint and remove directors; and
  - f) advertising.

**B. Regulatory architecture for superannuation**

6. In addressing this question, it may assist to first consider how the present allocation of regulatory roles came about and the resultant focus of each of APRA and ASIC.

*'Twin peaks' model – prudential regulation and conduct regulation*

7. The origins of the regulatory architecture for the financial system date to the 1997 Wallis Inquiry. This model established as a result of the Wallis Inquiry envisions a strong prudential regulator, focused primarily on the soundness of regulated entities and the safety of consumers' funds, and a strong conduct regulator, focusing on disclosure, market conduct and consumer protection.<sup>9</sup>
8. The twin peaks structure was designed around the Wallis Inquiry's analysis of the difference in 'intensity' of financial promises. In the case of financial promises judged to be 'high intensity' (that is those that may be difficult to honour, difficult to assess and/or likely to produce highly adverse consequences if breached – such as the promise to repay retail deposits) the Wallis Inquiry considered that prudential style regulation was required in addition to general conduct regulation that applied more

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<sup>9</sup> The Statement of Expectations issued by Government to APRA in April 2014 refers to "the interests of depositors, insurance policy holders and superannuation fund members" Witness statement of Helen Rowell, Exhibit 5.298, 14 August 2018 2, [23] [APRA.0007.0005.0051]. The Statement of Expectations issued by Government to ASIC in April 2014 refers to "the informed participation of investors and consumers". APRA expects that the Government's new Statement of Expectations will include a similar reference.

broadly. For less 'intense' promises, disclosure and conduct regulation alone was regarded as more appropriate.<sup>10</sup>

9. The Wallis Inquiry found that, because the risk in defined contribution superannuation is largely retained by the investor, prudential regulation of superannuation should sit at the lower end of the intensity scale and should focus on:

'ensuring that superannuation funds have risk management strategies and conduct, and administrative systems, which are appropriate to their purpose and accord with both government requirements and with the governing investment policies contained in the trust deed.'<sup>11</sup>

10. The model presupposes that, provided they have adequate information, consumers will impose discipline on the industry by choosing better products, with the result that the forces of market competition will ensure the delivery of constantly improved performance.<sup>12</sup> As discussed below, the assumption that market competition would operate effectively in the superannuation industry has not been borne out in practice.

#### *APRA and ASIC*

11. In response to the Wallis Inquiry, the Government established APRA and ASIC, which together replaced the Insurance and Superannuation Commission in regulating and supervising the superannuation industry. APRA was given responsibility for prudential regulation while ASIC was given limited responsibility for consumer protection under the SIS Act. There were few changes made to the SIS Act itself at that time.
12. In 2009, the Government commissioned a review into the governance, efficiency, structure and operation of Australia's superannuation system (the Cooper Review).

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<sup>10</sup> Financial System Inquiry (Wallis Inquiry), *Final report*, March 1997, pages 189, 191-192.

<sup>11</sup> Financial System Inquiry (Wallis Inquiry), *Final report*, March 1997, page 332.

<sup>12</sup> Financial System Inquiry (Wallis Inquiry), *Final report*, March 1997, page 487-488.

The Cooper review made a number of recommendations regarding the superannuation regulatory settings at that time including:

- a) the extension of APRA's mandate; and
- b) the introduction of a prudential standards-making power similar to those which APRA has in relation to other regulated industries, and also encompassing transparency, efficiency and outcomes for members.<sup>13</sup>

13. In 2013 as part of the reforms to implement the Cooper review recommendations, APRA's prudential role in superannuation was given more weight and aligned more closely with the framework for the other industries regulated by APRA with the addition of powers to issue Prudential Standards and to monitor "prudential matters".
14. Regulation and supervision of superannuation inherently involves consideration of the behaviour, decisions and practices of RSE Licensees and others involved in the operation of superannuation entities. Both APRA and ASIC necessarily have an interest in these issues from their respective perspectives as prudential and consumer protection regulators.
15. APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system. The SIS Act imposes stringent duties on RSE Licensees to manage the assets of their RSEs prudently and in the best interests of all the members of the fund.
16. As the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE Licensees and individual consumers. In particular ASIC's focus is on consumers receiving proper disclosure, being dealt with fairly by qualified people, continuing to receive useful information about their investments or products and having access to proper complaints-handling procedures.
17. It is not unusual for ASIC's consumer-focused conduct mandate and APRA's member outcomes perspective to result in the two agencies having common areas of interest

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<sup>13</sup> Super System Review (Cooper Review), *Review of the Governance, Efficiency, Structure and operation of Australia's Superannuation System*, June 2010, pages 307, 309.



in respect of the practices and conduct of a specific RSE Licensee, or broad industry trends, albeit from different perspectives.

#### *A separate regulator?*

18. Counsel Assisting has asked whether this allocation of regulatory roles is appropriate, which raises a question of whether alternatives to the underlying twin peaks framework should be considered such as a separate pension regulators covering both prudential and conduct matters.
19. A separate superannuation regulator could, *prima facie*, avoid the boundary issues between prudential and conduct matters, and bring clearer accountability for carriage of particular regulatory compliance matters. It would also allow significant specialisation in one agency. However, to the extent there are tensions between prudential and conduct related objectives, a revised structure would not remove these: they would simply be internalised into one body. A superannuation-only regulator would be unlikely to have a broad perspective on risks and linkages within the broader financial sector, which will be increasingly important as RSE Licensees consolidate, become more complex, and engage in more sophisticated activities such as direct lending and the provision on retirement products. Such a structure would also create new regulatory perimeter issues with other financial regulators, particularly in the case of superannuation operations within conglomerate groups.
20. APRA's view is that a separate superannuation regulator would not provide any greater clarity or more effective implementation of the SIS Act, given the issues noted above. Australia's financial services sector regulatory regime is among the most highly regarded in the world, and APRA submits that the twin peaks model has, on the whole, served Australia well and continues to do so.
21. However, in reaching the above conclusion, APRA is not asserting that there is not room for improvement, or that the judgment as to where to draw the line between the role of each regulator and the type of regulation that may be required should be revisited and adjusted from time to time.

#### *Particular complexities in the Superannuation Industry*

22. There are specific challenges in the regulatory architecture for superannuation relative to the other industries regulated by APRA. In light of these challenges and the matters investigated by the Commission, it is appropriate to consider whether legislative

changes to sharpen the prudential and conduct mandates could improve the current regulatory structure. APRA submits that reviewing, strengthening and potentially expanding the role of each regulator is needed to maximise effectiveness.

23. In superannuation, the distinction between prudential and conduct regulation is less clear than in the other industries APRA regulates. In part this arises because of the trust-based regulatory structure for superannuation and its focus on equitable principles and fiduciary relationships. The nature of prudential regulation is also different for products where a commercial promise of a capital guarantee of funds has been made (for example, as in the case of bank deposits, or defined benefits superannuation) compared to products where no such promise has been made and funds are deployed and applied on a 'best-endeavours' basis, by a trustee structure (as in the cases of superannuation fund contributions). As a result, APRA's mandate in superannuation is broader, and the objectives which it seeks to regulate are less clearly definable, compared with the other industries regulated by APRA.
24. Both the 2014 Financial System Inquiry Report and the draft 2018 Productivity Commission Report into superannuation have found that consumer-led competition (being one of the premises of the Wallis Inquiry recommendations) is weak, due to a combination of factors including compulsory superannuation contributions, disengaged members, complexity of decision making about retirement objectives and risks, and a lack of simple, relevant information to assist members.<sup>14</sup>
25. In sharpening the distinction between prudential and conduct responsibilities, and in recognition of the relative lack of consumer-led competition, consideration should be given to granting ASIC wider responsibilities and powers, in addition to APRA's current powers, to take enforcement action in relation to misconduct and potential misconduct. The range of matters under the SIS Act where ASIC is allocated general administration powers could be expanded to include all areas of individual consumer interaction on matters of disclosure, suitability, and general fairness considerations, or a specific covenant could be added covering the obligation to deal with consumers efficiently, honestly and fairly. Given the complexity of the SIS Act, however, a considered review process would be appropriate to ensure that the specific changes made to APRA's and ASIC's respective regulatory responsibilities achieved the intended purpose and did not have unintended adverse consequences.

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<sup>14</sup> Financial System Inquiry (Wallis Inquiry), Final report, March 1997, page 10. Superannuation: Assessing Efficiency and Competitiveness: Productivity Draft Report, April 2018, pages 23-24.

26. Further, APRA has noted its own powers are less robust relative to the powers it has in the banking and insurance industries. APRA therefore strongly supports the proposed Member Outcomes Bill. The proposed legislation would strengthen APRA's power to take timely and prompt action to address identified concerns rather than having to wait to act until after a breach has occurred. Further discussion about the proposed legislation is set out at paragraphs 28, 76 and 77, below.

*Enforcement of the best interests of members covenant and its connection with APRA's Prudential Standards*

27. The SIS Act established a trust-based model governing the relationship between superannuation providers and members. The SIS Act mandates in s 52 that superannuation trustees reflect a number of covenants in their governing rules, including the duty to act in the best interests of members, as well as covenants relating to investment strategy and other matters. As noted at paragraph 4 above, contravention of a s 52 covenant is not itself an offence.

28. The Members' Outcomes Bill provides for civil penalties against directors in respect of contraventions of s 52. APRA endorses the proposed change and considers that it will further strengthen its abilities to regulate compliance with s 52.

29. Section 34C of the SIS Act permits APRA to determine standards relating to prudential matters that must be complied with. Under section 34C(4) of the SIS Act, a 'prudential matter' includes a matter relating to the conduct by an RSE Licensee of a registrable superannuation entity in such a way as to:

- a) protect the interests or meet the reasonable expectations of the members of the entity;
- b) keep the entity in a sound financial position; and
- c) not cause or promote instability in the Australian financial system.

30. The statutorily mandated role of the prudential standards, as set out in s 34D of the SIS Act is to elaborate, supplement or otherwise deal with any aspect of:

- a) a prudential matter to which a covenant referred to in sections 52 to 53 or prescribed under s54A relates; or
- b) a prudential matter to which a provision of the Act or the regulations relates.

31. The matters for APRA's Prudential Standards and prudential supervision can therefore be seen as explicitly including the best interest obligation, but from a prudential lens. In fact, the best interest duty underpins many aspects of APRA's Prudential Standards. In addition, APRA's standards-making powers extend explicitly to prudential matters relating to the covenants in section 52 of the SIS Act. APRA has, in practice, referenced the best interest obligations throughout many of its prudential standards and guidance materials.<sup>15</sup>
32. For reasons that have been articulated in respect of the various case studies, the best interest covenant is often difficult to point to, on its own, as providing the basis for an enforcement action. What conduct will be, or not be, in the best interests of members will not always be clear, and actions taken or not taken may need to be considered within a broader context. For example, higher fees may not be contrary to members' best interests if better, more comprehensive or bespoke services are being provided. The use of member funds for advertising may be in members' best interests if the advertising increases membership, and hence delivers scale benefits. Cases of poor outcomes may not necessarily be attributable to conduct that could be characterised as contrary to the best interests duty – for example, poor investment outcomes may arise from an investment strategy that was, at the time it was initiated, well founded. On the other hand, conduct that might be regarded as not in the best interests of members may not necessarily produce comparatively poor outcomes – as an example, a very high risk, speculative investment strategy may provide reasonable returns for a period of time, even if it might not be expected to be in members' best interest in the long term.
33. Moreover, best interests relate to all members, not one or a subset of members. As a result, making decisions in line with the best interest obligation may not necessarily be the best outcome for any particular member. For example, where a member is not eligible for an insurance claim and an ex gratia payment is made, that may be in the interests of the member in question, but is not in the best interests of members overall.

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<sup>15</sup> Examples include: Prudential Standard SPS 160 Defined Matters; Prudential Standard SPS 510 Governance; Prudential Standard SPS 521 Conflicts of Interest; Prudential Practice Guide SPG 510 Governance; Prudential Practice Guide SPG 511 Remuneration; Prudential Practice Guide SPG 521 Conflicts of Interest; Prudential Practice Guide SPG 530 Investment Governance.

34. The limitations of the best interests covenant on its own as a basis for enforcement action does not detract from its importance as a benchmark for conduct and a guiding philosophy, in the same way that the philosophy of protection of depositors guides APRA's approach to banking regulation. However, it illustrates the challenges of regulating superannuation in general and specifically in using covenants as a basis for enforcement action.
35. APRA utilises its power to make Prudential Standards to support the achievement of its functions and objectives. Prudential Standards have the force of law and must be complied with by regulated entities in the superannuation industry and may impose different requirements to be complied with by different classes of RSE Licensees, in different situations or in respect of different activities.
36. Because the defined contribution nature of most superannuation funds means that it is the superannuation fund members who bear the risk of the amount of their superannuation benefit increasing or decreasing, the focus of the Prudential Standards, and prudential supervision for the superannuation industry generally, is on ensuring that the RSE Licensee has the necessary governance, risk management and operational capability and capacity to deliver quality outcomes for members.
37. APRA's supervision of its regulated entities is tailored around the Prudential Standards and assessing how effectively RSE Licensees are meeting the expectations outlined in those Standards. This approach reflects the view that if a regulated entity is meeting the requirements set out in the standards then it is reasonably likely that it will also be in compliance with the requirements of the SIS Act on which the standards have been built.
38. APRA is currently conducting a review of the superannuation prudential and reporting standards introduced in 2013 to determine whether the prudential framework is operating effectively and efficiently, and to identify and seek to address any unintended consequences or areas for improvement in the framework.<sup>16</sup>

### *Sole purpose test*

39. The other provision which arose for consideration in the course of the case studies was the sole purpose test in section 62(1) of the SIS Act, which requires each trustee

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<sup>16</sup> APRA's discussion paper, *Post-implementation review of APRA's superannuation prudential framework*, and accompanying papers are available at: <https://www.apra.gov.au/post-implementation-review-apras-superannuation-prudential-framework>.

of a regulated superannuation fund to ensure that the fund is maintained for one or more of the core purposes, or one or more of the core purposes and for one or more of the ancillary purposes.

40. The sole purpose test serves a critical prudential function, as it is the only legislative provision that prescribes the types of activities an RSE Licensee can undertake using fund assets and hence underpins APRA's prudential supervision of the industry.
41. The intent of the sole purpose test is to ensure that the activities of superannuation fund trustees are for the benefit of members. The core purposes, as defined under section 62 of the SIS Act, include providing benefits for each member of the fund on or after the member's retirement, attainment of preservation age or death.
42. The ancillary purposes, as defined under section 62 of the SIS Act, include the provision of benefits on or after the member's employment termination, cessation of work due to ill-health or death. APRA also has the power under section 62(1)(a)(v) to approve other ancillary purposes and it has done so in the past, including for the provision of resignation and retrenchment benefits, disability benefits and financial hardship benefits.
43. The sole purpose test is sufficiently broad to encompass the normal activities of superannuation fund trustees. It does not, however, allow a trustee to engage in commercial activities as a side business, or to invest members' money in its own ventures from which it derives other benefits or that may expose the members to other risks.
44. APRA's approach to the sole purpose test requires an RSE Licensee to justify why it considers the activity in question does not contravene the test. The factors APRA expects trustees to take into account, depending on the relevant facts and circumstances, include whether:
  - a) there is a reasonable, direct and transparent connection between the scheme and the core or ancillary purposes of the fund;
  - b) the service is limited to members of the superannuation fund only;
  - c) the benefit accrues to current or future members;
  - d) the advice or information provided is limited to superannuation issues and does not extend to non-superannuation issues;

- e) cost benefit analysis highlighting the benefit to members has been undertaken to demonstrate that the transaction is objectively and commercially justifiable;
- f) any service contract is on an arm's length basis;
- g) the scheme is paid for by existing fees or fund assets; and
- h) the benefit primarily accrues to the members of the superannuation fund, rather than the RSE Licensee.

45. APRA has used the sole purpose test to found supervisory action under which RSE Licensees restructured or exited certain businesses.<sup>17</sup> As part of the Members Outcome Review.<sup>18</sup> APRA wrote to industry noting that APRA is assessing the appropriateness of current guidance on the sole purpose test and inviting submissions.<sup>19</sup> The general response from the industry was that updated guidance was needed and APRA will progress this in due course as part of its response to the review of the prudential framework (referred to above).

### C. Prompt regulatory action on misconduct or potential misconduct

46. APRA does not accept the premise that it has not acted generally promptly on misconduct or potential misconduct relevant to its regulatory remit. The Commission's focus on specific instances of misconduct has brought to light instances in which misconduct has occurred, and these must be addressed. However, this focus does not bring to light the broader work undertaken as part of APRA's supervisory approach to intervene early to prevent problems from occurring in the first place, or to rectify small problems before they become large ones. APRA contends that its day-to-day supervision, built upon the Prudential Standards introduced in 2013, has materially lifted the standards of RSE Licensees in overseeing members' funds in recent years.

47. APRA submits that, whilst it has not relied on court action to achieve its goals, APRA acts promptly on a daily basis to identify and address misconduct or potential misconduct in the superannuation industry. This is demonstrated by the below small

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<sup>17</sup> See items A3 and A9 of Appendix A to APRA's confidential letter to the Commission dated 15 January 2018 (APRA has referred to this letter in order to assist the Commissioner and intends that the letter and its contents remain confidential).

<sup>18</sup> "**Member outcomes review**" means the Strengthening superannuation member outcomes review conducted by APRA in 2017/18. The review is focussing on how RSE licensees are prioritising the quality and value of products and services they deliver to members.

<sup>19</sup> APRA Discussion Paper: Strengthening superannuation member outcomes, 13 December 2017, Exhibit 5.298.

selection of examples, which highlight APRA's response to behaviours, practices and decision-making by RSE Licensees that may give rise to poor member outcomes.

- a) The Commission has already noted that it was APRA that identified to AMP Superannuation Limited/NM Superannuation Pty Ltd the existence of negative returns in its Cash Investment Option<sup>20</sup> as well as the high costs per member in certain MySuper products<sup>21</sup>. In the first case this led to the decision by the RSE Licensee to review the product fees and to compensate members who had experienced negative returns.<sup>22</sup> In the second case this led to the AMP substantially lowering the administration fees on those products;<sup>23</sup>
- b) As set out in Mrs Rowell's witness statement, APRA's Member Outcomes project in 2017/18 identified 28 outlier funds that were not consistently delivering quality member outcomes across a range of metrics. APRA's actions with each of these funds has resulted in 13 leaving the industry or merging, four making changes to operations to deliver improved performance and two being reclassified to performing based on additional information provided. The remaining nine funds continue to be subject to APRA supervisory action;<sup>24</sup>
- c) APRA has required RSE Licensees to rectify any operational errors so that affected members are placed in the position they would have been other than for the error (see, for example, APRA's response to the s 29WA breaches examined in the Colonial Case Study);<sup>25</sup>
- d) APRA intervened in 2016 to respond to the disrupted operation of the Sunsuper Pty Ltd (**Sunsuper**) board. APRA had concerns regarding the impact of proposed Board composition changes on the continuity and stability of the Board given the relatively short tenure of almost all of the directors on the Board, and in particular the replacement of skilled and experienced directors before the expiry of their first term. As such APRA required Sunsuper to commit to reviewing, and agreeing in consultation with the shareholders/nominating bodies of Sunsuper, the framework

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<sup>20</sup> Transcript, Rick Allert, 16 August 2018, 5090:40.

<sup>21</sup> Transcript, Rick Allert, 16 August 2018, 5097:15.

<sup>22</sup> Transcript, Rick Allert, 16 August 2018, 5102:45.

<sup>23</sup> Transcript, Rick Allert, 16 August 2018, 5097: 25.

<sup>24</sup> Witness statement of Helen Rowell, Exhibit 5.298, 14 August 2018 28, [180].

<sup>25</sup> Written submissions of the Australian Prudential Regulation Authority (APRA) in response to specific findings in Round 5: Superannuation, 31 August 2018, 13 [58].



which deals with the nomination, renewal and termination of directors to address APRA's concerns.<sup>26</sup>

- e) APRA had concerns about the structure of an RSE Licensee Board and management, as many of the same individuals sat on the Board of a related service company, which provided services to other superannuation entities. APRA identified potential conflicts of interest and potential breaches of duty to act in members' best interests, and treatment to the detriment of the RSE Licensee's members. As a result of the concerns raised by APRA, the RSE Licensee restructured its Board and management, addressed the conflicts, and divested its investment in the service company.<sup>27</sup>
- f) APRA undertook a formal investigation into the affairs of a number of funds operated by collapsed Trio Capital. APRA removed Trio as RSE Licensee and appointed an Acting Trustee. APRA liaised extensively with ASIC who also formally investigated the company. Between 2011 to 2013 APRA commenced disqualification proceedings against one Trio director and ultimately accepted Enforceable Undertakings from 13 former Trio directors, removing them from responsible person positions in the superannuation industry for various periods;<sup>28</sup>

48. There are, of course, steps that could be taken to improve the ability of both APRA and ASIC to take swift and effective action in cases of misconduct or potential misconduct. Those steps are collected at paragraph 2 above.

49. One such area is in relation to joint investigative work. APRA liaises closely with ASIC on a wide range of regulatory matters, including to consider issues concerning entities or persons that may be relevant to both agencies. Given the importance of inter-agency coordination in relation to enforcement matters, and following the recent introduction of the Banking Executive Accountability Regime (BEAR) for banks, APRA and ASIC are exploring the potential for closer cooperation in the investigation of individual cases. In doing so, an important area to address is to remove, wherever possible, impediments to the disclosure and use of protected information by each agency. For this purpose, the agencies have formed a working group which, in part,

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<sup>26</sup> Closing Submissions, [680]; Exhibit 5.332, Statement of Andrew Fraser, 4 August 2018.

<sup>27</sup> Item B11, Attachment B to APRA's confidential letter to the Commission dated 15 January 2018 (APRA has referred to this letter in order to assist the Commissioner and intends that the letter and its contents remain confidential).

<sup>28</sup> Report: Investigation of superannuation entities in respect of which Trio Capital Limited (in liquidation) acted as trustee; 7 April 2016, <https://www.apra.gov.au/media-centre/media-releases/apra-releases-trio-investigation-report>.

is developing a streamlined procedure for the exchange of relevant information without the need to impose use restrictions. Subject to ensuring that each agency is fully compliant with natural justice requirements, this would permit each agency to make unfettered use of the information obtained by the other agency in the course of an investigation without the need to conduct its own information gathering exercise to obtain the same information. The working group is also considering other options for the two agencies to work more closely on investigations, in order to benefit from particular areas of expertise within the agencies and avoid the duplication of investigative actions. This review is anticipated to be complete by year end and is expected to be of relevance to all of APRA's regulated industries.

**D. Specific and general deterrence**

50. While APRA has the ability to pursue penalties and administrative actions against both entities and individuals, it does not reach for these tools as an immediate course of action. It does so when supervisory engagement with an entity has not been successful in addressing APRA's concerns. This long-standing approach has been effective across the industries APRA regulates in achieving efficient and appropriate prudential outcomes in most instances.
51. APRA accepts that litigation by a regulatory agency, with the accompanying public scrutiny and potential sanction, can have a deterrent effect both on the particular entity concerned and on other industry participants. However, there are also a range of other measures that regulators can use to achieve deterrent effects without litigation. In her evidence, Mrs Rowell provided examples of such measures, being thematic review reports and letters, general industry letters on specific issues, speeches, industry engagement and articles in APRA publications.<sup>29</sup>
52. Nevertheless, APRA acknowledges that it could give greater weighting to the strategic benefits of formal enforcement action, including litigation, for the purposes of specific and general deterrence.
53. APRA is commencing a review of its enforcement strategy to ensure that it has appropriate regard to specific and general deterrence. APRA envisages, as part of this review, identifying where additional guidance would be beneficial for supervisors on appropriate circumstances in which to escalate an issue for consideration of formal enforcement action and the type of action that may be appropriate. APRA has also

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<sup>29</sup> Transcript, Helen Rowell, 17 August 2018, 5177:40-5178:46.

recently decided to split and realign its internal supervision and enforcement committees, to provide more focus on the escalation of prudential concerns through the enforcement process. This will provide a more focused forum for APRA senior management to consider any need for a broader deterrent effect in dealing with a specific prudential matter raised by an individual supervisor, and what action or actions may be appropriate.

54. Any enforcement strategy must, however, have regard to a range of relevant considerations, including:

- a) the seriousness of the breach in question. APRA accepts that, where legislation has identified the seriousness of certain breaches, such as by attaching criminal sanctions or differentiated penalties, APRA should have regard to this in its considerations. The review of APRA's internal policies and procedures will ensure this is a prominent feature of decision-making;
- b) the circumstances in which the matter came to APRA's attention. For example, a key feature of the regulatory framework is RSE Licensees being required to self-report breaches of relevant laws and regulations to the relevant agency. Underlying this framework is an assumption that regulators do not automatically commence litigation for all matters reported. While the framework can provide APRA with the opportunity for formal sanction, an important broader purpose is to encourage regulated entities to identify and draw attention to breaches, working with and under the supervision of the regulators (APRA and/or ASIC) to address issues of concern in a timely manner and develop responses to ensure the breaches are not repeated. In the event every breach reported led to automatic regulatory sanction, APRA's view is that entities would be less likely to promptly report breaches and address issues identified in a relatively timely and cost effective manner;
- c) whether the matter in question has widespread relevance to other industry participants;
- d) whether the costs of enforcement action would be borne by members;
- e) whether the concern relates to transitional issues. For example, in the case of the Stronger Super reforms in 2013 and 2014 which included changeover arrangements for the transition to MySuper products, litigation may have been less effective if related to particular one-off aspects of the transition, particularly given the time taken to pursue formal enforcement actions. In this circumstance, other

means to achieve effective and timely implementation of a new regime, such as industry wide communications was more appropriate.<sup>30</sup>

- f) APRA's obligations as a Model Litigant pursuant to the Attorney General's Legal Services Directions 2017 not to start legal proceedings unless it is satisfied that litigation is the most suitable method of dispute resolution<sup>31</sup> and to endeavour to

“avoid, prevent and limit the scope of legal proceedings wherever possible, including by giving consideration in all cases to alternative dispute resolution before initiating legal proceedings”.<sup>32</sup>

- g) the availability of other potential options and whether they may achieve a better or more timely outcome.

55. APRA also notes that, the stronger the regulatory powers, the less likely a regulator is to need to use them in practice, due to the deterrent effect that the existence of powers produces. APRA works towards, and believes it has regularly achieved, effective specific deterrence without having to resort to litigation, and in accordance with the practice of an effective prudential regulator.

56. Finally, it should be noted that regulatory litigation does not always achieve a deterrent effect. Unsuccessful litigation can be damaging to the perceived power of a regulator and can diminish the deterrent effect of the availability of enforcement powers.

### *Prudential regulation and enforcement*

57. APRA agrees that there can be tensions between the objectives of financial stability and conduct regulation in some circumstances. However, APRA does not agree that its objective in regards to financial stability necessarily precludes it from being able to exercise its enforcement (or 'coercive') powers. This was explored as part of APRA's testimony during the hearings.<sup>33</sup> As stated by Mrs Rowell, APRA's objectives include both protecting the interests of beneficiaries (in the case of superannuation, those beneficiaries are the super fund members), as well as financial stability. Indeed, in the

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<sup>30</sup> Letter from APRA to RSEs, 'Preparing for SuperStream implementation', 15 March 2013; Letter from APRA to RSEs, 'Trustee Responsibilities arising from certain SuperStream-Related Measures', April 2013.

<sup>31</sup> Attorney General's Legal Services Direction 2017, r 4.2.

<sup>32</sup> The Commonwealth's Obligations to Act as Model Litigant, Appendix B to the Legal Services Direction 2017, cl 2.

<sup>33</sup> Transcript, Helen Rowell, 17 August 2018, 5180 [12]-[18].

superannuation sector, protection of member interests is inextricably linked to the financial stability of funds.<sup>34</sup>

58. The use of coercive powers through enforcement action in the interests of these objectives is a necessary part of the role of any prudential regulator. Where appropriate, APRA takes public, formal enforcement action against systemically important regulated entities. A recent example is APRA's public report on governance failings within the Commonwealth Bank of Australia<sup>35</sup> and the enforceable undertakings that APRA obtained from the Bank in relation to those issues.<sup>36</sup>
59. The financial cost to a regulated entity of deterrence action is a consideration for APRA. All potential enforcement action by a regulator can have cost impacts for a regulated entity. From APRA's perspective, depending on the nature of the enforcement action taken this could be through the costs of an independent expert, timely system remediation, additional capital charges (for an ADI or insurer), use of existing reserves, infringement notice penalties or court-imposed fines. In the other industries APRA regulates, capital charges and the use of independent experts have been effective and costs are essentially borne by shareholders. Absent a parent company to absorb these costs, the imposition of a large fine, or an expensive court case, on an RSE Licensee is likely to be an additional expense for members. In an extreme case, it could threaten the financial viability of the RSE Licensee. However, this will not be a factor in an enforcement decision where the entity's exit or restructure can be managed in an orderly way that does not negatively affect beneficiary interests.
60. In superannuation, the trust structure of the superannuation industry and the direct financial risk borne by members makes this a more important consideration. Almost all superannuation trust deeds provide that the assets of the trust are to be used to indemnify the trustees from liability in most instances. The trustees of superannuation funds, whether corporate trustees or individual trustees, do not maintain any material capital resources compared to other entities regulated by APRA. Judgements or penalties assessed against a trustee may, absent legislative intervention to provide otherwise, be paid for by the superannuation members of the trust unless section 56(2) of the SIS Act applies. APRA submits that it is reasonable and appropriate for it to take this matter into consideration when considering potential enforcement action.

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<sup>34</sup> Transcript, Helen Rowell, 17 August 2018, 5173[31] – 5174[7].

<sup>35</sup> Prudential Inquiry into the Commonwealth Bank of Australia, April 2018.

<sup>36</sup> Enforceable Undertaking given by Commonwealth Bank of Australia and accepted by APRA, 30 April 2018.

61. The introduction of a civil penalty for breaches of s 52A by directors is one means by which the concern expressed above may be ameliorated.

#### **E. Directions powers**

62. APRA's current directions powers are framed narrowly and are limited to directing compliance with the licensing conditions. The proposed direction power in the Member Outcomes Bill will be able to be used for a wider range of circumstances.

63. The proposed direction power will enable APRA to take action (including pre-emptive action) where an RSE has breached or likely to breach the SIS Act, SIS regulations, Prudential Standards (superannuation legislation) or the *Financial Sector (Collection of Data) Act 2001* (FSCODA). In addition, APRA will also be able to take action when the direction is necessary in the interests of beneficiaries and in relation to financial matters relating the RSE Licensee or its RSE.

64. The types of directions that may be issued under the proposed power include directions to comply with the whole or part of the superannuation legislation or FSCODA; to take action in relation to responsible officers, auditors and actuaries of RSE Licensees; to take or not take certain financial actions or other actions in relation to the affairs of the RSE Licensee or its RSEs. These include a direction not to accept contributions from new or existing members, not to borrow, and not to accept any new liability or discharge an existing one. The power also extends to requiring an RSE Licensee or connected entity to make changes to its systems, business practices and operation

65. The proposed directions power will enable APRA to direct RSE Licensees and connected entities to take the action necessary to ensure beneficiaries' interests are protected. For example, APRA could direct an RSE Licensee to discontinue dealing with a related party provider where this is unlikely to provide effective services to the RSE Licensee beneficiaries.

#### **F. Managing conflicts**

66. Counsel Assisting has asked a number of questions that relate to the structural arrangements for superannuation trustees and the relationships between trustees and other parties, such as related parties and financial advisors.

*825.17 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?*

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

*825.19 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?*

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

67. Australian law permits a diverse range of corporate structures to facilitate the delivery of superannuation services. In all superannuation corporate structures, trustees are responsible for taking reasonable steps to manage the inherent conflicts between member interests, and the interests of other parties involved in delivering superannuation services. In both for-profit and not-for-profit corporate structures, conflicts of interest and inefficiencies are difficult to completely eradicate in the superannuation sector, particularly given the extensive use of related party or associated service providers.

68. However, APRA submits that, with care and diligence on the part of trustees, many potential conflicts of interest can be appropriately mitigated. In particular, APRA's prudential framework sets out expectations for transactions with related parties to be

made on an arms-length basis. For example, in the case of an outsourcing contract with a related administrator, APRA expects a trustee to take reasonable steps to assess the merits of the related party arrangements. These steps could include a trustee satisfying themselves that the price and service was commensurate with other providers in the market more generally by, for instance, a competitive tender; or, an objective (ideally externally conducted) benchmarking exercise. In the case of insurance arrangements, trustees often conduct competitive tenders.

69. As described in Mrs Rowell's witness statement, APRA's thematic review on related party arrangements concluded that there were a number of areas for improvement with respect to how trustees are managing their outsourcing arrangements. In light of the matters raised in hearings, APRA will be looking at how it can deepen its supervision of related party arrangements, particularly within conglomerate groups.
70. APRA notes the case studies the Commission explored showed evidence of trustees operating within conglomerate groups that did not appear to exercise independence and prioritise the interests of their superannuation members over other parties in the conglomerate group. APRA is making further enquiries with respect to these cases, as indicated in its 31 August submission.
71. APRA will also give consideration to reviewing its prudential requirements and guidance to strengthen the ability of RSE Licensee boards to effectively fulfil their obligations irrespective of ownership or corporate structure. This would include strengthening the expectations of RSE Licensees in relation to arrangements with potential conflicts, including governance arrangements and assessing performance; adequacy of resources to support the RSE Licensee in fulfilling its obligations; and the authority and independence of the RSE Licensee within corporate structures. Consideration should also be given as to whether it is appropriate for particular directors to sit on RSE Licensee boards as well as other group boards. There may be a need for legislative reforms to facilitate some of the above changes.
72. To the extent conflicts can be appropriately managed, APRA believes there is general benefit to the Australian financial system in the law continuing to allow diverse structures to compete in the market. This is for reasons including fostering competition, and providing members with greater choice about how their superannuation savings are managed. APRA observes the retail superannuation sector is already going through significant change to ownership structures, and the



business models that ultimately prevail are likely to evolve from those in existence today.

73. APRA's experience has shown, however, that not all trustees have been able to effectively manage the conflicts of interest inherent in dual-regulated entities (**DREs**), where the same corporate entity is an RSE Licensee and a Responsible Entity (**RE**) for managed investment schemes (**MIS**). Indeed, given that in these structures the board has obligations both to members of its RSEs and investors in its MIS, it is arguable that the inherent conflicts in such structures are unmanageable. APRA would therefore welcome legislative change that prohibited DREs. With the exception of DREs, APRA would not generally advocate broader structural constraints being imposed on RSEs.

74. The Commission has also asked whether it would be preferable to extend the obligation to act in the best interests of members of a superannuation fund to any related bodies corporate. APRA has reservations about such a change. There is a risk these proposals would undermine the core role of the trustee. It is also difficult to see how shareholders of trustees could reconcile such an obligation with other legitimate corporate interests.

#### **G. Other potential system changes**

*825.21 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?*

*825.22 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?*

*825.24 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?*

## *MySuper Assessments*

75. The MySuper regime has been in existence for five years, and it is timely to review whether the original objectives of the framework are being met. In authorising MySuper products, APRA was constrained to testing against the prescribed characteristics or criteria set out in the SIS Act, which primarily focus on scale rather than a set of meaningful performance criteria for MySuper products. APRA has previously stated that this so-called 'scale test' is insufficient on its own for determining whether a MySuper product is delivering appropriate outcomes for members.
76. APRA is therefore supportive of the concept of additional criteria for continued operation of a MySuper product as a way of ensuring a 'higher bar' in terms of the delivery of outcomes for members in MySuper products. This is consistent with proposals in the Member Outcomes Bill and also APRA's proposed Prudential Standards, which would require trustees to regularly and proactively assess the outcomes they are delivering for members.<sup>37</sup>
77. The Member Outcomes Bill would establish criteria to improve the quality of existing MySuper products. Specifically, the Member Outcomes Bill seeks to introduce an outcomes test, whereby RSE Licensees annually determine whether their MySuper product is meeting the financial interests of their members and they must annually compare their MySuper product against others in the market based on fees, returns, risk and other metrics. These changes, if implemented, are expected to improve the performance assessment of existing and new MySuper products, and hence provide better outcomes for members of these products over time. APRA would support this assessment also being extended to non-MySuper (choice) products, similar to APRA's proposed member outcomes assessment prudential requirements.
78. APRA does not see any conflict or impediment in APRA overseeing a review of MySuper products against additional criteria, potentially as part of a reauthorisation process. However, it would not be appropriate for APRA to be involved in applying criteria in order to select a 'shortlist' of products for default fund status (as proposed by the Productivity Commission) or other differential status.<sup>38</sup>

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<sup>37</sup> APRA Discussion Paper: Strengthening superannuation member outcomes, 13 December 2017, Exhibit 5.298.

<sup>38</sup> Refer to APRA's submission dated 2 November 2016 to the Productivity Commission Issues Paper, *Superannuation: Alternative Default Models* [available at https://www.apra.gov.au/submissions](https://www.apra.gov.au/submissions).

*825.23 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 a practical method of addressing this type of conduct noting that it is not suggested to be misconduct?*

79. The Commission has proposed that a mechanism be introduced to link a person’s superannuation account for receipt of default contributions to them such that changing jobs does not require creation of additional accounts. APRA supports this concept.
80. This issue has been canvassed extensively in the Productivity Commission’s Report on Superannuation. The Government’s Protecting Your Super package announced in the 2018-19 Budget would also provide authority for the Australian Taxation Office to automatically reunite a person’s existing inactive account with his or her existing active account. Over time, technological improvements are expected to further facilitate linking of superannuation accounts and hence reduce unintended and unnecessary multiple accounts.
81. APRA supports the concept that individuals should only ever have one default superannuation account, and that this should be linked to the individual rather than the employer.<sup>39</sup>

#### **H. Section 68A of the SIS Act**

*825.3 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?*

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<sup>39</sup> APRA’s submission to the Productivity Commission in response to its draft report, Superannuation efficiency and competitiveness, 3 August 2018, pages 8-9, available at <https://www.apra.gov.au/submissions>.

*825.4 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?*

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

82. A superannuation entity providing inducements to employers to gain or keep their business is at odds with the policy intent of the SIS Act covenants and is potentially a breach of s 68A (which falls under ASIC's remit). The selection of a superannuation default product by an employer should be based solely on consideration of how the fund will reasonably meet employee expectations, not on any financial, soft-dollar (e.g. entertainment, travel, etc.) or other considerations provided to the employer or its management. The expenditure of a fund on such inducements also raise concerns about acting in the best interests of members.

83. APRA would support an amendment to the SIS Act to strengthen the provisions to prevent superannuation entities from offering such inappropriate inducements.

**I. Payments from external responsible entities of managed investment schemes**

*825.6 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?*

84. A superannuation trustee should make decisions about the investment of members' money based on the interests of the members, and not influenced by the trustee's own interests. This situation is addressed by the "no conflicts" rule in s 52(2)(d) of the SIS Act. The covenants in s 52 are deemed to be included in the governing rules of a superannuation fund to the extent not already expressly included.

85. Considered from that perspective, it is apparent that it would not be appropriate for a trustee to retain payments from the RE of a MIS where the payment is derived from the investment of the members' funds in the MIS, unless the trustee applies the

payment for the benefit of members, for example by way of reduced fees or as refunds to members, or otherwise contributes them towards the assets or expenses of the superannuation fund.

86. In light of the matters considered by the Commission, APRA will also consider whether any aspects of its existing Prudential Standards or guidance on this topic could be strengthened.

**J. Discretion to appoint and remove directors**

*825.14 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?*

87. APRA's view is that there should be some constraints on the shareholders of RSE licensees having discretion to appoint and remove directors as outlined below. Consideration should also be given to other measures that would strengthen the ability of RSE licensee boards to effectively fulfil their obligations irrespective of ownership or corporate structure.<sup>40</sup>
88. APRA's Prudential Standards impose requirements on RSE boards to consider director capabilities, have appropriate appointment and renewal processes (including setting tenure policies), and assess fitness and propriety in appointing directors. In APRA's experience, however, unfettered shareholder control over board appointments can be problematic depending on how it is exercised and can materially impact on the quality and effectiveness of the board.
89. Concerns from an APRA perspective may arise where directors are sourced from a restricted pool of individuals and may not have the skills, capabilities and experience needed to adequately fulfil their responsibilities. This can arise, for example, where sponsoring organisations appoint directors primarily because of a specific role they may hold in an organisation. Concerns may also arise where the board and/or key directors, such as board or committee chairs, are unwilling or unable to exercise adequate influence, oversight or challenge in relation to the RSE Licensee's operations (particularly within some group structures), as has been evident in some of the cases explored by the Commission. In other cases considered by the

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<sup>40</sup> See paragraph 71 above.

Commission, there have been examples of fund mergers not proceeding, at least in part, because of shareholders (sponsoring organisations) wanting to maintain their control over director appointments.

90. APRA's view is that the board of the RSE Licensee should have a significant role in the nomination and renewal process for directors, working with the shareholders to ensure that the board has the objectivity, skills and capability need to effectively meet its obligations.<sup>41</sup> This could include, for example, use of independent search processes to identify candidates that met the skills and experience criteria that the board had identified as being needed. It could also include the board having the right to reject a nominee that was inconsistent with the agreed appointment and renewal process or to seek a replacement director in some circumstances. This may be appropriate, for example, where the nominee had exceeded the agreed tenure limit, did not have skills or experience that align with the RSE Licensee's skills matrix, had been assessed as not a fit and proper person under the relevant policy, or had been assessed as underperforming on the board in the context of the board's performance assessment process.
91. As noted above, APRA would recommend caution with respect to extending the best interest obligation to shareholders or other parties. Extending this obligation to others who do not have a fiduciary duty to superannuation members could dilute or undermine the critical obligation of the trustee. Potentially this could also conflict with obligations of a corporation under the Corporations Act. Further, it is not clear how, in practice, this covenant could be extended via the SIS Act, or whether it would be likely to produce better outcomes.
92. Finally, following its investigations into the collapse of Trio Capital, APRA sought more powers to monitor the ownership and control of an RSE Licensee to ensure that RSE Licensees are best placed to carry out their duties free of any influence that may not be in the best interests of the members of their fund. While APRA assesses the suitability of persons to hold an RSE licence when an application is made, it is currently unable to consider the suitability of trustees or directors who may subsequently obtain ownership or control (including practical control) of the RSE licensee. APRA therefore strongly supports the proposed powers included in the Member Outcomes Bill that would address this gap.

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Refer APRA's letter to RSE Licensees titled [Board Governance Thematic Review](#).

## K. Advertising

*825.1 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?*

*825.2 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?*

93. APRA's well-established view has been that advertising can provide benefits to members through increased scale, if the advertising successfully attracts new members and assets under management. This would potentially provide enhanced opportunities to spread operational costs over a larger number of accounts, invest in particular asset classes that require large amounts to be committed, leverage greater bargaining power with service providers, attract and retain high calibre staff, and pool risks (for example in relation to retirement income and insurance products). Advertising can also support innovation and greater price competition, as it allows funds to, for example, communicate their unique service offering or lower cost to potential members.
94. APRA's approach to the sole purpose test requires an RSE licensee to justify why it considers the activity in question does not contravene the test, and in particular why the activity or feature has a reasonable, direct and transparent connection to the core or ancillary purpose. APRA expects to see that a fund has demonstrated a business case that supports the need for the expenditure in relation to the best interest of members.

95. Viewed against these criteria, it is not clear that a differential treatment for 'political' advertising is needed. To the extent that is nevertheless considered necessary, any such restrictions on political advertising should be enacted through clear legislative provisions.

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21 September 2018