

# IMPROVING THE GOVERNANCE OF SUPERANNUATION FUNDS

Professor John H. Farrar  
Bond University and University of Auckland  
and  
Professor Kenneth S. Levy, RFD  
Bond University and a Senior Member of the Administrative Appeals Tribunal

## Social Change and Superannuation

Prior to 1945 superannuation was the exception rather than the rule. Individual pensions were uncommon and generally either self funded by the employer as in the case of banks and the public service or were effected through contractual arrangements such as insurance or purchased annuities. A national culture focussed on the availability of the Australian Government pension and a reluctance to embrace the concept of superannuation by many employers and employees. Limitations on trustee investment inhibited the growth of superannuation funds.<sup>1</sup>

In the last thirty years there has been the international growth of three types of superannuation funds – institutional, contractual and trust based funds.<sup>2</sup> Institutional funds are separate entities; contractual funds depend on the nature of the contract and trust based funds occupy a strange limbo between the two. The legal concept of fund in common law systems is relatively underdeveloped<sup>3</sup> and consequently the nature of the employee’s interest is even less defined<sup>4</sup>.

The present Australian concept of a “superannuation fund” is statutorily defined in section 10 of the Superannuation Industry (Supervision) Act 1993 (“The SIS Act”)<sup>5</sup>. This act makes provision for the prudential regulation of certain superannuation

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- <sup>1</sup> See Y. Avrahampour, “A Recent History of UK Pension Provision” in Pensions Funds online (<http://www.pensionfundsonline.co.uk/articles/Retrospective.aspx>)  
For an earlier study see P. Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America*, Harper Collins, New York, 1976. See also K.P. Ambachtsheer, *Pension Revolution: A Solution to the Pensions Crisis*, John Wiley & Sons Inc, Hoboken, NJ, 2007.
- <sup>2</sup> See F. Stewart and Juan Yermo, “Pension Fund Governance: Challenges and Potential Solutions”(2008) OECD Working Papers on Insurance and Private Pensions, No. 18, OECD Publishing, © OECD. doi:10.1787/241402256531,6.
- <sup>3</sup> See R.Nolan, “Property in a Fund”, (2004) 120 LQR 108. For an earlier discussion see R.M.Goode, “The Right to Trace and its Impact on Commercial Transactions” – I (1976) 92 LQR 360, 384-6.
- <sup>4</sup> Legitimate expectation - right or expectancy? Substantive or procedural ‘right’? See *Re Coram* (1992) 109 ALR 353, 356-7; *Wrightson Ltd v Fletcher Challenge Nominees Ltd* [2002] 2 NZLR 1 at [28]; *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* [1991] 2 All ER 597, 608; *Official Assignee v NZI Life Superannuation Nominees Ltd* [1995] 1 NZLR 684, 696-7; *Stannard v Fisons Pension Trust Ltd* [1992] IRLR 27; *London Regional Transport v Hatt* [1993] PLR 227; *National Grid Co PLC v Laws* [1999] 2PLR 37; *Air Jamaica Ltd v Charlton* [1999] 1 WLR 1399; See Justice G. Hill “The True Nature of a Member’s Interest in a Superannuation Fund”, [2002] JA Tax 1 and see generally *Jacob’s Law of Trusts in Australia*, seventh edition by J.D Heydon and M.J Leeming, Lexis Nexis Butterworths, Chatswood, 2006, Chapter 29, para [2938].
- <sup>5</sup> Section 10 of SIS Act. See P. Hanrahan, *Funds Management in Australia: Officers’ Duties and Liabilities*, LexisNexis Butterworths, 2007, 1.50

funds, approved deposit funds and pooled superannuation trusts and their supervision by the Australian Prudential Regulatory Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Commissioner of Taxation. That meaning is adopted in the Income Tax Assessment Act 1997 and reflects earlier definitions in the 1936 and 1997 Income Tax Assessment Acts. This requires a superannuation fund to be a “public sector superannuation scheme” or an “indefinitely continuing fund”. The latter must also be “a provident, benefit, superannuation or retirement fund”. The term “indefinitely continuing fund” has been judicially considered<sup>6</sup> and the term “a provident, benefit, superannuation or retirement fund” has also been the subject of judicial comment<sup>7</sup>. These emphasize the sole purpose test in that the purpose is to ensure the funds are managed competently and continue to provide retirement benefits to members of those funds. The indefinitely continuing funds are private sector funds and are industry funds, retail funds (e.g. insurance companies), funds established by large corporations or personal funds (including Self Managed Superannuation Funds - SMSFs).

These terms are not mutually exclusive categories and individuals can have membership of multiple funds. The results are problematic and complex, to say the least. Add to this mixture government intervention – well intentioned but not necessarily well designed – and there were further complications.<sup>8</sup> The Labor Government introduced compulsory superannuation in 1992 and this was continued and enhanced by the subsequent Coalition Government. To protect employees, registrable superannuation entity licensing (RSE) was introduced in 2004. The Australian developments contrast sharply with New Zealand which opted for a voluntary, non subsidised system until the introduction of the recent KiwiSaver System. This is still voluntary but it attracts a small government benefit of \$1000 on joining, a tax credit and, if one qualifies, a first home deposit subsidy.<sup>9</sup>

For many Australians, balances in superannuation funds are now their largest financial asset. It was estimated in April 2008 that superannuation funds were valued at \$1.15 trillion, and about one quarter of those (or 372,000) were SMSFs.<sup>10</sup> Of course, due to the current international financial crisis, the current total balances since that time are now significantly less than the above official valuations.

Most superannuation funds covered by the SIS Act are required to operate as trusts and some duties are codified or referred to in the Act while other duties are subject to general trust law.<sup>11</sup>

In practice there are six main types of fund. These are:<sup>12</sup>

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<sup>6</sup> *Cameron Brae Pty Ltd v FCT* [2007] FCAFC 135

<sup>7</sup> *Walstern Pty Ltd v FCT* (2003) 54 ATR 423 at 435

<sup>8</sup> See P. Hanrahan, “*Fund Governance; How can we integrate the different strands*”, powerpoints of a presentation at Superannuation Fund Governance Conference, AIST in conjunction with the Melbourne Centre for Financial Studies, 2008.

<sup>9</sup> See generally, Susan St.John and Michael Littlewood, *Does KiwiSaver improve the unique New Zealand mix of retirement policies?*. The 14<sup>th</sup> Australian Colloquium of Superannuation Researchers: Choice in Retirement Funding. UNSW, 20-21 July 2006.

<sup>10</sup> Institute of Chartered Accountants in Australia. “Self Managed Superannuation Funds – Review of the existing regulatory and governance framework”, April 2008

<sup>11</sup> Jacobs op cit Chapter 29.

<sup>12</sup> Wikipedia – Superannuation in Australia.

- Industry Funds are multiemployer funds run by employer associations and / or unions. Unlike Retail / Wholesale funds they are run solely for the benefit of members as there are no shareholders.
- Wholesale Master Trusts are multiemployer funds run by financial institutions for groups of employees. These are also classified as Retail funds by APRA.
- Retail Master Trusts / Wrap platforms are funds run by financial institutions for individuals.
- Employer Stand-alone Funds are funds established by employers for their employees. Each fund has its own trust structure that is now necessarily not shared by other employers.
- Do-It-Yourself Funds (or Self Managed Superannuation Funds) are funds established for a small number of individuals (usually fewer than 5).
- Public Sector Employees Funds are funds established by government for their employees.

Retail and Wholesale Master Trusts are the largest sector of the Australian Superannuation Market.

The SIS Act regulates ‘superannuation entities’ which is defined as meaning ‘regulated superannuation funds’, ‘approved deposit funds’ and ‘pooled superannuation funds’.

A regulated superannuation fund has to satisfy three conditions. First, it must have at least one trustee: s 19(2). Second, either the trustee must be a trading or financial corporation in the sense employed in s 51(xx) of the Constitution, or the governing rules of the fund must provide that the sole or primary purpose of the fund is the provision of old-age pensions: s 19(3). Third, the trustee or trustees must have given The Australian Prudential Regulatory Authority (APRA) a notice electing that the SIS Act is to apply to the fund: s 19(4).

Pooled superannuation funds and (in large measure) approved deposit funds must also have trustees. Pooled superannuation trust means a unit trust, the trustee of which is a corporation, and under the regulations is a unit trust to which the definition applies. An approved deposit fund means a fund that (a) is an indefinitely continuing fund (b) is maintained by a RSE licensee which is a constitutional corporation and (c) is maintained solely for approved purposes (section 10 of the SIS Act).

The reasons for the regulatory regime are to prevent abuse of the tax concessions and because of the size and social importance of superannuation.<sup>13</sup> The Australian system is thus an evolving system driven by changing regulation, financial innovation and changing domestic and international political and economic events.

Julian Disney<sup>14</sup> has recently criticized the current system as “excessively inefficient, unfair and complex,” favouring the rich at the expense of the poor and old at the

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<sup>13</sup> Jacobs op cit [2904]. See also Wilson Sy, *Working Paper, Superannuation Fund Governance: An Interpretation*, APRA. August 2008.

<sup>14</sup> “Superannuation and Lifelong Saving” [2007] UNSWLR 528

expense of the young. Sue Taylor<sup>15</sup> has criticized the system for its capture by the industry. These are cogent arguments but are not the subject of this paper which concentrates on the governance of superannuation funds. However the paper will adopt a fairly broad approach to governance. In doing so it will attempt to supplement the excellent recent work by Pamela Hanrahan<sup>16</sup>.

### The Scope of Governance

Governance refers to control and accountability of those in control of assets.<sup>17</sup> It can be basically divided into public and private regulation and private regulation we can further subdivide into contractual and self regulation.<sup>18</sup>

Legal regulation of superannuation is a curious combination of trust law, corporations law, financial services law, prudential requirements, licensing of superannuation entities and mandated governance.<sup>19</sup>

Contractual governance refers to the governance system set up by the contract. Self regulation refers to rules adopted by the entity.

Australian trust law is an amalgam of state Trustee Acts, case law and trust deeds. The trust deed is, subject to any statutory restrictions, the guiding constitutional source of the trustees' duties and obligations. For example, a trustee may accept a Binding Death Nomination Declaration, either time-limited a permanent Declaration, where the Deed so provides.<sup>20</sup> However, a court may be willing to consider a departure from the trust deed provisions where there is an equitable reason for so doing.<sup>21</sup> In those circumstances, a court will distinguish with a degree of acuity, decisions properly made, from decisions of trustees where there is an apparent lack of power or proper consideration or even a lack of good faith.<sup>22</sup>

In addition the SIS Act imposes statutory duties, and mandates content for operating standards (s.31, 32, 33) and covenants to be included in governing rules (s. 52) Section 52 (1) – (2) provide covenants to be included in governing rules.

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<sup>15</sup> “The \$200 million / Year Price Tag for Superannuation Fund Governance: A Case Study of Fund Member Loss” in Proceedings of Accounting & Finance Association of Australia and New Zealand. 2007 Gold Coast.

<sup>16</sup> P. Hanrahan, *Funds Management in Australia: Officers' Duties and Liabilities*. LexisNexis Butterworths, 2007. See also the earlier work P. Ali, G Stapledon and M.Gold. *Corporate Governance and Investment Fiduciaries*. Thomson LawBook Co 2003.

<sup>17</sup> See J.H.Farrar, *Corporate Governance: Theories, Principles and Practice*, 3<sup>rd</sup> ed., Oxford University Press, Melbourne, 1.

<sup>18</sup> See Stewart and Yermo, op cit. (footnote 2 above).

<sup>19</sup> See Hanrahan op cit (footnote 8 above).

<sup>20</sup> Section 59(1) and (1A) SIS Act; SIS Regulation 6.17A.

<sup>21</sup> *Inversys Australia Superannuation Fund Pty Ltd v Austrac Investments Limited* [2006]VSC 112.

<sup>22</sup> *Attorney General (Commonwealth) v Breckler* (1999) 197 CLR 83.

### Governing rules taken to contain covenants

- (1) If the *governing rules* of a *superannuation entity* do not contain covenants to the effect of the covenants set out in subsection (2), those *governing rules* are taken to contain covenants to that effect.

### The covenants

- (2) The covenants referred to in subsection (1) are the following covenants by each *trustee* of the *entity*:
  - (a) to act honestly in all matters concerning the *entity*;
  - (b) to exercise, in relation to all matters affecting the *entity*, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;
  - (c) to ensure that the *trustee's* duties and powers are performed and exercised in the best interests of the beneficiaries;
  - (d) to keep the money and other *assets* of the *entity* separate from any money and *assets*, respectively:
    - (i) that are held by the *trustee* personally; or
    - (ii) that are money or *assets*, as the case may be, of a standard employer-sponsor, or an *associate* of a standard employer-sponsor, of the *entity*;
  - (e) not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the *trustee's functions* and *powers*;
  - (f) to formulate and give effect to an *investment* strategy that has regard to the whole of the circumstances of the *entity* including, but not limited to, the following:
    - (i) the risk *involved* in making, holding and realising, and the likely return from, the *entity's investments* having regard to its objectives and its expected cash flow requirements;
    - (ii) the composition of the *entity's investments* as a whole including the extent to which the *investments* are diverse or involve the entity in being exposed to risks from inadequate diversification;
    - (iii) the liquidity of the *entity's investments* having regard to its expected cash flow requirements;

- (iv) the ability of the *entity* to discharge its existing and prospective liabilities;
- (g) if there are any reserves of the *entity*—to formulate and to give effect to a strategy for their prudential management, consist with the *entity's investment* strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due;
- (h) to allow a beneficiary access to any prescribed information or any prescribed documents.

Boards of superannuation entities which are corporations also fall within the Corporations Act 2001 and the Financial Services Act 2001. They are also subject to the Australian Stock Exchange Corporate Governance Council's *Principles of Corporate Governance and Recommendations* or will tend to follow them.

Subsection (1) operates like replaceable rules as a default system. Subsection (2) (a) reflects the old statutory duty of directors which was eventually replaced by section 181 (1) of the Corporations Act 2001. The wording of subsection (2) (b) differs from section 180 (1) in the express reference to skill and to “an ordinary prudent person..... in dealing with property of another for whom the person felt morally bound to provide.” The first part is more lenient in its reference to an ordinary person and no reference to their position in the company but the Trustee Acts of the states impose a higher duty and standard. The second part is stricter than section 180 (1) in its reference to moral obligation to provide. This must also be read in conjunction with the provisions relating to investment. Section 180(2) (the Business Judgment Rule) does not apply to directors of a Superannuation fund. Subsection (2) (c) resembles the duty to act for the good of the company. Subsection (2)(d) requires strict trust accounting. Subsection (2) (e) resembles in general terms the duty not to fetter one's discretion and also resembles sections 182 and 183. Subsection (2) (f) et seq are more explicit than the duties of directors and resemble Principle 7 of the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations (2nd edition)*. Subsection (2) (h) refers to the SIS Act prescriptions as to required information and documents.

Section 109 (1) of the SIS Act set out arms length requirements for investment transactions. These are in addition to the related party provisions of Part 2E.1 of the Corporations Act 2001.

The reference in section 52 (8)[which states that a covenant by a corporate trustee also operates as a covenant by each director] to a reasonable degree of care and diligence is a reference to the degree of care and diligence that a reasonable person in the position of *director* of the *trustee* would exercise in the *trustee's* circumstances.

The prudential requirements are laid down by the APRA under its statutory responsibilities for the superannuation industry. There are also OECD Guidelines for Pension Fund Governance which are currently undergoing revision and which we will discuss later.

The application of the above covenants can be appreciated by consideration of *Re VCA*,<sup>23</sup> where APRA disqualified three directors under s.120A (2) of SIS Act on the basis of alleged contraventions of the Act and that the directors were not “fit and proper persons”.<sup>24</sup> That decision was overturned by the Administrative Appeals Tribunal. The tribunal decision was based on the covenants in section 52 (2) and whether they were merely synonymous with the general law or whether they extended the general law. The tribunal’s decision cited the decision of *Re VBN and APRA*<sup>25</sup> which held that the section 52 (2) covenants did not just restate the general law but were “statutory enhancements”.<sup>26</sup> There, it was highlighted that it differs from the ordinary standard of a director<sup>27</sup> and reflects the conservative approach expected of a trustee.<sup>28</sup> As to the duties in sections 52 (2) (c) and 52 (2) (e), the covenants are akin to the duty of a trustee to ensure integrity in dealing with trust assets, and the duty to invest for the advantage of beneficiaries or members of superannuation funds. The tribunal in *Re VCA* held that section 52(2)(e) requires a conservative approach rather than a more “entrepreneurial” approach.

It has been suggested that the covenants “..... are just reiterations of the general law without an evinced intention to extend those parameters.”<sup>29</sup> Until a higher court determines definitively the interpretation of those covenants, there may be some conjecture, at least in relation to the duty to invest for the betterment of the members of a superannuation fund. The restriction in the interpretation of that duty must be considered in the light of the purpose of superannuation law to provide funding in retirement for those who are too old or infirm to work. A conservative approach to the covenant in section 52(2)(e) may appear to be contradictory to that purpose and the sole purpose test laid down in section 62 of the SIS Act. A defensive approach is consistent with the trustee’s role, but that approach does not sit comfortably with the section 62 purpose which seems to require an entrepreneurial aspect to ensure there is a reasonable pension balance on retirement.

### Basic models of governance of superannuation funds

We have seen how there are three basic forms of superannuation funds – institutional, contractual and trust. There are two basic models for the *governance* of superannuation funds – trust governance and corporate governance and they differ in certain respects.<sup>30</sup> What the SIS Act tries to achieve in a piecemeal way is a third hybrid model suited to the industry and taking account of the social dimensions of superannuation.

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<sup>23</sup> [2008] AATA 580

<sup>24</sup> S. 120A (3) SIS Act.

<sup>25</sup> (2006) AATA 710 per DP Forgie.

<sup>26</sup> at [339].

<sup>27</sup> See also *ASIC v Vines* (2003) 48 ACSR 322 at [33].

<sup>28</sup> *Daniels v Anderson* (1995) 37 NSWLR 438. See generally Hanrahan op. cit. footnote 16, Chapter 7, 7.00.

<sup>29</sup> Vrisakis, M. (2008) “Statutory Covenants – turning up the light”. Australian Superannuation Law Bulletin. Vo 20(1), pp 6-8.

<sup>30</sup> *ibid*

This gives rise to four distinctive features.

First, while it must be recognised that not every entity involved in superannuation is a licensed entity or indeed subject to the Act, those which are are subject to the detailed provisions of the SIS Act.

Secondly the role of boards of RSEs is different from that of trading companies. Also with some there is compulsory membership by interest groups.

Thirdly the traditional trust model provides prudential overlay which is not reflected in modern corporate law and differs from it in some respects. The SIS Act and the Trustee Acts add further prudential regulation by detailed rules relating to investment and related party provisions peculiar to the superannuation industry.

Fourthly, there is a strong argument to which we refer later, that superannuation trust principles need to differ in certain respects from normal private trust principles<sup>31</sup>.

Superannuation is linked with the employment contract<sup>32</sup> and is the subject of increasing statutory intervention<sup>33</sup>. It is arguably now sui generis or at least sui specii.

### Theoretical Issues

The two main socio-economic theories which are applicable to the governance of superannuation funds are agency theory and stakeholder theory.<sup>34</sup>

The two main agency problems are controlling the self interest of trustees, and political issues of investment and activism.

Self interest arises where there is employer or employee representation and each group has its own interest. Where professional trustees are used there is also the possibility of conflict where investment is placed in associated vehicles. These problems are dealt with by the statutory and caselaw duties imposed on trustees and the system of criminal and civil penalties and civil redress. The problem is how active is the monitoring by APRA, ASIC and the ATO. As we have seen the interest

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<sup>31</sup> See *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* [1991] 1 WLR 589 at Sir Robert Walker, Some Trust principles in the Pensions Context in A.J Oakley (gen. ed) *Trends in Contemporary Trust Law*. Clarendon Press, Oxford 1996, 122; S. Chareneka. "Legal Darwinism: The Evolution of a New Trust Species". [1999] 11 Ins L J 120; D. Hayton, "Pension Trusts and Traditional Trusts: *Drastically Different Species of Trusts*". [2005] Conveyancer and Property Lawyer 229; compare Justice Hill op cit. footnote 4 above.

<sup>32</sup> See Santow J in *Uncle v Parker* (1995) 55 IR 120; *Cullen v Pension Holdings Ltd*, Unreported New Zealand Court of Appeal CA 304/91, 1 March 1993.

<sup>33</sup> See Walker, op cit. footnote 31, 124.

<sup>34</sup> See David Hess and Gregorio Impavido, "Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence", World Bank Policy Research Working Paper 3110, August 2003. As to agency theory see Farrar op cit 31 et seq and literature cited. As to stakeholder theory see the DTI Steering Group of the UK Company Law Review, Working Papers.

of the individual is often ill defined and in some cases based on the exercise of discretion by the trustees.

Stakeholder theory supplements legal theory because the interest recognised by it does not have to be a legal interest.

Stakeholders in superannuation include current contributors, retired members in receipt of benefits and the survivors and dependents of participants. Some professional advisers can also be regarded as stakeholders where legislative reform is concerned. The interests of these can conflict. The category also includes the government and taxpayers since private superannuation reduces the welfare burden on the state and the conferral of tax benefits must be regulated and not abused.

Political issues can arise where the trust deed or general law imposes limits on certain types of investment. They also arise where a superannuation body such as CALPERS, the California Public Employees Retirement Scheme uses funds to maintain a shareholder activist campaign in respect of corporate governance of the private sector. Such activism often leads to reciprocal activism by the private sector to question the governance by the funds themselves.

The absence of defined residual claimants makes the reliance on public enforcement all the more significant and yet there are limited funds available for this purpose.

The Australian system has led to capture by the financial services industry of many of the benefits, the payment of commissions without performance and the absence of effective monitoring has resulted in poor performance in many cases which is now highlighted in the current financial crisis.

### Specific Practical Issues of Governance

We will concentrate on eight key governance issues –

- (a) trustees' role and the sole purpose test
- (b) conflict of interest
- (c) care, diligence and skill
- (d) risk management
- (e) investment monitoring
- (f) disclosure and reporting to members
- (g) trustee protection and liability insurance
- (h) enforcement

#### (a) Trustees' Role and the Sole Purpose Test

The Trustees' role is inextricably linked to the sole purpose test,<sup>35</sup> which is related to the consequential taxation benefits available to such funds. These benefits are conferred because of the objectives of the funds ultimately relieve the burden on public funding for a person in retirement. To provide some secure mechanisms around such funds, they are set up with a trust structure. A trustee of such a trust may be an individual or a company.

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<sup>35</sup> Section 62 of SIS Act

The trustees' role taken together with provisions of the SIS Act are an amplification of the central tenet of governance of superannuation funds – the sole purpose test.<sup>36</sup> This means that a superannuation fund must exist (and continue to exist) for the sole purpose of at least one of the “core” purposes and “ancillaries” purposes i.e. the fund’s operations are governed in the interests of members prospective retirement (subject to preservation age and other exceptional provisions), or on reaching 65 years of age or in the event of a member’s death. Benefits must then be paid to the member (or the member’s dependent(s) in the case of death).

The sole purpose test is also a vital consideration in the governance of superannuation funds investments. For example, prudential considerations require investments in “in-house assets” to be limited to 5% of the market value of the fund’s assets.<sup>37</sup>

Similar considerations apply to borrowing for the purpose of investment or for the urgent payment of benefits to members.<sup>38</sup>

#### (b) Conflict of Interest

Trustees are subject to the normal conflict rules which are based on strict fiduciary principles. Section 52 of the SIS Act requires covenants in respect of such matters as we have seen. Directors of corporations are also subject to sections 181 at seq. of the Corporations Act 2001 which are more lenient than the trustee rules. Although early cases stated that directors were trustees this is not normally the case.<sup>39</sup> However it is the case that the basic conflict of interest rules developed out of equity and trust cases were cited. Now in the case of superannuation funds falling within the SIS Act it is made clear that the corporation is liable as a corporate trustee and the directors are subject to a similar duty. This means that they are subject to two tier fiduciary duties. Whether this system is effective with retail trustees / directors handling investment management contracts is debateable. These issues arise from a shift of the global financial system to a market system which is not necessarily consistent with the earlier institutional systems.<sup>40</sup> However, a failure to put in place adequate internal arrangements to monitor conflict of interest and fraud may lead to liability under section 52(8) of the SIS Act<sup>41</sup>.

#### (c) Care, Diligence and Skill

We have discussed section 52(2)(b) of the SIS Act above. The introduction of the RSE “fit and proper” requirements has raised board competence level and

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<sup>35</sup> Section 62 of SIS Act

<sup>36</sup> Section 62 of SIS Act

<sup>37</sup> E.G. section 85 SIS Act

<sup>38</sup> Section 67 SIS Act

<sup>39</sup> See eg. Kay J in *In re Faure Electric Accumulator Co* (1888) 40 Ch D 141 at 150 – 1

<sup>40</sup> See Wilson Sy, APRA Working Paper cited to footnote 12 above. See generally Hanrahan op cit footnote 16, Chapter 9

<sup>41</sup> See *Re Preuss and APRA* (2005) 87 ALD 629 (AAT) and Hanrahan op. cit. footnote 16, 7.11

awareness.<sup>42</sup> In a survey titled *the Governance of Superannuation Funds – the Industry Three Years on from Trustee Licensing, which was published in March 2008* and undertaken jointly by Deloitte and the Institute of Chartered Accountants in Australia, 81% of the replies said that both had increased. 58% said that board practices for appointment and removal of directors had improved.<sup>43</sup> The “fit and proper” requirements do not specify a skills set. APRA guidance note SGN 110.1 states that not all directors must be “technical experts in the Superannuation field”. The SIS Act requires an equal number of member and employer directors making this difficult in any event.

It was felt that there was a need for more education of board members. Some favoured qualifications offered by the Australian Institute of Superannuation Trustees (AIST). There was a need for greater objective evaluation of board performance.<sup>44</sup>

#### (d) Risk Management

Although there is greater awareness of risk management issues since the SIS Act there was a feeling in the above Survey that it needed to be embedded on the culture of the organisation and that a partnership approach should be adopted in doing business with outsourced service providers to improve the quality of service.<sup>45</sup> It was considered that APRA should provide prudential guidance on “alternative investments” such as derivatives or hedge funds.<sup>46</sup> The use of data analytics should be used to manage the risk of fraud.<sup>47</sup>

#### (e) Investment Monitoring

Under the SIS Act section 52(2), the trustee is required to formulate and give effect to an investment strategy which covers risk, diversification, liquidity and the discharge of current and prospective liabilities. Adherence to this strategy protects the trustees from liability for poor investment decisions.

Like any trust, the trustees of superannuation trust are bound by the ordinary duties of a trustee. That is, they have the following duties –a primary duty to obey the terms of the trust deed<sup>48</sup>; a duty to avoid any conflict of interest or to gain from any authorised profit<sup>49</sup>; a duty to account for any proceeds of property or other dealings

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<sup>42</sup> For detailed discussion of section 180 see Farrar op cit. Chapter 13

<sup>43</sup> Page 6

<sup>44</sup> Pages 6 and 7

<sup>45</sup> Page 7. See Hanrahan op. cit. footnote 16, 4.84.

<sup>46</sup> Ibid

<sup>47</sup> Ibid

<sup>48</sup> *Mendelsohn v Centrepont Community Growth Trust* [1999] 2 NZLR 88 at 95.

<sup>49</sup> *Holder v Holder* [1968] Ch 353; but this duty has been held in Australia to require power in the Trust Deed or to have Court sanction, together with an obligation to ensure beneficiaries are fully informed and where the Trustee gaining from the Trust property pays a fair price. *Edmunds v Pickering* (1999) 75 SASR 407 at 557.

or the benefit of beneficiaries<sup>50</sup>; a duty to personally administer the trust<sup>51</sup>; a duty to act impartially<sup>52</sup>; and a duty to invest in accordance of the trust deed and any statutory or other legal requirements<sup>53</sup>. In respect of the latter, a superannuation trustee has a particular responsibility to endeavour to ensure investment decisions are made for the advancement of the financial status of the trust<sup>54</sup>.

The state Trustee Acts now contain uniform provisions which impose detailed duties on trustees in respect of investment. Thus, sections 14A and 14C of the New South Wales Trustee Act 1925 provide as follows.

Subject to the instrument (if any) creating the trust, section 14A (2) provides that a trustee must, in exercising a power of investment:

- (a) if the trustee's profession, business or employment is or includes acting as a trustee or investing money on behalf of other persons, exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the affairs of other persons, or
- (b) if the trustee is not engaged in such a profession, business or employment, exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons.

Section 14C sets out in some detail the matters to which trustee is to have regard when exercising power of investment.

- (1) Without limiting the matters that a trustee may take into account when exercising a power of investment, a trustee must, so far as they are appropriate to the circumstances of the trust, if any, have regard to the following matters:
  - (a) the purposes of the trust and the needs and circumstances of the beneficiaries,
  - (b) the desirability of diversifying trust investments,
  - (c) the nature of, and the risk associated with, existing trust investments and other trust property,
  - (d) the need to maintain the real value of the capital or income of the trust,
  - (e) the risk of capital or income loss or depreciation,
  - (f) the potential for capital appreciation,
  - (g) the likely income return and the timing of income return,
  - (h) the length of the term of the proposed investment,
  - (i) the probable duration of the trust,
  - (j) the liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment,
  - (k) the aggregate value of the trust estate,
  - (l) the effect of the proposed investment in relation to the tax liability of the trust,
  - (m) the likelihood of inflation affecting the value of the proposed investment or other trust property,
  - (n) the costs (including commissions, fees, charges and duties payable) of making the proposed investment,

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<sup>50</sup> *Re Simersall* (1992) 108 ALR 375 AT 379-380

<sup>51</sup> But may employ agents and delegate to the extent permitted by the Trust Deed and not prohibited by statute.

<sup>52</sup> *Re Zimpel* (dec'c) [1963] WAR 171

<sup>53</sup> *Adamson v Reid* (1880) 6 VLR (E) 164

<sup>54</sup> *Cowan v Scargill* [1985] 1 Ch 270

- (o) the results of a review of existing trust investments in accordance with section 14A (4).
- (2) A trustee may, having regard to the size and nature of the trust, do either or both of the following:
- (a) obtain and consider independent and impartial advice reasonably required for the investment of trust funds or the management of the investment from a person whom the trustee reasonably believes to be competent to give the advice,
- (b) pay out of trust funds the reasonable costs of obtaining the advice.
- (3) A trustee is to comply with this section unless expressly forbidden by the instrument (if any) creating the trust.

These provisions are much more detailed and onerous than the normal duties of directors under the Corporations Act 2001 and corporate constitutions.

Reference has been made above to “alternative investments.” The recent financial crisis shows that investments have grown more complex and the present structure of many boards does not qualify them to deal with the complexities or even to evaluate the professional advice.<sup>55</sup> The effects of complex derivatives, securitisation and the activities of various capital and hedge funds have all been involved in the current financial crisis.

(f) Disclosure and Reporting to Members<sup>56</sup>

The present situation is unsatisfactory. On the one hand there is excessive boiler plate disclosure of an unreadable kind generated by the Financial Services Act and on the other the inadequate regular reporting on investment performance to members. The position in respect of private trusts laid down in *Re Londonderry's Settlement*<sup>57</sup> which entitles trustees to withhold reasons for decisions is being increasingly called into question and should not apply to superannuation trusts.<sup>58</sup> The law in Australia as stated by Powell J in *Spellson v George* (1987) 11 NSWLR 300 and Mahoney J.A in *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405 at 425 may be more liberal.<sup>59</sup>

(g) Trustee Protection and Liability Insurance

In the past trustees have relied on exoneration and indemnity clauses.<sup>60</sup> Now they need to seek appropriate insurance cover. The UK Pensions Ombudsman has expressed the view that consideration should be given to making insurance compulsory.

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<sup>55</sup> Page 16. For an interesting discussion of the UK Pensions Act 1995 sections 34 – 36 see G. Moffat, *Trust Law and Materials*, 4<sup>th</sup> ed. Cambridge University Press. 2005, 658 et seq.

<sup>56</sup> Page 18. See Jacobs op cit [2927]

<sup>57</sup> [1965] Ch 918. Cf *Schmidt v Rosewood Trust Ltd* [2003] 2 AC 709

<sup>58</sup> See Lord Browne-Wilkinson “Equity and its Relevance to Superannuation Today”, a paper given to the Annual Conference of Australian Superannuation Funds in 1992 cited by Balmford J. in *Crowe v Stevedoring Employees Retirement Fund* [2003] VSC 316 at [34].

<sup>59</sup> See the criticism in Jacobs op cit [1716].

<sup>60</sup> As to indemnities and exoneration see Jacobs op cit [2910]

A UK commentator<sup>61</sup> has argued that extensions to existing D&O policies is not the best way to go and a policy specially designed for the context is needed. One reason is that some trustees may be directors of the sponsoring employer company and so will be in a conflict of duty and duty situation. The statutory indemnity is limited to where the trustee has acted honestly and reasonably and in the opinion of the court ought to be excused from liability for breach of trust. This is necessarily *ex post*.

The insurance policy needs to cover liability at corporate and personal level. It is preferable to have loss cover rather than simple legal liability cover. Retired trustees need to be protected. The cover should extend to legal expenses in seeking directions of the court. Risk management procedures reduce the risk and insurers need to be kept informed about them.

(h) Enforcement<sup>62</sup>

The ultimate test of any governance system is its effectiveness. There are public and private law sanctions for breach of the governance requirements.

The public law sanctions are civil and criminal penalties and criminal proceedings under the Criminal Law. There are specific disqualification provisions under Part 15 of the SIS Act.

Private law remedies include -

- (a) the company's remedies under the general law and the Corporations Act 2001 and sections 55 and 313 of the SIS Act.
- (b) investor remedies under the Corporations Act 2001 and the SIS Act. The lack of clarity in the nature of the interests of a contributor and beneficiary reduces the effectiveness of civil redress.

The Role of the Australian Council of Superannuation Investors (ACSI), the Association of Superannuation Funds of Australia Ltd (ASFA) and the Australian Institute of Superannuation Trustees (AIST)

The Australian superannuation industry has three not for profit bodies which coordinate activities.

These are ACSI, ASFA and AIST.

ACSI is a not for profit organisation formed in 2001 to provide independent research and education to superannuation funds on corporate governance. It has its own guidelines on corporate governance and has taken a leading role in recent corporate governance issues. It was active in the move by News Corp from the Australian Stock Exchange and in challenging a poison pill in the Delaware Courts.

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<sup>61</sup> See J. Bull "Trustee Protection and Liability Insurance" Pension Funds Online Articles (<http://www.pensionfundonline.co.uk/articles/topdu.aspx>)

<sup>62</sup> See Hanrahan *op. cit.* footnote 16, Chapter 13 for a detailed discussion.

ASFA is another not for profit which represents the interests of Australia's superannuation funds, their trustees and their members. It has produced Best Practice Papers on Superannuation Fund Governance (no.7), Negotiating Investment Management Agreements (No.12) and Outsourcing and Delegation: Compliance issues for Trustees(no.15). In May 2003 it produced Active Share Ownership Guidelines for Superannuation Fund Trustees Best Practice Paper 17. ASFA was also consulted in the development of the Investment and Financial Services Association's Blue Book and is represented on the Australian Stock Exchange's Corporate Governance Council. The Best Practice Papers are available to non members at \$3,000 per paper! Both organisations perform a useful role. However, ASFA could make its best practice papers more freely available to non-members. The current cost is punitive and suggests a lack of transparency.

The Australian Institute of Superannuation Trustees (AIST) is an independent professional body which is a company limited by guarantee. Its members are representative, not-for-profit superannuation funds, their Trustee Directors and Staff.

AIST is also a Registered Training Organisation and offers a range of services including Professional Development and training. Events both national and international, compliance services and member support. AIST also advocates on behalf of its members to relevant stakeholders.

AIST provides support, encouragement, education, training and other resources for those involved with the representative superannuation industry.

AIST's mission is to:

- Promote the values of the representative superannuation industry.
- Promote the benefits of representative Trusteeship in providing a viable and equitable retirement system in Australia.
- Provide support, encouragement, education and training and other resources for those involved in the representative superannuation industry.

AIST realises this mission through the provision of a range of services and activities that:

- Meet strategic and operational needs identified by representative superannuation funds and their people.
- Provide recognition of contributions to the industry; and
- Present a positive industry image to the wider community.<sup>63</sup>

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<sup>63</sup> This is taken from the AIST Website [www.aist.asn.au](http://www.aist.asn.au)

## OECD Guidelines for Pension Fund Governance<sup>64</sup>

The OECD Guidelines for Pension Fund Governance were first issued in 2002.

The latest draft was open for consultation until 1 October 2008 and must be read in conjunction with the OECD Principles of Corporate Governance revised in 2004. The draft guidelines require the governance to address structure and mechanisms of governance. The structural requirements require clear identification of operational and oversight responsibilities and deal with the governing body, delegation and the role of the auditor and actuary. They address accountability to members and beneficiaries and the skill sets required.

The governance mechanisms deal with risk based internal controls, reporting and disclosure. The specific information required is described in the OECD Guidelines for the Protection of the Rights of Members and Beneficiaries. The governing body can also disclose how environmental, social and governance issues have been taken into account in the investment policy.

The submissions were considered at the meeting of the Working Party on 1 December 2008, and will be released in January 2009.

## The Impact of the Current International Financial Crisis

The international financial crisis is beginning to become a broader based economic crisis which the recent G20 Summit has attempted to deal with.<sup>65</sup>

The crisis reflects the dangers of a globalised world. Sub prime loans, (the consumer equivalent of junk bonds) were securitised and the securitised products taken up by many financial institutions. The worst hit banks were in peril and some of them have been bailed out by government finance. This crisis led to a collapse of confidence in stock markets and the result is bad news for superannuation funds. Some had invested directly or indirectly in the securitised debt products. All invested in the Stock Market and the value of their funds has rapidly declined. This has also resulted in lower income for beneficiaries. Little useful advice has been provided by the industry which is reeling from the shock of an unfolding crisis. Government intervention has been necessary to safeguard the banking system. At the moment dealing with the crisis is a work in progress with a tendency by governments to resort to Keynesian solutions.<sup>66</sup>

## Conclusion

Australia has been a pioneer of compulsory superannuation and the licensing of superannuation providers. This was well intentioned reform but while some of the efforts have been beneficial to employees and beneficiaries, there are also

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<sup>64</sup> Draft OECD Guidelines for Pension Fund Governance.

<sup>65</sup> See Declaration of the Summit on Financial Markets and the World Economy November 15 2008

<sup>66</sup> See J.M.Keynes, *General Theory of Employment, Interest and Money*, Harcourt, Brace & World, New York 1935, Chapter 12 “The State of Long Term Expectations”

impediments and inconsistencies. The recent amendments effective from 1 July 2007 have been universally accepted for the most part. Some imperfections become apparent over time. For example, the amendment to Section 290 – 150<sup>67</sup> has created an inequity in that deductions which would otherwise be allowable are denied where a member gives a valid notice but makes a transfer or “roll over” to another fund or where the member is no longer a member of the fund.

There has been a substantial decline in wealth for employees in the last two years. Yet the reforms have led to industry capture of these investment funds and the ability to charge massive fees and commissions irrespective of performance with little tangible gain for employees and beneficiaries.<sup>68</sup> Given the statutory purpose in the SIS Act, trends in director remuneration might be reviewed and restricted. There are broader social issues also about the unequal benefits of the present arrangements in terms of rich and poor and young and old.<sup>69</sup>

The current financial crisis means that governments and the financial services industry will come under closer scrutiny than in more prosperous times.

Irrespective of the global financial downturn which was not controllable by fund Trustees, it is arguable there has been defective governance in the past and inadequate useful disclosure and reporting to members. Our consideration of practical issues of governance – trustees’ roles; care, diligence and skill; risk management; investment and statutory provisions to assist in Funds satisfying the sole purpose test - points to a number of issues of inadequate governance.

There have been many corporate governance reports.<sup>70</sup> There has also been increased regulation of audit and governance activities.<sup>71</sup> Some of these promoted ‘principle based’ changes involving less prescription. The application of these to superannuation funds is sometimes problematic and often those on Boards have had little knowledge or experience for the responsible roles involved. For superannuation funds in particular, the role of trustee involves the complex interaction of responsibility of taking risk to enable fund deposits and capital to grow while not taking risks high enough to expose the funds to large losses. To improve the standards of governance, new mechanisms must be examined, such as:

- a. Trustees must be adequately trained to understand the superannuation industry and the fund’s organisational processes;
- b. Trustees should have more knowledge of the financial markets and investments, domestically and internationally;
- c. Trustees should have greater awareness of their legal responsibilities and the regulatory arms which oversee the superannuation industry;

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<sup>67</sup> Income Tax Assessment Act 1997

<sup>68</sup> See Disney op cit (footnote 13 above)

<sup>69</sup> See Taylor op cit. (footnote 15 above)

<sup>70</sup> See for example Cadbury Committee in 1993 (UK) to Royal Commission into HIH in Australia. See Farrar op. cit. footnote 16, Chapter 27.

<sup>71</sup> By accounting professional bodies following collapse of Andersons, Enron, Worldcom etc in the early 2000’s.

- d. The structure of the trustee board might include, (apart from satisfying any statutory prescription) relevant experts e.g. technology, as well as finance and the law;
- e. Whether trustees/directors of trustee companies should have any potential conflict of interest minimised. For example, whether a separate supervisory board (not a subcommittee of the board of trustees) should have decision making for remuneration of directors, auditors and consultants. Similar considerations might be justified for decision making in relation to changes to the organisation's constitution.
- f. Whether a separate supervisory board or group should have responsibility for communicating risks to Directors i.e. apart from the management of the organisation?
- g. Methods of valuation of units need to be more transparent where these units are unlisted.
- h. Currently there is little attention paid to the different age groups reading the disclosure document. The disclosure and reporting and the role of financial planning services and the basis of remuneration need to be less legalistic and more transparent. The websites of superannuation funds needs to be made more user friendly with standardised format.

Remuneration issues for any company are often sensitive. The rate of director remuneration in the past decade has been seen to grow out of proportion to the rest of the community. Therefore, given the statutory purpose of the SIS Act, the question arises as to whether performance bonuses for professional trustees of superannuation funds should be allowed, particularly the excessive "corporate" style of remuneration bonuses. If they are to be restricted, this should be done by statute.

Another issue of governance of superannuation funds is whether investment advisers perform a professional role or merely a "sales" role. In any event, there is sound reason for restricting the decision point to the client and then, only where the client has been given full knowledge of the commission/ fees to be paid to the adviser, well in advance of meeting with the adviser. An objective basis for allowing an adviser to receive commission / remuneration which is determined only by the product provider, without reference to or a decision by the client is currently lacking.

The issue of governance in relation to advisers / sales staff also has relevance to the standard of competence of those staff. The standard of knowledge of such persons across the industry is often low compared with lawyers and accountants and many have little practical experience for such a role. Of course, similar comments may also be made about real estate agents who often sell property for inclusion in superannuation funds.

Finally there should be more recognition of the fact that superannuation funds are a distinctive form of trust which gives rise to complex questions of beneficial interest and conflict of interest.<sup>72</sup> It is no longer satisfactory to deal with these issues by legislation contained in different statutes which often resembles a patchwork quilt. There is a need for consolidation of the legislation. Some overseas jurisdictions

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<sup>72</sup> See Hayton *op. cit.* footnote 30 above but compare Justice Hill *op. cit.* footnote 4 above.

which do not have the trust use an institutional form.<sup>73</sup> In Germany and the Netherlands these have supervisory boards or visitation commissions. While there is an argument based on the distinctiveness of superannuation for such an approach, to adopt it in Australia would require a long and costly review. Given the social importance of superannuation this might nevertheless be justified.

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<sup>73</sup> See Stewart and Yermo *op. cit.* footnote 2 above, 6.