Law Council
OF AUSTRALIA

Legal Practice Section

APRA Discussion Paper: Strengthening Financial Resilience in Superannuation

Australian Prudential Regulation Authority (APRA)

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Telephone **+61 2 6246 3788 • *Fax* +61 2 6248 0639**
Email **mail@lawcouncil.asn.au**
GPO Box 1989, Canberra ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612
Law Council of Australia Limited ABN 85 005 260 622
www.lawcouncil.asn.au

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About 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 Law Firms Australia, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- 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 Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

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

The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. 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 members, led by the President who normally serves a 12 month term. The Council's six Executive members are nominated and elected by the board of Directors.

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The Acting Chief Executive Officer of the Law Council is Ms Margery Nicoll. The Secretariat serves the Law Council nationally and is based in Canberra

About the Section

The Legal Practice Section of the Law Council of Australia was established in March 1980, initially as the 'Legal Practice Management Section', with a focus principally on legal practice management issues. In September 1986 the Section's name was changed to the 'General Practice Section', and its focus broadened to include areas of specialist practices including Superannuation, Property Law, and Consumer Law.

On 7 December 2002 the Section's name was again changed, to 'Legal Practice Section', to reflect the Section's focus on a broad range of areas of specialist legal practices, as well as practice management.

The Section's objectives are to:

- Contribute to the development of the legal profession;
- Maintain high standards in the legal profession;
- Offer assistance in the development of legal and management expertise in its members through training, conferences, publications, meetings, and other activities.
- Provide policy advice to the Law Council, and prepare submissions on behalf of the Law Council, in the areas relating to its specialist committees.

Members of the Section Executive are:

- Ms Maureen Peatman, Chair
- Mr Geoff Provis, Deputy Chair
- Dr Leonie Kelleher OAM, Treasurer
- Ms Tanya Berlis
- Mr Mark Cerche
- Ms Peggy Cheong
- Mr Philip Jackson SC
- Ms Christine Smyth

The Section's administration team serves the Section nationally and is based in the Law Council's offices in Canberra.

Acknowledgement

The Law Council is particularly grateful for the expertise of the Superannuation Law Committee of its Legal Practice Section in leading the development of this submission.

Executive Summary

In this submission, the Superannuation Law Committee of the Legal Practice Section (**the Committee**) provides its feedback on some of the questions posed in APRA's Discussion Paper entitled 'Strengthening Financial Resilience in Superannuation' which was released for consultation in November 2021. Some areas for further clarity have been suggested, having regard to the law.

APRA Discussion Paper - Strengthening Financial Resilience in Superannuation

Sources of financial resources questions – question 1

When examining the sources of funding and support used by Registrable Superannuation Entities (**RSE**) licensees to address the three identified purposes of financial resources, there should be no blurring of the important distinction between fund assets (held on trust by the RSE licensee) and the RSE licensee's personal assets.

Likewise, when discussing 'fund contingency expenditure items', the Committee notes on page 8 of APRA's discussion paper that resources required for 'potential future remediation and rectification programs where members have suffered loss' is categorised together with 'payment of penalties incurred' and 'fund mergers'. These are all fundamentally different types of contingency expenditure, each having to be funded in different ways (members' losses from the Operational Risk Financial Requirement (**ORFR**) and penalties from outside the fund, and merger expenses being more flexible, but often paid from within the fund). In any final guidance issued by APRA, it is important that those items not be grouped together in a way which might inaccurately imply that those contingency expenditures rely upon same sources of funding.

Further, in relation to the text box on page 9 of APRA's discussion paper (extracted below), the Committee notes that there needs to be better clarity in any final guidance issued by APRA that, once income has been received by the RSE licensee as fees so that it becomes a personal asset of the RSE licensee, any 'fiduciary obligations' no longer apply to the trustee or RSE licensee in respect of those monies received.

Income derived from the management of reserves in the fund or investment of assets held in the personal capacity of the RSE licensee	*An RSE licensee needs to ensure that resources held in reserves in the fund, or as a personal asset of the trustee company, is managed efficiently. Such efficient management, arising, for example, from unit pricing activities and differentials arising from tax and insurance premium reserves, gives rise to questions about the appropriate use of the income consistent with the RSE licensee's fiduciary obligations*

ORFR questions – questions 7 and 8

Summary

The treatment of the ORFR in APRA's discussion paper suggests there is widespread misunderstanding about the legal framework governing the use of superannuation fund assets to meet losses resulting from operational risk events. Where a trustee meets the ORFR by maintaining an operational risk reserve in the fund, the trustee should use the operational risk reserve to meet any loss resulting from an operational risk event and, in particular, the trustee must not use any other fund assets to meet such a loss unless and until the operational risk reserve has been exhausted. APRA's guidance in SPG 114 does not say anything about this rule and the Committee submits that SPG 114 should be amended to explain it.

Further details

APRA's discussion paper includes the following statement (p15):

> *Whilst [ORFR] financial resources were intended to be used by RSE licensees to make good any losses to members caused by operational risk events, it is evident that RSE licensees are reluctant to call on these financial resources, even where they would be entitled to do so under the provisions of the standard. Instead, RSE licensees are calling on other financial resources (in the form of other reserves or external sources of capital) following an operational risk event. This means that information about such events may not be reported to APRA and potentially reduces the efficiency of the money held to meet the ORFR.*

This text suggests some RSE licensees think that where a loss to members results from an operational risk event, the RSE licensee may choose whether to make good to members the loss from:

- the financial resources set aside to meet such operational risk events; or
- fund assets *not* forming part of an operational risk reserve.

With respect, the Committee considers that view to be mistaken.

Section 56(2A)(b) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) has the effect of preventing a superannuation trustee from indemnifying itself:

> *… out of any assets of the entity that do not form part of a reserve maintained for the purpose of covering the operational risk relating to the entity, any amount that relates to that risk, without first exhausting the reserve and any other financial resources managed and maintained by the trustee to cover the risk.*

SPG 114 does not say anything about this rule, nor about the rule in section 56(2A)(a), which has the effect of preventing a superannuation trustee from indemnifying itself out of fund assets for any amount expended out of ORFR maintained as trustee capital. All SPG 114 says is (at [40]):

> *An RSE licensee may call upon the financial resources held to meet the ORFR target amount to address an operational risk event.*

While this statement is, strictly, true, it is also incomplete. Further, by saying that a trustee *may call* upon ORFR financial resources to satisfy a loss resulting from an operational risk event, SPG 114 has the potential to contribute to the apparently widespread misunderstanding recorded in the extract from the discussion paper set out above.

Managing financial resources – chapter 3

Extracted below is a sentence from the introductory text to chapter 3 (on page 12 of APRA's discussion paper). The Committee suggests that any guidance in these terms should be clearer in the final materials. That is, although trustees do have choices about how to structure the holding of amounts, it always remains the case that if held as a fund reserve these amounts cannot be used for fines or penalties.

> *An RSE licensee can structure their financial resources in a manner that best suits their particular circumstances, with RSE licensees able to hold financial resources in the RSE licensee's personal capacity on the corporate balance sheet or as fund reserves (or a combination of the two).*

The list which is then given in the discussion paper following the text above suggests that decisions about these structures are informed by a variety of matters, but the law is not mentioned. The Committee submits that decisions about structuring financial resources should first be approached having regard to legal constraints (in particular, legal constraints affecting the ORFR and the payment of fines and penalties).

Contingency expenditure – section 3.5

In relation to item 3.5 of APRA's discussion paper, the following list is given which deals with fundamentally different types of losses. However, similar to a point raised earlier in this submission, by grouping them together as items which need to be dealt with as part of 'contingency provisioning', it may appear as though APRA is suggesting they can be similarly treated from a funding perspective = which they cannot. The Committee has extracted the list following, with its suggestions in square brackets:

> *An RSE licensee is responsible for determining the financial resources necessary to fund contingency events. Typical events and circumstances that may require contingency provisioning include:*
>
> • *remediating losses experienced by members; [paid from the ORFR]*
>
> • *spending to fix the root cause of losses experienced by members and other unplanned or uncommitted material expenditure e.g. essential changes to systems and processes to address industry risks and requirements; [could be paid from the fund, although if related to member losses should come from the ORFR]*
>
> • *restructures of the RSE licensee's business operations, including product closures, mergers and successor fund transfers (SFTs); and [paid from the fund]*
>
> • *paying penalties levied on the RSE licensee. [must be paid outside the fund]*

Accordingly, the Committee suggests that the final guidance avoid any confusion as to the relevant distinctions between the lawful available funding options for such contingency expenditures.

Payment of penalties – questions 22 to 26

Summary

The Committee suggest that APRA should not make any prudential standards concerning the payment of penalties. And if APRA publishes any prudential guidance concerning the payment of penalties, the Committee submits that APRA should refrain from providing guidance in prescriptive terms. Without limitation, the Committee suggests that APRA should not suggest that introducing a trustee fee power, or exercising a trustee fee power, is only a means of 'last resort' for mitigating the risk of trustee insolvency, or a step that would be viewed with suspicion.

Further details

When APRA issued its discussion paper in November 2021, there was only one court decision in relation to steps taken by a superannuation trustee in response to the recent amendments to section 56 of the SIS Act: *Re QSuper Board* [2021] QSC 276. Between then and Christmas 2021, nine further court decisions were handed down: *HEST Australia Ltd* [2021] VSC 809; *Re Care Super Pty Ltd* [2021] VSC 805; *Application by LGSS Pty Ltd atf Local Government Super* [2021] NSWSC 1613; *Application by Maritime Super Pty Ltd atf Maritime Super* [2021] NSWSC 1614; *Application by Motor Trades Association of Australia Superannuation Fund Pty Ltd atf Spirit Super* [2021] NSWSC 1672; *Application by United Super Pty Ltd atf Construction and Building Unions Superannuation Fund* [2021] NSWSC 1679; *Re Care Super Pty Ltd (No 2)* [2021] VSC 854; *Application by NGS Super Pty Ltd atf NGS Super* [2021] NSWSC 1694; and, *AustralianSuper v McMillan* [2021] SASC 147.

APRA intervened in each of these cases. Therefore, the Committee limits its comments to some high-level observations.

First, in each case the trustee approached the court for advice or orders to address circumstances which the trustee faced as a consequence of the section 56 amendments. As those cases made clear, the effect of the section 56 amendments was to create an insolvency risk for superannuation trustees, which compounded to create an associated risk of loss to the assets supporting the retirement savings of millions of Australians. While no-one can doubt Parliament's right to create that risk, and while no-one can doubt it is APRA's responsibility to administer the law, the fact remains that Parliament created a direct and significant risk to the retirement savings of millions of Australians. In each of the cases mentioned above, the court was ultimately satisfied that it was legitimate for the trustee to introduce and/or charge a trustee fee in order to reduce that risk. That was the unanimous conclusion of six judges across four States in nine cases. A number of those cases also involved a contradictor taking a contrary position.

Secondly, in each case the circumstances and considerations were a little different. The estimated size of the risk of loss to retirement savings (on insolvency of the trustee) was different; the analysis leading to the setting of the fee (and any constraints on the fee entitlement) was different; and the terms of the new (or altered) fee entitlement were different. And yet in each case the court came to the same ultimate conclusion that introducing and/or charging a trustee fee was justified. In addition to the nine trustees that went to court, and consistent with APRA's discussion paper, we expect there will be many other cases where the trustee took one or more steps in response to the section 56 amendments. As APRA is aware, there is no legal obligation to seek judicial advice or a court order, and the fact that some trustees did not enlist the court's assistance should not, in our view, be taken to suggest any lack of care or diligence on their part; the circumstances of each fund and their trustee will differ.

Thirdly, for trustees, particularly (but not exclusively) profit-to-member trustees, there is, in the end, a finite list, indeed a very short list, of steps that can be taken to guard against trustee insolvency risk, and the associated risk that trustee insolvency poses for the retirement savings of members. That risk has been created by the section 56 amendments. Improving governance and compliance practices and arrangements is important but an incomplete solution for addressing that risk. Insurance is also, in several respects, an unsatisfactory solution. Indemnification by a subsidiary may be available in some cases, but the cost of that indemnification will (like the costs of a trustee fee) ultimately be borne by members' retirement savings. Indemnification by a shareholder, in circumstances where the shareholder does not receive any return on capital (and would presumably be criticised if they charged a fee for the indemnity), is, self-evidently, a purely theoretical possibility. It may also give rise to undesirable conflicts of interest and duty. In the end, the fact of the matter is that there is no reasonably practicable alternative to taking a step that is at a cost to retirement savings, being the charging of a trustee fee (or indemnification by a subsidiary).

In its discussion paper, APRA says:

> *APRA expects an RSE licensee would, when demonstrating that a fee charged to build a financial contingency reserve meets the obligation to act in the best financial interests of beneficiaries, ensure full details of alternative avenues pursued for building or using financial resources are clearly documented.*

To the extent that this statement may reflect a priori suspicion about charging a trustee fee in response to the section 56 amendments, we would be concerned. In any guidance it may issue, we suggest that APRA should take care to avoid conveying any suspicion or negativity about a trustee taking that step. Indeed, it would be odd if APRA, a prudential regulator, sought to cast any generalised doubt on a step that may be taken by trustees to reduce the risk of trustee insolvency, given the associated risk that trustee insolvency presents to members, and given the combined weight of the analysis in the court decisions referred to above.

Finally, we note that the public debate about the section 56 amendments seems to have involved a considerable amount of confusion on the part of some of the participants. We suggest that it might help to lessen further confusion if any guidance APRA were to publish on these matters was to draw specifically on the judges' own explanations for why they saw the trustees' actions as legitimate and to draw attention to the question of the financial risk to members’ retirement savings of a trustee becoming insolvent. There can be no doubt that there are some penalties where it would be in members' best financial interests for the trustee to become insolvent. An obvious case would be where the cost to the members of insolvency would be a very small fraction of the penalty in question. Equally, however, there can be no doubt that there are some penalties where it would not be in members' best financial interests for the trustee to become insolvent. An obvious case would be where the penalty in question was a very small fraction of the cost to the members of insolvency. Teasing out fact-based propositions of this kind, in any guidance that is issued, would, we suggest, tend to assist.