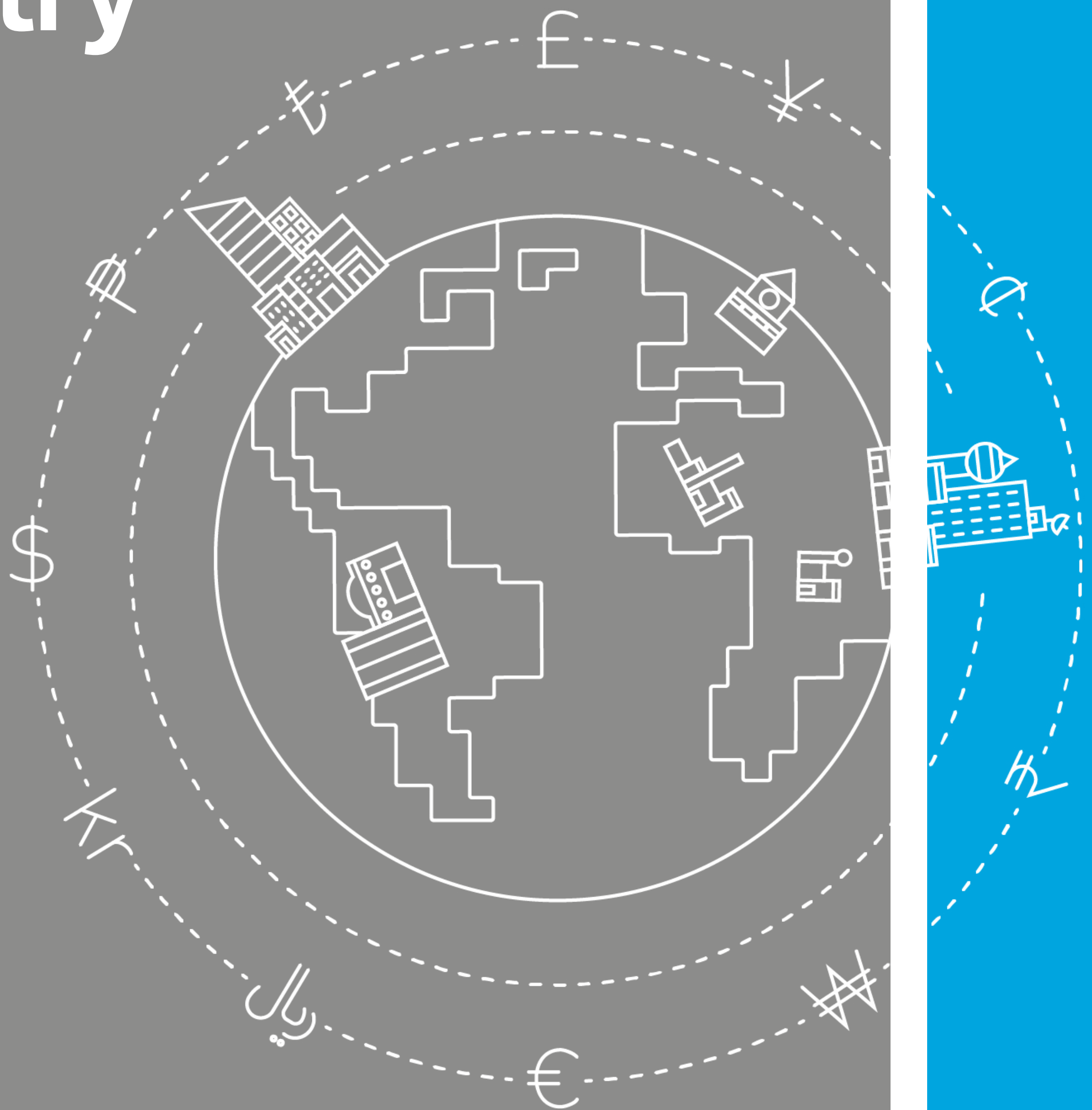
Royal Commissioner's Assessment of the Superannuation Industry



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The Australian superannuation and wealth management sector has been in the spotlight over the past year as a result of the Hayne Royal Commission.

The role of the Trustee and the suitability of the vertical integration model within the sole purpose test, has been challenged.

Whilst governance of the industry fund sector had been the focus prior to the royal commission, the major focus of the Royal Commission was the suitability and conduct of the retail superannuation sector.

At March 2018, superannuation savings comprised assets worth about $2.6 trillion: more than 140% of Australia's nominal gross domestic product. At June 2017, more than 14.8 million Australians had a superannuation account.

Effective governance is necessary for a superannuation fund to fulfil the basic promise that the trustee will administer the fund in the best interests of members, and in particular, in the best financial interests of members.

CONFLICTS OF INTEREST

Trustees' Covenants with members include covenants of honesty, care, skill and diligence, as well as a covenant to perform the trustee's duties, and exercise the trustee's powers 'in the best interests of the beneficiaries'. This provision in the Act is often referred to as 'the sole purpose test'.

Of particular interest to the Royal Commission was the covenant covering conflict of interest in Section 52(1) of the SIS Act:

> *Where there is a conflict of interests and duties: – to give priority to the duties to and interests of the beneficiaries; – to ensure that the duties to the beneficiaries are met; – to ensure that the interests of the beneficiaries are not adversely affected; and – to comply with the prudential standards in relation to conflicts.*

The Royal Commission found that some trustees had difficulty understanding when and how the best interests covenant is applied. These difficulties were borne out of conflicts arising between the beneficiaries' interests and the interests of the trustee or another person or entity which, whilst disclosed, were not appropriately resolved. **Disclosure of conflicts of interests on its own is not enough.**

Rarely did entities identify how the interests of beneficiaries were prioritised over others that conflicted. None said that the trustee should have avoided the conflict in the first place. Instead, trustees relied on policies that attempted to identify and manage the conflict. As discussed further below, those policies were often ineffective. A number of retail trustees failed to manage conflict effectively, despite having elaborate written frameworks in place.

Commissioner Hayne re-emphasised the requirements of Prudential Standard SPS 521 that avoidance is the surest way to prevent the potential conflict entirely. It should be concerning to regulators that professional trustees apparently struggle to understand their most fundamental obligation as the case studies showed that trustees rarely sought to avoid a conflict.

APRA's focus had been on whether regulated entities had robust frameworks and policies, on the basis that:

"If you have a good set of frameworks and policies and your audit and compliance function are doing their job ... things should broadly work as intended".

As per above, a number of retail trustees have failed to manage conflict effectively, despite having elaborate written frameworks in place.

OUTSOURCING OF TRUSTEE'S FUNCTIONS

Of particular risk is the outsourcing of the trustee's day-to-day administration and management of a fund to a related entity, or indeed, any third party. This requires ongoing care and diligence on the part of a trustee.

Prudential Standard SPS 231 provides that an RSE licensee who outsources a material business activity to a related party 'must be able to demonstrate that the arrangement is conducted on an arm's length basis and in the best interests of beneficiaries'. No matter what duties other persons may owe to members of the superannuation fund, the trustee would still be bound by its duties. And, at least in the case of administration arrangements, the agreements made between trustees and administrators now commonly provide that the administrator must act in a way that will not adversely affect the trustee's performance of its duties.

Commissioner Hayne considered that **the existing rules, especially the best interests covenant and the sole purpose test, set the necessary standards**. Those standards should be applied according to their terms and without more specific elaboration. The Commissioner specifically highlighted that **trustees of for-profit funds have not always performed their duties. Trustees and regulators must give close and continuing attention to these issues**.

FINANCIAL ADVICE FEES

The Royal Commission considered that using superannuation money to pay for broad financial advice is not consistent with the sole purpose test prescribed. The core purpose of a superannuation fund hinges on the provision of benefits upon a member's death or retirement. For a trustee to apply funds held by the trustee to paying fees charged by an adviser to consider, or re-consider, how best the member may order their financial affairs generally or may best make provision for post-retirement income, is not consistent with the sole purpose test.

Such broad advice might include how the member might best provide for their retirement or maximise their wealth generally. Allowable advice would be limited to advice about particular actual or intended superannuation investments (such as consolidation of superannuation accounts, selection of superannuation funds or products, or asset allocations within a fund). It is difficult to imagine circumstances in which a member would require financial advice about their MySuper account.

Commissioner Hayne concluded **that there are few circumstances in which paying fees for ongoing advice of that kind would be in the best interests of a member**.

The existence of ongoing advice fee arrangements poses a danger to trustees: if they permit ongoing advice fees to be deducted, and no service is provided, they are likely to be in breach of their obligations under the SIS Act. The Commissioner recommended neither preserving these arrangements further nor providing any grandfathering. The grandfathering arrangements made at the time of the Future of Financial Advice (FoFA) reforms should end. The time for transition has passed.

UNSOLICITED SUPERANNUATION OFFERS

Unsolicited offers of a superannuation product are not appropriate nor in the interests of consumers. **All forms of unsolicited offering of superannuation arrangements should be prohibited**. The prohibition should not prevent trustees or related entities from advertising the availability of the fund generally.

The customer to whom an offer was made may have incorrectly assumed that the seller thought that the product was suitable for the particular customer's needs, when, in fact, the seller had no basis on which to form any view about suitability.

NOMINATING DEFAULT FUNDS

Section 68A of the SIS Act should be amended by prohibiting where the supply may reasonably be understood by a recipient to be made with a purpose of having the recipient nominate the fund as a default fund or having one or more employees of the recipient apply or agree to become members of the fund. **A person should have only one default account** and machinery should be developed for 'stapling' a person to a single default account.

REGULATORS

Superannuation presents particular regulatory issues. It is a compulsory product. All who are employed, and very many of those who have been employed, will have superannuation arrangements. Superannuation performance directly affects the public purse by reducing the call on social security payments and other public welfare measures including, but not limited to, housing, care and health measures.

The superannuation provider makes no promise about what its future performance will be, but the quality of its performance is important not only to members but also to society generally. And because obtaining proper future outcomes is important, the regulatory task extends beyond issues of disclosure (at and after the time of acquisition of an interest in the product that is offered), and issues of risk management.

The Productivity Commission identified that strategic conduct litigation – that is, bringing strategic enforcement action to both address the immediate member harm, and to deter future conduct – appears at times to be 'missing in action' in the superannuation industry.

The Cooper Review recommended that APRA be given general standards-making power in relation to superannuation in order, among other things, to 'drive efficiencies in the industry' and 'improve transparency of outcomes'.

The Commission recommended that the roles of the two superannuation regulators be adjusted to accord with the general principle that **APRA is to act as prudential regulator and ASIC as the conduct regulator. ASIC would be the agency that would take any enforcement action**. APRA's prudential supervision of RSEs may be the most likely means by which issues about performance of the covenants emerge. **RSEs cannot and will not meet what APRA has called their 'financial promises without adhering closely to the trustees' covenants and the sole purpose test**.

Failures of governance must be examined by the regulator and made the subject of the appropriate regulatory response.

The Commissioner went further for the larger superannuation funds recommending that they be subject to statutory obligations similar to those imposed on members of the board and banking executives by the BEAR – to conduct the responsibilities of their positions:

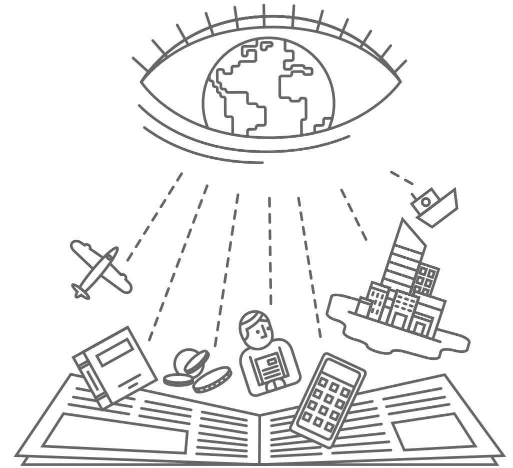
- by acting with honesty and integrity, and with due skill, care and diligence;
- by dealing with APRA and ASIC in an open, constructive and co-operative way; and
- by taking reasonable steps in conducting those responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the fund.

THE COMMISSION CONCLUDED...

Trustees must improve the performance of their duties. Their role should be restricted in order to avoid conflicts, including by precluding them from acting as dual-regulated entities and prohibiting them from the 'treating' of employers. And trustees and their most senior executives should be accountable, in the same way that authorised deposit-taking institutions are accountable under the BEAR.

RSM UK | CASE STUDY

As can been seen by the study from RSM UK, Australian Superannuation Trustees are not alone in their concerns about the future.



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RSM Australia can assist trustees with a health check of their current arrangement to assess any regulatory risks and help them to be future-ready for any changes coming out of the Royal Commission.

If you require further information, or wish to speak to one of our advisers, please contact your local RSM office.

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