Law Council
OF AUSTRALIA

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Secretary-General

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Mr Neil Grummitt
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Australian Prudential Regulation Authority
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By email: superannuation.policy@apra.gov.au

Dear Mr Grummitt

Second Set of Draft Prudential Practice Guides

I am pleased to enclose a submission prepared by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia.

The Committee would welcome the opportunity to discuss the submission further. In the first instance, please contact the Chair of the Law Council of Australia's Superannuation Committee, Pamela McAlister on (03) 9603 3185 or at pam.mcalister@hallandwilcox.com.au.

Yours sincerely

MARTYN HAGAN

Second Set of Draft Prudential Practice Guides

Australian Prudential Regulation Authority

Submission by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia

3 July 2013

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About the Law Council of Australia's Superannuation Committee

The Law Council of Australia is the peak national representative body of the Australian legal profession; it represents some 60,000 legal practitioners nationwide. Attachment A outlines further details.

This submission has been prepared by the Law Council of Australia's Superannuation Committee (the Committee), which is a committee of the Legal Practice Section of the Law Council.

The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable, clear and consistent with the Law Council's *Policy Statement on Rule of Law Principles* and *Corporate Plan 2012–14*. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

Executive Summary

On behalf of the Law Council, the Superannuation Committee has reviewed each of the draft prudential practice guides released on 9 May 2013 and this submission makes several technical comments of a legal nature with regard to most of them.

As an introductory general comment, the second set of prudential practice guides, much like the first set of prudential practice guides, takes a highly prescriptive approach to largely operational matters and goes beyond what is expressly required by the associated prudential standards.

All Registrable Superannuation Entities (RSE) licensees by now should have adopted policies for the purposes of complying with the prudential standards ahead of the 1 July 2013 commencement date. As these prudential practice guides are yet to be finalised, it is inevitable that some RSE licensees will, in due course, want to review their recently approved policies with the benefit of the finalised prudential practice guides. This will take some time after the prudential practice guides are released in final form. It would provide comfort to industry if the Australian Prudential Regulation Authority (APRA) could take a facilitative and staggered approach towards applying the prudential practice guides and reassure the industry that APRA will not, for example, apply the prudential practice guides retrospectively from 1 July 2013.

APRA's prudential standards expressly require certain policies to be approved by the board of the RSE licensee and, by implication, permit responsibility for other policies to be delegated to relevant sub-committees of the board. To the extent that subsequently released prudential practice guides suggest that additional policies must also be approved by the board (for example, SPG 533 on Valuation), this would be unexpected, and represent an additional burden for RSE licensees.

Defined Benefit Matters: SPG 160

In relation to paragraph 10 of SPG 160, it is stated that a strong financial position of a defined benefit fund would be evidenced by vested benefit and accrued benefit indices in excess of 100% and a reasonable expectation that the indices would remain at that level.

However, it does not state for what time period that expectation of remaining over 100% should exist. For example, would it suffice that the expectation is that the indices would remain over 100% for the next three to six months?

In relation to paragraph 30 of SPG 160, the last sentence mentions a range of circumstances to consider when setting the duration of a restoration plan. One of the considerations mentioned is "whether particular assets are contingent on the continued operation of the employer-sponsor(s)". Given the in-house asset limits under the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act), and the fact that most defined benefit funds are hybrid funds, the proportion of an in-house asset within the pool of the defined benefit fund's assets would also be very small. This seems to give undue weight to the in-house asset risk. There is perhaps no harm in this, but it raises the question of whether there is something else that APRA has in mind as a risk.

Management of Reserves: SPG 222

Paragraph 5 of SPG 222 discusses the fact that some reserves may be used to spread costs across different generations of members and the fairness of that outcome. However, it may not be fair where a member’s account has been charged with an amount to build up a reserve, the reserve is used and the member is once again charged an amount to replenish the reserve. In such cases SPG 222 may wish to discuss the issues associated with this having regard to the duty to act fairly between beneficiaries (s 52(2)(e) and (f)) and the possibility of spreading out any replenishment of the reserve to avoid one generation paying for the benefit of another.

Paragraph 9 of SPG 222 sets out measures that APRA would regard as sound practice in a strategy for the management of a reserve. Specifically, APRA suggests clearly defining the purpose of the reserve and its objectives. However many superannuation funds maintain a general reserve in addition to specific purpose reserves. The Committee suggests that there is no mischief in maintaining an additional general reserve and that paragraph 9 should be amended to contemplate this.

Further, the Committee suggests that paragraph 9 should also list as a matter to be included in a reserving strategy the conditions upon which the reserve would be distributed back to members as contemplated by paragraph 11 of SPG 222.

Paragraph 11 of SPG 222 states that APRA would expect that, in distributing reserves among members, the RSE licensee would be expected to have regard to the period over which the reserves have been accumulated and how they have been funded. The Committee also suggests that RSE licensees should be expected to have regard to the particular members from whose accounts the reserve has been built. This is important to ensure intergenerational equity given the requirements of section 52(2)(e) and (f).

Remuneration: SPG 511

SPG 511 states generally in "About this guide" that RSE licensees that operate within corporate groups regulated by APRA and/or RSE licensees which have complex remuneration structures should also refer to the Prudential Practice Guide PPG 511–Remuneration. However, this is only mentioned in the substantive content of SPG 511 in relation to equity related components (paragraph 46). This requirement to refer to both SPG 511 and PPG 511 (as relevant) has the potential to cause confusion and additional complexity for some RSE licensees that may not be required. The Committee suggests that if PPG 511 is to apply in certain circumstances, that this is more explicit in each case rather than relying on this general reference.

Paragraph 48 is particularly contentious to the extent that it suggests that up-front cash payments to incoming staff should be ‘subject to performance validation or risk adjustment and deferral’. As APRA acknowledges, these payments are often compensation for forgoing remuneration at a previous employer. As such, it is punitive for the individual concerned if compensation for amounts actually forgone in the past were to be ‘clawed back’ in future. From an individual’s perspective, the remuneration at the earlier employer was ‘earned’, possibly having been deferred already subject to achieving longer-term performance goals at the previous employer. In light of APRA’s expectations in this context, RSE licensees could potentially find it more difficult to persuade senior executives to leave their current employment prior to the payment or vesting of remuneration at the previous employer. This may not be in the best interests of the RSE licensee or the RSE.

Paragraph 12 states that the Board Remuneration Committee may make recommendations on the annual distribution of an RSE licensee's or group's bonus pool to the extent relevant to the operations of the RSE licensee. While in some cases, the bonus component of remuneration is discretionary, in other cases, this is determined by reference to prescribed criteria or a formula agreed between an employee and employer. In some cases, the Board Remuneration Committee will not be able to control all of the distribution of bonus payments. This limitation should be noted in SPG 511.

Similarly, the guidance in paragraphs 32–44 requires the Remuneration Policy to encourage behaviour that supports the risk management framework of the RSE licensee. In line with paragraphs 24–26 of SPS 510–Governance, APRA expects that the Remuneration Policy must provide for the Board to adjust performance based components of remuneration downwards, to zero if appropriate. For example, Paragraph 34 states that "A prudent policy will require that performance based remuneration is low, perhaps zero, where the individual has been found to have exposed the institution to risk beyond its risk appetite or controls." While the Committee supports this policy approach, not all remuneration arrangements will be able to be amended in such a manner under the transitional arrangements due to potential employment issues. This limitation should be noted in SPG 511.

In relation to the "Payments to non-employees" section (particularly paragraphs 26–29 inclusive), paragraph 27(b) states "where the RSE licensee contracts with a related body corporate, persons employed by the body corporate who provide services to the RSE licensee are to be treated as employees of the RSE licensee". The Committee is concerned about how this will work in practice, especially in relation to those persons who perform work for a group (across different entities) but who provide services to the RSE licensee. The Committee notes that a different approach is taken in relation to contracts with an unrelated body corporate.

In relation to an unrelated body corporate, an RSE licensee is still expected to review services contracts against the Remuneration Policy to ensure the terms of the contract align with the Remuneration Policy (for example, to ensure that it considers the terms reasonable and that they do not encourage risk taking beyond the RSE licensee's risk appetite) (see paragraphs 27–29). The Committee is concerned about how this is to work in practice, as the RSE licensee would not ordinarily be provided with the detailed information required to perform this type of review. The Committee suggests that this section be revised to ensure that an RSE licensee can comply with the practical requirements.

Investment Risk Management: SPG 532

Paragraph 13 of SPG 532 suggests there must be a segregation of duties between those involved in implementing investment decisions and those responsible for the investment risk management arrangements. Apart from this going beyond the requirements of the prudential standard on investment governance, this would appear to reflect an over-simplification of matters in the following regards:

- In contrast to paragraph 13 of SPG 533 (Valuation), there is no recognition that some RSE licensees may utilise internal investment teams where strict segregation may pose practical difficulties and involve the loss of relevant input from those capable of providing it. For example, those with particular expertise in certain asset classes may provide input to the overall risk management activities of the RSE licensee. Further, those involved in portfolio management would necessarily be very mindful of risk at the portfolio level and SPG 532 ought not to preclude this.
- Taken literally, paragraph 13 would pose a dilemma for most investment committees (i.e. board sub-committees to whom investment functions have been delegated) since they would necessarily be involved in investment risk management and in certain investment decisions.

The Committee suggests that paragraph 13 be modified so as to accommodate greater flexibility in arrangements.

Valuation: SPG 533

As APRA correctly points out, s 52(6)(a)(iv) of the SIS Act requires an RSE licensee to consider whether reliable valuation information is available with regard to investments covered by the relevant investment strategy.

However, APRA seems to interpret this as meaning that RSE licensees must have knowledge of the underlying investments held by pooled funds in which the RSE has invested: see, for example, paragraphs 6, 57, 58 and 59 of SPG 533. While this may or may not be a desirable principle, from a legal perspective, it is clear that s 52(6)(a)(iv) does not provide a basis for that view.

The statutory provision is concerned with access to valuation information, not access to underlying holdings data. The former is achievable without the latter. Further, the statutory provision does not preclude an RSE licensee from having *any* exposure to investments where access to valuation information might be less readily available than other investments: rather, it is a consideration to be taken into account when formulating the investment strategy. Where access is less readily available, the risk may be managed by making a lower allocation to that asset class. It is also relevant to point out that the statutory provision is concerned with matters at a ‘macro’ level: specifically, whether investments are covered by the relevant investment strategy. The investments covered by a strategy form an abstract class. For example, an investment strategy may cover investments in the private equity or unlisted infrastructure asset classes. The statutory provision is concerned with whether reliable valuation information is available for these categories of investment. It is incorrect to suggest that the statutory provision is directed at particular investment decisions.

If APRA wishes to express a view on the transparency of particular investment vehicles and the appropriate initial and ongoing due diligence to be exercised, a prudential practice guide on valuation considerations is not necessarily the most apt vehicle for expressing those views. Further, section 52(6)(a)(iv) of the SIS Act does not provide a particularly strong justification for those views.

Paragraph 8 of SPG 533 suggests that valuation policies ought to be approved by the board of an RSE licensee. There is no legal requirement for these policies to be approved by a board of directors and there is no reason why responsibility for approving these policies cannot be appropriately delegated to a relevant sub-committee, such as an investment committee and/or an audit committee.

The Committee queries the desirability of APRA 'hard-coding' particular third party documents into the prudential practice guides – for example, paragraph 22 expressly endorses a publication of the CFA Institute.

At paragraph 53, APRA suggests that unlisted assets ought to be valued quarterly. Our understanding is that this (i.e. quarterly valuations) would generally be the highest frequency with which unlisted assets are valued and that some RSE licensees only temporarily moved to quarterly valuations during the volatility experienced through the Global Financial Crisis. The Committee suggests that APRA perhaps discuss this issue with relevant stakeholders further, as it may be that quarterly valuations represent only a 'temporary norm'. Conducting valuations this frequently during less volatile times potentially leads to unnecessarily higher costs being incurred at the expense of members, especially since valuation risk could be managed by staggering the valuation cycle in the manner suggested by paragraph 54 of SPG 533.

Adequacy of Resources Guide: SPG 221

In paragraph 8 of the SPG, APRA says that:

> *Where an RSE licensee has multiple RSEs, APRA expects that an RSE licensee would at all times be mindful of its obligations as set out in the covenants in s 52 of the SIS Act, particularly those covenants that relate to acting fairly in dealing with the beneficiaries of its business operations.*

It is not clear what an RSE licensee should do to meet APRA's expectations under this paragraph, particularly given that the paragraph appears under the heading "financial resources".

An RSE licensee has a duty to comply with each of its obligations in s 52 of the SIS Act and therefore APRA's expectation that a trustee would be mindful of these obligations in fact understates the position. If APRA is saying that in considering the financial resources required by the trustee, it should consider the level of financial resources it requires to comply with these duties, the Committee suggests that the statement be amended to expressly say so. However, if that is what this paragraph is intended to say, it is unclear why the same expectation should not apply to all of the resources available to any RSE licensee irrespective of whether they have multiple RSEs or not and, finally, it is also unclear why the duties of fairness are particularly relevant to the financial resources of the RSE licensee.

Given that a Prudential Practice Guide is intended to assist an RSE licensee to comply with their obligations and satisfy APRA's expectations, the Committee thinks that it would helpful if this paragraph could be redrafted so as to explain what APRA expects an RSE licensee to do and how the covenants are relevant to this duty.

As a drafting point, the Committee also suggests that the reference to the "beneficiaries of [the RSE licensee's] *business operations*" be amended to refer to the beneficiaries of its *RSEs*".

Contribution and benefit accrual standard: SPG 270

The Committee has no new comments on the SPG.

When the existing PPG was released, the Committee commented on the section dealing with mistakes. In particular the Committee was concerned that the section did not refer to the law of mistake or the relevance of mistake to contributions tax.

While APRA does not have jurisdiction over the taxation of contributions, the discussion about whether or not an amount paid in error (administrative or otherwise) can be refunded or reallocated within a fund without breach of the preservation rules or the accrued benefit standard, ignores the very significant issue of whether a contribution will still be subject to tax if it is refunded, with or without relief from APRA.

While the Committee agrees with APRA's comments about administrative errors, the most relevant point is that the law of mistake will apply to these contributions so that they are not treated as contributions at all. It follows then that they can be refunded to the contributor without breach of the preservation rules and without being subject to contributions tax (or excess contributions tax). By contrast, a contribution that is not treated as having been paid under a mistake for the purposes of the law, can only be paid out of a fund with the consent of APRA (by modification of the preservation rules) and will be subject to tax, unless the Commissioner exercises his or her discretion.

The Committee considers that the discussion should refer to tax and the relevance of the law to how an RSE licensee deals with a contribution which is alleged to have been made by mistake.

Payment standards: SPG 280

The Committee has no comments on the content of SPG 270. However, the Committee thinks that it would be helpful to include commentary on what APRA expects RSE licensees to do when asked to rollover an amount from an illiquid investment option. The section on portability has been revised to take account of the new periods that will apply to RSE licensees rolling over or transferring members' benefits. However, it does not say what is required where the investment is illiquid. Unlike the existing regulations, the new regulations (which commenced on 1 July 2013) do not impose an obligation to rollover or transfer an amount in an illiquid investment within any specified time frame. Rather, they imply that the time frame will be the time that is required by the RSE licensee given the nature of the asset. This is counter to the expectations of most RSE licensees about what is required of them and it would be useful to include commentary in this section of the standard to assist RSE licensees in the administration of illiquid investments.

Management of Security Risk in Information and IT: CPG 234

The Committee understands that CPG 234 adopts the content of Prudential Practice Guide 234, which currently applies to Approved Deposit-Taking Institutions, and appears intended to extend the same guidelines on ‘Management of Security Risk in Information and Information Technology’ to superannuation funds.

The guidelines are detailed, and to properly consider them it is likely trustees will need to consult with their administrators and that administrators will need to undertake a detailed review and assessment of their information management and information technology practices. Trustees will also need to consider whether the administration agreement adequately addresses the issues identified in Attachment C (Service provider management).

The Committee therefore suggests that superannuation trustees should not be expected to have considered these guidelines until a reasonable future date; for example, an implementation date of July 2014 may be appropriate.

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian state and territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are the:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Independent Bar
- Large Law Firm Group (LLFG)
- Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of approximately 60,000 lawyers across Australia.

The Law Council is governed by a board of 17 Directors – one from each of the Constituent Bodies and six elected Executives. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive, led by the President who serves a 12-month term. The Council's six Executive are nominated and elected by the board of Directors. Members of the 2013 Executive are:

- Mr Michael Colbran QC, President
- Mr Duncan McConnel President-Elect,
- Ms Leanne Topfer, Treasurer
- Ms Fiona McLeod SC, Executive Member
- Mr Justin Dowd, Executive Member
- Dr Christopher Kendall

The Secretariat serves the Law Council nationally and is based in Canberra.