



Guidance Notes and Circulars

Superannuation Circular No. II.D.1

Managing Investments and Investment Choice

March 2006



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Objective

1. The aim of this circular is to:
 - explain the requirements of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) for managing investments and investment choice in APRA-regulated superannuation entities; and
 - provide guidance to trustees on APRA's supervision approach in relation to these and some other investment-related matters.
2. This circular replaces *Superannuation Circular No. II.D.1 Managing Investments and Investment Choice* which was released by APRA in April 1999.¹

Introduction

3. Under the SIS Act, the trustee of a superannuation entity is solely responsible and directly accountable for the prudential management of the investment of the entity's assets. It is the trustee's duty to make, implement and document decisions about investing those assets and to carefully monitor their performance.
4. Trustees' responsibilities when making investment decisions include formulating and implementing an investment strategy or strategies. This important duty is codified in s. 52 of the SIS Act as a covenant (an obligation of the trustee) and its importance is further reinforced by incorporation into the operating standard set out in r. 4.09 of the SIS Regulations which is applicable to trustees of all superannuation entities regulated under the SIS Act. The intent is to ensure trustees make appropriate decisions to protect beneficiaries' retirement benefits by identifying and managing investment risks, and to ensure investments are made in accordance with, amongst other things, the sole purpose and investment provisions of SIS.²
5. When formulating an investment strategy the trustee is required to consider, at the entity level, the risk and likely return from investments, the diversification of those investments, liquidity requirements and the ability of the entity to discharge its liabilities. Where investment choice is offered, beneficiaries may choose between strategies that have been developed by trustees according to this framework.
6. These requirements are found, firstly, in s. 52(2)(f) of the SIS Act and mirrored in r. 4.09 of the SIS Regulations which set out the matters that must be taken into account in formulating and giving effect to an investment strategy for a fund, and, secondly, in s. 52(4) of the SIS Act which allows a strategy that has been thus developed to include provision for members to give directions, in specified circumstances³, to trustees about the strategy for investment of particular assets of the entity.
7. The underlying policy intent is that the provision of member choice of investment strategy does not remove the need for the trustee to ensure that the investment strategy or strategies of the fund comply with the requirements set out in the legislation.

¹ The circular released by APRA in April 1999 replaced the circular issued by the former Insurance and Superannuation Commission in December 1995.

² The sole purpose and investment provisions of the SIS Act are further discussed in APRA *Superannuation Circulars No's. III.A.4 and II.D.2 to 6* available on the APRA web site at www.apra.gov.au

³ Regulation 4.02 of the SIS Regulations sets out the circumstances in which a member may give a direction to a trustee about choice of investment strategies.

8. Rather, s. 52 of the SIS Act should be read and complied with in its entirety. That is, trustees accepting member direction under s. 52(4) of the SIS Act are not relieved of their s. 52(2)(f) duties, most relevantly the duties to ensure a reasonably liquid and properly diversified fund.
 9. This circular provides guidance on trustees' responsibilities in these areas. In particular, the circular addresses the following issues:
 - the principles to which trustees must have regard in setting investment strategies (see paragraphs 13 to 36);
 - the application of those principles where investment choice is offered to members of a superannuation fund (see paragraphs 37 to 49), and
 - conflicts of interest that may occur in implementing an investment strategy (see paragraphs 65 to 72).
- Some preliminary notes about this circular**
10. 'Superannuation entity' is defined in s. 10(1) of the SIS Act to include a regulated superannuation fund, an approved deposit fund (ADF) and a pooled superannuation trust (PST). For ease of reference, the circular will generally refer to superannuation funds regulated by APRA, however the principles outlined will be relevant in most cases to the investment management by trustees of ADFs and PSTs as well.
 11. Implicit in the fund disclosure requirements set out in the *Corporations Act 2001 and Corporations Regulations 2001* (Corporations Act and Regulations) is the requirement for trustees to also cater for subplans of regulated superannuation funds in formulating investment strategies.⁴ 'Subplan' here is used in the context of a segment of a fund where there is a common factor, such as the members in that segment having the same employer, and for whom a different investment strategy may be developed. The term may also be applied, as relevant, in the context of an investment option that the trustee determines is appropriate for offer to members. Throughout the circular, a reference to 'fund' will also include, as relevant, a reference to 'subplan'.
 12. Trustees need to be aware that the Corporations Act and Regulations include additional obligations that will affect how trustees communicate with members about investment objectives and investment strategies. This disclosure regime is administered by the Australian Securities & Investments Commission (ASIC) and ASIC has published guidance on disclosure.⁵ If the trustee holds an Australian financial services licence, the trustee also has obligations as a licensee under the Corporations Act, including obligations about managing conflicts of interest.

⁴ For example, see s. 1017DA of the Corporations Act 2001 and Corporations Regulations 7.9.30, 7.9.35, 7.9.36 and 7.9.37

⁵ See the ASIC web site at www.asic.gov.au

Framework for developing investment strategies

13. The investment covenant prescribes that a trustee must formulate an investment strategy. An investment strategy is a plan for making, holding and realising fund assets consistent with the investment objectives adopted for the fund. A trustee may have a single all-inclusive strategy to achieve the investment objectives, or it may develop and offer to members a fund wide strategy and (consistent with that strategy) a number of strategies (or choices) to implement particular investment objectives. The duty to formulate an investment strategy applies regardless of whether the trustee invests directly, or through one or more investment managers, or where the fund assets are invested in the statutory funds of a life insurance company.
14. An investment strategy will usually outline the policy that the trustee will adopt and the actions that will be taken to achieve the investment goals. For example, a whole of fund investment strategy may specify the long-term strategic asset allocation, a crediting strategy and a reserving strategy.
15. APRA expects trustees to consider, and be able to justify and document, how all investments made under an investment strategy are consistent with that strategy and the safeguards, if any, that will be used to enable both the objectives of the strategy and the requirements contained in the investment covenant to be met.
16. The process for formulating an investment strategy offered for choice by members of a regulated superannuation fund will need to be consistent with the fund’s broad strategy for investment of all of the entity’s assets, which requires consideration of the following elements:

Elements of investment strategy	Requirement
Fund circumstances	The investment strategy must have regard to the whole of the fund’s circumstances
Diversification	The investment strategy must have regard to the composition of the fund’s investments as a whole including the extent to which the investments are diverse or involve the entity in the being exposed to risks of inadequate diversification
Risk and return	The investment strategy must have regard to the risk involved in making, holding and realizing the investments, as well as the likely return from the investments having regard to fund objectives and expected cash flow requirements
Liquidity and cash flow	The investment strategy must have regard to the liquidity of the fund’s investments having regard to its expected cash flow requirements; and to the ability of the fund to discharge its existing and prospective liabilities
Investment choice	An investment strategy is valid notwithstanding that it provides for directions to be given to the trustee about the strategy to be followed in regard to the investment of a particular asset or assets of the fund, and the directions are given in circumstances covered by the regulations.
Other desirable considerations for trustees	<ul style="list-style-type: none"> • obtaining advice about investment strategies, particularly in relation to defined benefits funds • documenting trustee consideration of investment strategy • expressing investment strategies – asset allocation ranges • application of requirements to subplans • defence in relation to investment strategy

Fund circumstances

17. Section 52(2)(f) of the SIS Act and r. 4.09 of the SIS Regulations set out that the whole of the entity's circumstances must be taken into account by the trustee when formulating an investment strategy for the entity. In the case of a fund, the fund's circumstances include, but are not limited to, the membership profile (for example, members' age and expectations, occupational profile, compulsory or voluntary membership), benefit structure (for example, defined benefit or accumulation fund), whether portability and choice of fund are available to members, fund 'phase' (accumulation phase, withdrawal phase or composite), whether investment choice is offered to members, continued employer support in the case of a defined benefit fund, tax position and fund size. Such circumstances affect the diversity and liquidity requirements of fund investment strategies.
18. A fund's circumstances may also be influenced by internal and external factors, including the financial state of the fund, the position in the market, the growth rate of the fund and the likelihood of future support by employer-sponsors.
19. Funds may adopt a reserving policy, which may help smooth investment returns to members. Where reserves are held, a strategy must be formulated to manage these reserves⁶. The strategy must be consistent with the fund's investment strategy and its capacity to discharge its actual and contingent liabilities as and when they fall due. In reviewing a reserving strategy, trustees should have regard to equity between continuing and exiting members, amongst other things. Refer also to paragraph 96.
20. When documenting their consideration of fund circumstances, trustees should also address the objective or objectives of the investment strategy or strategies and any:
 - statutory limitation or constraints on investments, for example, the SIS sole purpose test and other investment requirements (refer paragraphs 97 to 99);
 - non-statutory limitations or constraints on investments that are included in the governing rules of the fund, for example in the governing rules or policies of a specialist public offer fund that focuses on ethical or environmental issues;
 - relevant reports obtained from experts;
 - in the case of defined benefit funds, benefit design, fund solvency, employer support and the general economic climate, as well as assumptions about contribution levels, salary escalation and investment earnings used in the actuarial reports; and
 - actual and potential trustee/director conflicts of interest present at the time the strategy is developed, and, if these are not already addressed in the trustee's ongoing policy and processes to address conflicts of interest, how they will be dealt with in regard to specific investments, for example, directorships, controlling influences etc.
21. The investment objectives would indicate the desired investment outcome for the fund, or for each particular investment strategy offered by the trustee. The objectives should be documented and capable of being clearly communicated to assist interested parties in understanding the investment approach of the fund as a whole or of the specific investment strategy. It is APRA's view that, where possible, investment objectives should state explicitly the expected range of investment returns and how they are to be measured and also state the overall attitude to risk-return trade-off across the investment portfolio and how it is to be measured.⁷ The following examples illustrate approaches that may be taken in the formulation of investment objectives:
 - to obtain a rate of return matching or exceeding, by a specified percentage, a benchmark (for example, the All Ordinaries Accumulation Index or CPI) over a specified period (for example, five years);

⁶ The requirement to formulate a reserving strategy is set out in s. 52(2)(g) of the SIS Act and applies if there are any reserves of the fund

⁷ ASIC Policy Statement 170 *Prospective Financial Information* is relevant

- to provide real long-term (at least x years) capital growth of at least y% compounded and a level of income no less than z% from a balanced portfolio.
22. As superannuation investments are long term and markets often go through cycles, it would be appropriate for trustees to consider, and articulate, the risk tolerance for the occasional negative returns in setting an investment strategy. For example, the strategy may be designed so that, on average, negative returns on overall investments are not expected to be incurred more frequently than once in x years.

Risk and return

23. Risks include the chance of loss on an investment, of achieving a return that is less than expected or insufficient to meet liabilities,

or underperforming an index or benchmark. In this context, risk is usually measured by reference to the volatility of returns. Trustees must, in formulating and giving effect to an investment strategy, be able to identify, measure and manage the risks associated with particular investments or types of investments. As risks are subject to factors such as economic changes, new products, new risk management techniques and legislative changes, trustees are obliged to continuously monitor, assess and review the fund’s investment objectives, strategies and performance. Different risks are normally associated with different assets and asset classes with the result that the level of exposure to particular assets or asset classes may need to be adjusted from time to time. The principal investment risks include:

Type of risk	Risk description
Market	the possibility of loss resulting from changes in market conditions, including share prices, inflation, interest rates, foreign exchange risk on foreign currency denominated assets and sovereign government actions
Operational	the risk of loss occurring through error, fraud or failure to perform investment activities in a timely manner as a result of human errors, a deficiency or breakdown in systems, internal controls and processes or corporate governance
Conflict of interest	the risk that trustees are unable to optimize the cost and value of services provided by third parties, due to trustee or third party interests which conflict with the member interest
Hedging	the risk of loss resulting from a mismatch between movements in the price of a hedge instrument (such as a futures contract) and movements in the price of the underlying financial instrument or commodity; also in defined benefit funds, setting of investment strategies which are not aligned to the benefit structure
Liquidity	the risk of capital loss or losses arising from delays in converting an investment into cash, or changes in the marketability of the investment
Credit	the risk that a counter party to a transaction fails to fulfil its contractual obligations
Settlement	the risk that a settlement in a transfer system does not take place as expected, for example in currency trading across different time zones

24. Trustees that apply for an RSE licence must develop a risk management strategy for their own operations and a risk management plan for each superannuation fund for which they are trustee. Amongst other things, the plan must set out reasonable measures and procedures to identify, monitor and manage the risks to the investment strategy relevant to the fund. A risk management plan that meets the requirements of s. 29P of the SIS Act is a pre-requisite to the registration of the fund with APRA, following the granting of an RSE licence to the trustee.
25. Investment risk can be managed through the careful assessment of assets proposed to be purchased and through diversification. Where relevant, trustees should specify criteria for asset quality, for example minimum counterparty ratings or grading requirements for cash and fixed-interest investments. In deciding on the composition of an investment portfolio the trustee should ensure that the range of authorised investments:
 - facilitates the building of an investment portfolio that can serve the needs of the fund;
 - takes into consideration potential changes in circumstances in the short-term; and
 - avoids undue concentration in any investment market or in any single asset.
26. There is a strong correlation between risk and return. In setting the fund's investment strategy, trustees must determine the acceptable level of possible risks and volatility of returns bearing in mind all the circumstances of the fund.
27. Trustees may use derivatives to manage risk by protecting assets against changes in the market (hedging).⁸ Derivative use must be specified in the investment strategy and, if required, a derivatives risk statement (formerly termed 'risk management statements') prepared and/or obtained from relevant parties, for example, pooled superannuation trusts (refer *Superannuation Circular No. II.D.7 Derivatives and Addendum*). The derivative risk statement covers the controls over derivative use and the process for assessing compliance with those controls.

⁸ See r. 13.15A of the SIS Regulations

Diversification

28. The appropriate level of diversification and the method by which it is achieved will depend on the individual circumstances of the fund and the trustee should take a systematic approach to this. Diversification to manage the risk and variability of returns involves spreading investments over a number of individual assets, asset classes (including property, fixed interest, cash, and equities), countries and/or investment managers. Diversification may also be achieved within each asset class, for example, investing in commercial and residential property, domestic and foreign equities, and long and short-term fixed-interest investments.
29. Non-traditional assets, such as infrastructure, private equity and public-private partnerships, are acceptable in a diversified portfolio, provided the trustee has considered their expected return and diversification effect on the portfolio and can demonstrate appropriate expertise and process to manage such asset classes within a superannuation fund portfolio. The 'label' attached to an asset class such as 'hedge fund', may suggest a homogenous class, but trustees should be aware that the label may obscure the fact that a wide range of different tactics are employed by operators of such funds.
30. A well-formulated investment strategy would not ordinarily provide that all, or a large proportion, of the fund's assets be invested in one asset (such as a single property) or a single asset class. This does not preclude specialised pooled superannuation trusts concentrating on particular market segments. Nor does it preclude options being available to fund members to select from different portfolios with varying risk/return characteristics. However if, on a reasonable evaluation, investments of a particular fund do not display adequate diversification given the nature of the fund, the onus will be on the trustee to provide a justification, for example to APRA or to members, for these investments, including an outline of how they are viewed as consistent with the investment strategy.

31. In cases where, because of past decisions, a whole of fund investment strategy has resulted in the assets of a fund being heavily concentrated in a single investment (for example, a retail or industrial property), or in a small number of similar assets, APRA expects the trustee to devise a plan to ensure that the risks to members arising from this concentration are reduced over a reasonable period. In devising the plan, the trustee should assess whether continuing to hold the single asset, or the small number of similar assets, is consistent with the liquidity and cash flow requirements of the fund, and the extent to which future contributions and investment earnings could be used to further diversify the investment portfolio.
 - the expected timing, through cash flow projections, of investment income and contributions;
 - the age profile of members and forecast inward contribution and outward benefit payment levels;
 - whether portability and choice of fund are available to members;
 - actual, contingent or expected expenditure, for example, fees due under contracts with service providers, taxation, self-insured benefits on member exits etc. ; and
 - procedures for managing liquidity, including a contingency plan for dealing with a liquidity shortfall.
32. Where a trustee, in developing an investment strategy for a fund, determines that some concentration is permitted within the fund, the trustee should conduct due diligence that includes an independent market evaluation based on an arms-length transaction before acquiring the asset, or assets. As noted in the previous paragraph, the management of concentration risk includes assessment of the liquidity and cash flow requirements of the fund, and the extent to which future contributions and investment earnings could be used to reduce that risk.
33. In the case of funds with a small balance, the benefits of diversification may be best achieved by investing in an investment vehicle established to hold a diverse portfolio (for example, a collective investment fund).
35. For each asset class and the overall portfolio, trustees should identify liquidity characteristics and ensure that the fund assets taken as a whole meet necessary liquidity requirements. However, surplus liquidity would be costly over the long term due to its effect on investment returns and trustees should not seek to avoid any potential for liquidity problems by maintaining a higher level than prudent.
36. APRA does not require or expect a minimum level of cash to be held for liquidity purposes. Given sufficiently robust cash-flow forecasting capability, trustees may prudently choose to run a low or zero cash position as long as ready access to other liquid assets is maintained.

Liquidity and cash flow

34. The liquidity and cash flow position of the fund, particularly the capacity to pay expenses, tax and benefits when they become due, is an essential consideration for trustees' investment decisions. When formulating strategies, trustees should consider:
 - the desired liquidity;
 - the required amount of investment in cash or in assets readily convertible to cash without material loss;

Investment choice

37. Many changes have taken place in the offering of member investment choice over the past 10 years or so. Investment choice is now the norm for accumulation funds and the number and types of choices, and the ways in which they are offered, have expanded over this period. Nevertheless, trustees must continue to observe the requirements in relation to setting the investment strategies offered to members which have been in the SIS Act since it commenced. The guidance provided in this circular is not intended to significantly impinge on the choices

that trustees can offer and members make. Rather, it focuses on trustee protection of members' interests by means of sound processes and policies to manage investment risks.

38. An investment strategy is taken to be in accordance with the requirements set out in the covenant even if it provides for a specified beneficiary or class of beneficiaries to give directions to the trustee where the directions relate to the strategy to be followed in relation to the investment of a particular asset or assets of the fund and are given in circumstances covered by Regulations.⁹

Trustees of APRA-regulated funds that offer investment choice are expected to:

- recognise their statutory responsibility to set each investment strategy offered by the fund;
- consider the circumstances of the fund when formulating each investment strategy;
- ensure that appropriate controls are in place to manage risk, diversification and liquidity; and
- recognise that if it fails to fulfill its obligations, it leaves itself open to loss of the statutory defence available under s. 55(5) of the SIS Act against claims for the investment losses.

39. The offer of investment choice does not remove the obligation to formulate and implement each investment strategy. Provided a trustee has properly developed each investment strategy offered to beneficiaries and has disclosed the necessary information about each strategy and the range of directions that may be given in respect of each¹⁰, a beneficiary may then, and only then, direct the trustee to allocate his or her interest in the fund to one or more of the trustee

determined investment strategies. It follows that the trustee is, in such circumstances, entitled to accept a direction coming from the member without contravening the requirement that a trustee must not be subject to direction.¹¹

40. In developing and implementing each separate strategy, it is the trustee's primary responsibility to consider all the circumstances of the fund. The extent to which a trustee, in developing a strategy, is able to consider external circumstances as they apply to individual members will necessarily be limited and always incidental. The impact of a particular strategy on elements such as fund diversification and fund liquidity must be taken into account when developing the strategy, and, where necessary, controls should be in place to manage exposure to a particular strategy.
41. Some funds offer a wide array of investment strategies with varying degrees of inbuilt diversification and liquidity. These may range from those that are diversified within themselves (for example, a 'balanced fund' or a listed investment company), or represent a temporary safe harbour such as a cash option, to very narrow or undiversified strategies (such as a single equity) that are offered on an unrestricted basis.
42. Offering a broad range of investment options to members creates two potential prudential risks for trustees. First, at the fund level, it is possible that a large number of members selecting the same or similar narrow investments would jeopardize the entire fund's diversification or liquidity position. As an extreme example, if a large proportion of members elected to put 100 per cent of their investment into illiquid real property vehicles, then at a later date these members elected to exercise their portability options in switching to another fund, then the fund's overall liquidity would be at risk. While this extreme example is provided for

⁹ Section 52(4) of the SIS Act and r. 4.02 of the SIS Regulations

¹⁰ See r. 4.02 of the SIS Regulations and s. 1012IA of the Corporations Act (NB, temporary relief from compliance with s.1012IA has been provided up to 30 June 2006 under ASIC Class Order 05/346)

¹¹ Section 58 of the SIS Act generally provides that the governing rules of a superannuation entity with more than four members must not permit a trustee to be subject to direction by another person.

illustrative purposes, trustees need to manage the risks associated with members making sudden changes in their investment choices and formulate investment strategies with such contingencies in mind. APRA will take such strategies into account when forming a view as to whether trustees have complied with the requirements in s.52 of the SIS Act.

43. The second prudential risk in allowing unconstrained member investment direction is the risk that the member will choose an undiversified portfolio (such as a single equity or a highly volatile narrow asset class), and subsequent losses on this portfolio will greatly reduce the member's retirement income. This may lead to claims against the trustees by members.
44. Where the trustee considers that a particular investment option is inappropriate if made as the sole or major investment of a member in the fund but appropriate when undertaken in conjunction with other investments in the fund, this must be clearly stated in the notification to members of the strategy choices they can make in the fund. The information should cover the objectives and risks of the strategies offered for choice and how the diversification of the investments is intended to operate to place the member in a prudent risk position.
45. In APRA's view, it is difficult to conclude that a trustee is acting in the best interests of members if narrow or risky choices are made available without regard to the amount or proportion of the member's interest that may be placed in the particular strategy. Quantitative limits set by the trustee are one way to reduce concentration risk at the individual member level. For example, a trustee may require the members to hold a minimum of five separate stocks if single equities are offered as investment options. Trustees could also mitigate this risk by advising members on a regular basis (such as in conjunction with annual member reporting), of the benefits of diversification. Where it is possible to identify members that are solely or heavily invested

in narrow or risky options, trustees could also consider providing particular 'health' warnings to such members.

46. If there are circumstances in which the trustee will rebalance a member's investments in the fund to conform to the directions previously made by the member, then the trustee should disclose the circumstances and the manner in which any rebalancing would be achieved. Similarly, if there are circumstances in which the trustee will **not** rebalance a member's investments in the fund, those circumstances should be disclosed.
47. As in the case of a fund with a small balance, diversification may practically be made available to individual members with only a small amount in the fund, by offering an investment vehicle established to hold a diverse portfolio.

A trustee cannot abrogate responsibility in relation to investment strategies by requiring members to seek their own financial advice.

48. Trustees of some funds that offer a wide array of investment strategies require the member to attest to having obtained advice from a financial adviser before accepting contributions or rollovers or instructions regarding allocation of the member's interest in the fund. While it may be normal practice for a financial adviser to consider the assets of an individual member held outside the fund when providing advice on the allocation of the member's investments within the fund, that approach is generally not available to a trustee when developing an investment strategy for the fund. Accordingly, and as noted previously, investment strategies must be developed in a whole of fund context.
49. APRA would be concerned if a trustee held the view that a financial adviser's involvement in the member's investment choice relieved the trustee of the duty to formulate and implement appropriate investment strategies for the fund.

Such a view would be wholly unsupported by the SIS legislation which is based on the concept that the trustee is the sole responsible entity in relation to the fund. The fact that members may, in limited circumstances, direct their investments does not relieve a trustee itself of the requirement to act prudently, nor can it divest the trustee of its duty to have regard to diversification, risk, liquidity and other factors when setting investment strategies.

Beneficiary investment choice and member directed investment

50. The discussion at paragraphs 37 to 49 has referred to investment choice which may be offered to members within any regulated superannuation fund. Beneficiary (or member) investment choice allows a beneficiary to give a direction to a trustee in regard to the strategy for investing the beneficiary's interest in the fund, and can only occur within the investment strategies determined and offered by the trustee and in accordance with the range of directions specified by the trustee.
51. 'Member directed investment', on the other hand, enables members of funds with fewer than five members to have direct input to the investment decisions of the trustee. However, the exclusion of small super funds from the rule that trustees must not be subject to direction does not lead to the consequence that the trustee must simply accept the member's direction in relation to investment. Although the exclusion means that members of such funds are able to direct trustees to purchase certain assets that accord with the overall investment strategy of the fund¹², the trustee of the small fund, whether a self managed fund or a small APRA fund, is subject to the same statutory duties as other funds including the duty to formulate and implement an investment strategy.

52. The trustee is not relieved of those duties by the ability of members of small funds to provide input to the development of the investment strategy. Trustees of these small funds remain responsible for the investment strategy and are only bound by a direction to purchase a specific investment where the governing rules permit the direction, the resulting investment is in accord with the trustee-determined investment strategy for the fund and the investment does not conflict with SIS requirements.

Other desirable considerations for trustees

53. Trustees may seek help to formulate investment strategies; however, the responsibility remains with the trustees who should document any advice received and their consideration of it.
54. Given the significant impact of investment outcomes on the financial soundness and security of defined benefit funds, APRA expects trustees of defined benefit funds to consider, on an ongoing basis, the need to obtain actuarial advice in regard to the suitability of the investment strategy. Unlike accumulation plans where the expected benefits can be related to actual investment outcomes, defined benefit plans have to manage volatility in investment outcomes and broad matching of assets and liabilities is important.
55. In the event that vested benefits are not fully funded, APRA expects not only that the funding position will be rectified over a reasonable period, but that the trustee seek advice as to whether the investment strategy is appropriate to ensure that the deficit does not deteriorate further. The trustee should be able to justify its decision to APRA. Poor investment outcomes affect defined benefit funds that are closed to new members (now the majority of funds) more than ongoing funds open to new members. The particular investment strategy adopted may differ depending on the assessment of current and expected investment conditions, the maturity of the fund and its funding level.

¹² Item 39 of the Explanatory Statement to *Superannuation Legislation Amendment Bill (No. 3) 1999* stated: 'Excluded funds are currently exempted from s. 58 of the SIS Act which limits circumstances in which trustees can be subject to a direction from another person. As a result members of excluded funds are able to direct trustees to purchase certain assets that accord with the overall investment strategy of the fund. This item will enable this exception to continue for all regulated superannuation funds with fewer than five members (including those that are regulated by APRA) and excluded approved deposit funds.'

56. Members and employers of standard employer-sponsored funds can express their views concerning investment strategies through their trustee representatives or through the fund's policy committee, as applicable (refer to *Superannuation Circular No. III.A.2 Trustee Arrangements – Superannuation Funds Other Than Public Offer Funds* and *Superannuation Circular No. III.A.3 Trustee Arrangements – Public Offer Superannuation Funds*).
57. Trustees must be able to demonstrate, for example through trustee minutes, other documentation such as reports from investment advisers and the actual wording of the strategy that they have considered, at a minimum, the specific issues that have been taken into account under the investment covenant, that is, risk and return, diversification, liquidity and the ability to meet liabilities, in the context of the fund's circumstances (refer to paragraph 16).
58. It is important for interested parties (such as members and prospective members, APRA, auditors and actuaries) to be able to easily understand a fund's investment strategy so that they can assess the potential investment performance and management of the fund.
59. Where investment strategies are expressed via asset allocation ranges with associated benchmarks against which performance may be measured, trustees should ensure that the benchmarks are appropriate for the fund, and establish a policy for intended actions should a fund manager, asset or asset class diverge from benchmark expectations.
60. Asset allocation ranges should be of sufficient scope to allow for normal market fluctuation, but not so wide as to render ineffectual their use as a monitoring tool. For each asset class, trustees should also consider whether or not investment will be made on a passive (indexed) or actively managed basis. Trustees should regularly, and at least annually, review these strategic decisions.
61. In following a structured approach to formulation of an investment strategy in accordance with the investment covenant, trustees would be expected to establish a process to continually monitor and respond to changing circumstances to promote considered and responsible decision-making. Such a due diligence process would also afford a measure of protection to the trustee, under s. 55(5) of the SIS Act, from action by members in the event of unsuccessful investments.

Implementing investment strategies

62. Implementation of the strategy involves further considerations such as the quantum of fund assets, the expertise of the trustees, the availability to the trustee of appropriate advice, administrative capabilities and the costs of managing investments. It may involve direct investment, indirect investment (for example, through collective investments), using investment managers or a combination of these approaches.
63. Particular investment strategies may require processes to be put in place to manage particular exposures, such as foreign exchange exposure, asset valuation and unit pricing risk. In unitised funds or where a fund has an investment in a unitised product, unit pricing controls are of critical importance and trustees should develop robust risk management processes to ensure that unit prices are calculated correctly. See paragraph 80 for further discussion on asset valuation, and paragraphs 94 to 95 in regard to unit pricing processes and the determination of crediting rates.
64. Regardless of the approach taken, trustees must ensure that the fund's ownership of the investments is beyond doubt. Where assets are not held custodially, this would mean that assets are held in the name of the fund trustee. A trustee may enter into a contract with a custodian to perform custodial functions in relation to all or some of the fund's assets. Approved trustees or RSE licensees with a public offer licence that do not meet the net tangible asset or approved guarantee capital options must use a custodian for all fund assets.¹³ Where assets are registered in the name of custodians, the trustee's (and therefore the fund's) interests need to be effectively assured through the contractual agreement with the custodian (refer paragraphs 76 to 79 for the rules relating to the engagement of custodians). Annual statutory audits are expected to test ownership on a regular basis.

Conflicts of interest

65. Trustees will often be faced with actual or potential conflicts of interest. Managing such conflicts is an essential element of the trustee's role, and, where the trustee holds an AFS Licence, it is required to have in place adequate arrangements for the management of conflicts of interest.¹⁴ The following examples highlight particular practices that APRA would consider to be inconsistent with a trustee's responsibilities and which would attract additional scrutiny from the Regulator.
66. 'Implemented consulting' is an extension of traditional asset-consulting services where investment advice and fund manager selection services are combined into an integrated service. Effectively, this allows a trustee of a superannuation fund to delegate the role of selecting investment managers to the asset consultant. Although such an arrangement offers the benefit of an 'all in one' service, negative prudential outcomes can arise. For example, the 'all in one' service has the potential to completely replace trustee decision making in crucial investment management areas. In some instances an implemented consultant may offer its own product, or recommend a related party, in competition with those which it will assess and advise to the Trustee.
67. The trustee's duty to act in the best interests of members could be compromised if the trustee accepted, without independent review of the selection process, an implemented consultant's recommendation for retention or engagement of a fund manager or product manager related to the consultant. One way to manage such a conflict would be to limit implemented consultant recommendations to unrelated parties. Alternatively, trustees should ensure that disclosure of related party engagements is required in their agreement with the implemented consultant, and the manner in which conflicts are managed should be part of the independent review of the selection process.

¹³ See s. 26(1)(b) and s. 29DA of the SIS Act

¹⁴ See s. 912A(10)(aa) of the Corporations Act and guidance on management of conflicts of interest contained in APRA *Superannuation Guidance Note SGN 110.1 Fit and Proper* (paragraph 26) and ASIC *Policy Statements 81 Licensing: Managing Conflicts of Interest*

68. The phrase 'soft dollars' describes practices where one third-party supplier is offered non-cash inducements by another third party supplier in order to encourage business being directed to their products or services. Provision of research, information systems and other expense defrayal by equity brokers to fund managers would be examples, as would be the situation where an asset allocation or fund manager selection consultant sought soft dollar compensation to place fund managers in a selection or candidate group.
69. 'Soft dollars' are ultimately real expenses for members and trustees must manage material soft dollar arrangements in the interests of members, rather than in the interests of other parties. Smaller trustees may have limited ability to manage soft dollar arrangements. Larger trustees, however, have demonstrated that (among other items) soft dollar equity brokerage arrangements can be renegotiated to produce a more accountable and better value service for fund members.
70. Some other circumstances that create a conflict of interest include situations where a director of a trustee company is also a director of a related party used by the fund, or of an investment manager used by the fund, or of an entity in which the fund invests, or where an asset consultant engaged for the purpose of providing independent advice is appointed to the board of an investment company on behalf of the trustee.
71. Most trustees outsource some aspects of their operations, notably administration, funds management or custodianship. Regulation 4.16 of the SIS Regulations governs outsourcing arrangements of RSE licensees. In many cases trustees use, or consider the use of, services provided by related parties. While this is not prohibited, trustees clearly are not able to presume that a related party service offering is inherently superior to unrelated party offerings. Consistent with their duty to act in the best interests of members, trustees should be able to demonstrate that services provided by a service provider, and in particular a related party provider, are provided on terms and conditions that are no less favourable than the best terms and conditions reasonably available from other possible providers at the time the contract is let.
72. Furthermore, in negotiating terms and reviewing engagements with related parties, good practice dictates that trustees should have a process to conduct regular assessments and comparisons of services provided by a related party to that of other 'market best' unrelated parties. Trustees should document the reasons for deciding to continue or terminate the services, and why the decision is in the best interests of fund members.

Investment managers

73. Where trustees delegate the investment management function, they must ensure proper selection processes have been undertaken and their due diligence examinations should be documented. If an implemented consultant is used, the due diligence process should extend to identification and consideration of conflicts of interest, as discussed at paragraphs 65 to 72. An appointment of an investment manager must be in writing.¹⁵ The investment management agreement should clearly specify the function to be delegated and address issues such as the required investment parameters or constraints, performance standards and benchmarks, regular reporting processes, fees and charges, termination clauses, ownership of books and records, dispute resolution procedures and indemnification conditions. As investment management is a material business activity of a trustee that is an RSE licensee, the agreement must comply with the outsourcing operating standard in r. 4.16 of the SIS Regulations.
74. The SIS Act makes it impossible for the agreement between the trustee and the investment manager to exempt the investment manager from liability for negligence or to limit that liability.¹⁶ The trustee is obliged to ensure that the mandate enables the trustee to seek information from the investment manager at any time.¹⁷ Generally,

¹⁵ Section 124 of the SIS Act.

¹⁶ Section 116 of the SIS Act.

¹⁷ Section 102 of the SIS Act.

investment management contracts entered into by a trustee that is an RSE licensee will be required to meet the outsourcing operating standard in r. 4.16 of the SIS Regulations.

75. An investment manager must be a body corporate¹⁸ and must not be a disqualified person.¹⁹ Broadly, a body corporate may be disqualified from being an investment manager as a result of insolvency, being wound up or where the body corporate knows or has reasonable grounds to suspect that a disqualified person is acting as a responsible officer. A responsible officer is a director, secretary or an executive officer of the body corporate. For further information refer to *Superannuation Circular No. III.A.2 Trustee Arrangements – Superannuation Funds Other Than Public Offer Funds* and *Superannuation Circular No. III.A.3 Trustee Arrangements – Public Offer Superannuation Funds*.

Custodians

76. Trustees may also choose to use custodians for services ranging from clearing, settlement and safekeeping of assets to investment administration, unit pricing or reporting to the trustees or investment managers.
77. Like all delegations to service providers, proper selection processes and agreements should be in place. An agreement entered into by a trustee that is an RSE licensee with a custodian would generally be required to meet the outsourcing operating standard in r. 4.16 of the SIS Regulations. A custodian must be a body corporate and meet certain capital requirements²⁰ and must not be a disqualified person²¹ (refer paragraph 75). Unless acting as a custodian only for self managed superannuation funds, the custodian must hold net tangible assets or an approved guarantee for an amount not less than five million dollars, or the total

value of the net tangible assets of the custodian and the approved guarantee must not be less than five million dollars.²²

78. An investment manager cannot appoint a custodian without the written consent of the trustee.²³ Custodians should be appointed under a contractual agreement which complies with the outsourcing operating standard in r. 4.16 of the SIS Regulations and sets out, at a minimum, the delegated functions, investment parameters, performance standards and benchmarks, regular reporting processes, fees and charges, termination clauses, ownership of books and records, ownership of assets, rules for appointment of any sub-custodian, dispute resolution and indemnification conditions. The trustee should ensure that the agreement with the custodian (which will be either between the custodian and the trustee or the custodian and the investment manager) enables the trustee to seek information from the custodian at any time. For further information refer to *Cross Industry Circular No. 1 Custodian Requirements for APRA Supervised Entities* and *Superannuation Guidance Note SGN 130.1 Outsourcing*.
79. All delegated functions remain the responsibility of the trustee and adequate reporting and controls must be in place.

Asset valuation

80. Ease, or otherwise, of asset valuation should also be considered when a trustee is making investment strategy decisions as this affects equity between continuing and exiting members. Australian Accounting Standard 25 (AAS 25) *Financial reporting by superannuation plans* applies to the general purpose financial reports of superannuation funds. AAS 25 requires assets to be measured at net market values as at the reporting date. In respect of property and

¹⁸ Section 125 of the SIS Act. Trustees should carefully consider whether investment managers domiciled overseas meet the statutory requirements. Note that self managed superannuation funds are exempted from the requirement for an investment manager to be a body corporate.

¹⁹ Section 126 of the SIS Act.

²⁰ Section 123 of the SIS Act and r. 13.19 of the SIS Regulations. Note that self managed superannuation funds are exempted from the requirements of s. 123 of the SIS Act.

²¹ Section 126A of the SIS Act.

²² Section 123 of the SIS Act and r. 13.19 of the SIS Regulations.

²³ Section 122 of the SIS Act.

other assets that are not officially traded on a regular basis, the periodical valuations should be independent and updated regularly (especially in times of market volatility). In APRA's view, reliance on internal appraisals on a recurring basis is not sufficient and independent valuations should be obtained no less frequently than every three years. More frequent valuations should be undertaken for assets that are not traded.

Funds 'switching' from ATO to APRA regulation

81. A self managed fund may 'switch' to regulation by APRA. If there are no more than four members, a trustee approved or licensed by APRA to operate small funds must be appointed.²⁴
82. Trustees of small APRA funds provide a service to the funds for a fee, with the members of the fund often taking a greater involvement in the operations of the fund than in other, larger, APRA-regulated funds. This is particularly so in regard to investments. However, APRA requires the trustees of small APRA funds to exercise the same degree of care and diligence in setting, monitoring and reviewing the investment strategies as for any other APRA-regulated fund. Particular care is needed in respect of funds that transition from self management, to ensure that the marketing pressures of enlisting or retaining clients do not dilute the rigour of initial and ongoing due diligence, as the trusteeship moves from the members themselves to an arms-length professional trustee, licensed by APRA.
83. APRA expects that such trustees would undertake due diligence to ensure the investment strategy of the switching fund was acceptable to the trustee, and if necessary remedy the situation within six months of appointment.
84. The prudential scrutiny applied by APRA to small APRA funds in respect of protecting members' long term retirement benefits must be kept in mind by trustees. The protection of the culpability test that applies to APRA-regulated funds could be lost if the trustee fails to exercise requisite independent oversight in respect of investments and simply relies on the dictates of members.

²⁴ Section 121A of the SIS Act.

Monitoring

85. Trustees must monitor investments, strategies, objectives and supporting systems to ensure compliance with legislative and contractual requirements and to minimise risk, including the risk of fraud or mismanagement. Monitoring must take into account any actual or proposed changes to the fund and to external conditions. These may include:
- proposed and actual legislative amendments which may impact on the fund, such as changes to retirement income standards or tax arrangements;
 - a sudden unexpected growth of membership or change in membership profile due to corporate restructures;
 - changes to the economic climate and the status of specific markets; and
 - changes to service providers (including legacy system issues).
86. Once such factors are identified, the appropriate response will depend on the circumstances but may include re-balancing the investment portfolio, altering the investment strategy, reporting to members or reviewing business continuity plans.
87. All fund investments should be regularly monitored and reviewed to ensure that the investments remain consistent with the investment strategy, objective and performance benchmarks. The amount, complexity and type of investments will govern the frequency and style of monitoring needed, for example daily, weekly; computerised or manual monitoring etc. It is recommended that reviews against strategy and benchmarks be undertaken at least every six months unless more frequent reviews are warranted in individual circumstances.
88. If asset ranges are specified, investments should be regularly reviewed to ensure they are maintained within the pre-determined asset ranges; that is, they are adjusted as necessary in the light of market movements. Where asset allocation ranges are used in setting investment strategies, investment performance should be monitored against the benchmarks factored into those strategies. As well, consideration should be given regularly to whether the actual allocation ranges should be maintained or varied.
89. Trustees also have a responsibility to monitor the on-going conformity of investments with the investment strategy when assets are directed into particular strategies pursuant to the exercise of member choice. Trustees should actively manage and correct breaches of investment strategy or asset allocation conditions. To do this, a robust control process needs to be in place.
90. Procedures should be in place to monitor adequately direct investments in particular assets (for example, property or equities). This includes monitoring of performance to ensure that the investments remain relevant and appropriate, the receipt and recording of income, and obtaining proper valuations. If the management of direct investments has been delegated to an external service provider, monitoring should not be limited to performance but also cover the underlying framework of the manager's approach, including operational aspects relative to the trustee's investment strategy.
91. Trustees should also ensure that procedures are in place to adequately monitor indirect investments (for example, collective investments such as pooled superannuation trusts, unit trusts, life policies, etc.). This includes monitoring of performance to ensure that the investments remain relevant and appropriate, the underlying fundamentals of the investment manager's approach, including operational aspects, remain consistent with the trustee's investment strategy, and that regular and timely transaction reports are received.
92. Consistent with the initial formulation and implementation of investment decisions, trustees should document the review and monitoring process and any resulting actions.
93. Where trustees have delegated the investment management or custodial function (in whole or in part), sufficient information and reports must be available to trustees to enable informed decisions to be made. In particular, APRA's statutory reporting requirements dictate that trustees must be able to determine the amount of expense imposed by fund managers and be able to report this amount to APRA annually. The reporting mechanism should form part of the written agreements and include frequency, performance benchmarks and compliance issues. The activities of investment managers and custodians should also be monitored to ensure they can continue to meet their obligations.

Distribution of investment earnings

94. Generally, for funds which are not operated on a unitised basis, trustees determine amounts to be credited or debited to members at least once a year, taking into account investment returns less costs and any transfers to or from reserves. Trustees may also determine from time to time interim crediting rates to be paid upon a member's exit taking into account changes in the fund's investment performance.
95. Trustees should ensure that there is an adequate procedure to determine crediting rates which are fair and reasonable between all members and the various kinds of benefits. While trustees should be alert to cross-subsidisation and resulting inequities, returns that are fair and reasonable need not necessarily result in uniform investment returns for all members. Where members are offered a choice of different investment strategies the returns experienced by each member should reflect their choice of strategy and would therefore not be uniform. Refer to *Superannuation Circular No. I.C.1 Minimum Benefit Standards* for further information concerning investment returns. Substantive considerations with regard to pricing, valuation and risk management, and areas of potential for error in calculation of crediting rates, are in many aspects similar to those identified in relation to unit pricing. ASIC and APRA have issued joint guidance on unit pricing issues.²⁵ APRA expects that trustees would ensure that pricing processes are independently verified, for example by the fund auditor or actuary.
96. A trustee may maintain reserves of the fund unless prohibited by the governing rules of the fund.²⁶ Reserves may be used to smooth returns, enabling the trustee to determine either a higher return to be distributed than actually received from the investments or to increase the reserve and distribute a lower than actual return. Reserves may, over time, create an expectation in the minds of members about future smoothing actions that may not be able to be met in the context of the existing reserves and market volatility. As discussed at paragraph 19, trustees must ensure that reserves are managed in a manner consistent with the investment strategy and the fund's ability to meet its liabilities. In the context of choice and portability, trustees should closely consider the arguments for and against reserves.

Other investment requirements

97. In addition to trustees' responsibility to formulate and give effect to an investment strategy, trustees must comply with other SIS investment rules. These include the general prohibitions on:
- borrowing;
 - lending to members;
 - placing charges over fund assets (except in relation to certain derivative contracts); and
 - acquisition of assets from members;
- as well as:
- the requirement for investments to be made on an arm's length basis; and
 - restrictions on holdings of in-house assets.
98. These investment issues are discussed in *Superannuation Circular No's. II.D.2 to II.D.7*.
99. The sole purpose test set out in s. 62 of the SIS Act requires that the trustees of regulated superannuation funds must ensure the fund is maintained solely for the purposes listed in the section. APRA's *Superannuation Circular No. III.A.4 The Sole Purpose Test* comments on the interaction between the sole purpose test and the investment restrictions listed in paragraph 97 above and reminds trustees that a contravention of the test may arise where there is no retirement purpose behind an investment.

²⁵ Unit Pricing – Guide to Good Practice – Joint ASIC and APRA Guide, November 2005.

²⁶ Section 115 of the SIS Act

Statutory defence for loss or damage

100. Whilst contravention of a covenant is not an offence, a person who suffers loss or damage as a result of a contravention by another person may seek recovery against the other person.
101. Section 55(5) provides trustees who have acted properly with a statutory defence against an action for loss or damage suffered as a result of the trustee making an investment. This defence is available where the investment was made in accordance with an investment strategy formulated and implemented under the investment strategy covenant.
102. The existence of a statutory defence allows trustees to focus on the overall risk of the total investments, rather than the risk attached to each investment in isolation. This enables the trustee to invest fund assets according to the investment strategy in what might, when considered in isolation, appear to represent a rather risky investment, but which is prudent in the context of a well diversified and proactively managed portfolio.
103. Trustees should be aware that this valuable defence is dependent on their discharging the burden of proof. This emphasises the importance of trustees documenting their considerations and approaches to investment decisions.
104. Trustees should also be aware that s. 298 of the SIS Act empowers the relevant Regulator (APRA, ASIC or the ATO as the case may be) to begin or carry on an action for the recovery of loss or damages on grounds including negligence and breach of duty. This power is available for use if, as a result of an investigation or examination conducted under Part 25 of the SIS Act, it appears to the Regulator to be in the public interest to do so.
105. A breach of the trustee's obligations under s. 52 of the SIS Act, or generally, cannot be rectified by disclosure of that breach to members of the Fund. Further, trustees' duties under s. 52 of the SIS Act are not discretionary or optional and disclosure to members is not an alternative to compliance with a trustee's obligations.

Penalties

106. Significant penalties may apply where trustees have contravened operating standards, including the standard concerning the formulation and implementation of investment strategies.²⁷
107. Trustees and trustee directors may also incur personal liability as a result of their actions if they breach or fail to comply with their duties contained in the investment covenant.²⁸
108. Trustees also need to be aware that the manner in which they disclose their investment strategy obligations may be subject to scrutiny by ASIC. Meeting the requirements discussed in this circular may not be enough to fully satisfy all of the trustee's disclosure obligations under the Corporations Act.

²⁷ See for example penalties referred to in Part 3 of the SIS Act

²⁸ See s. 55 of the SIS Act



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