CHAPTER 3:

THE SOLE PURPOSE TEST AND CHARGES OVER ASSETS

Introduction

3.1 This chapter deals with issues arising from the submissions and evidence concerning the sole purpose test (section 62 of the SIS Act) and SIS regulation 13.14 which prevents charges over the assets of funds.

3.2 These issues are:

(i) that SIS regulation 13.14, preventing charges on superannuation assets, be relaxed;[53] and

(ii) the possible conflict between garnishee orders issued under section 1233 of the *Social Security Act 1991* and the sole purpose test.[54]

Charges over the assets of funds

Legislation

3.3 SIS regulation 13.14 states:

> For the purposes of subsections 31(1) and 32(1) of the Act, it is a standard applicable to the operation of regulated superannuation funds and approved deposit funds that, subject to regulation 13.15, the trustee of a fund must not give a charge over, or in relation to, an asset of the fund.

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[53] National Australia Bank, SISREG Sub No 5

Arthur Robinson and Hedderwicks, SISREG Sub No 19

[54] LIFA, SISREG Sub No 17

3.4 SIS regulation 13.15 states:

> The standards stated in regulations 13.12, 13.13 and 13.14 do not apply to an assignment or charge that is permitted, expressly or by implication, by the Act or these Regulations.

The provision of security against various transactions

I - Derivatives

3.5 Arthur Robinson & Hedderwicks (ARH) submitted that the prohibition against charges over assets, as currently worded, could operate to prevent trustees from entering into agreements with brokers which would enable them to undertake transactions in respect of futures, options and other derivative instruments, both in Australia and overseas.[55] These transactions could be prevented because the 'standard form' agreements upon which these transactions are based require the fund trustees to lodge with brokers an amount of money or securities in a 'collateral account'. These accounts are charged in favour of the broker as security against unfavourable margin calls and can be viewed as a charge over the assets of the fund. ARH stated in their submission that the ISC had advised that the legislation had not been intended to prevent trustees from entering into derivative transactions.

3.6 Notwithstanding that derivatives transactions can be a valuable instrument for managing financial risk, for example, by hedging funds' exposure to currency and other risks, the committee considered that a cautionary note needed to be sounded in the use of these financial products. Although the use of such derivatives to manage financial risk would appear to be perfectly legitimate in the financial management of superannuation funds, overseas experience, particularly in the United States of America, has demonstrated that some derivative transactions have been devised which move beyond this relatively simple function. One example is the volatile, illiquid derivative based on the price of mortgages.[56] Such transactions appear to be approaching the realm of speculative investments for their own

55 SISREG Sub No 19

56 'Mutual funds' derivatives dilemma', *The Economist*, 3 September 1994,p73

sake, rather than serving any hedging function. They do not appear to be investments appropriate to superannuation, other than within the normal construction of diversified portfolios, with their attendant spectrum of risk profiles.

3.7 The Committee considers that it would be appropriate for this issue to be examined in greater detail, as excessive use of these transactions may well expose superannuation funds, and hence their members' accrued entitlements, to unnecessary risk.

> Recommendation 3.1
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> The committee recommends that the Government review, and if necessary move to limit, the exposure of superannuation entities to certain derivatives transactions.

II - Custodians

3.8 In a supplementary submission, ARH stressed the importance of custodians, particularly master custodians, within the superannuation industry:

> ...many large superannuation funds engage a master custodian to take responsibility for all of the fund's investment asset administration needs, and to provide clearing and settlement functions, consolidating reporting, "paperwork control" and information regarding rights issues, takeovers and other corporate actions relevant to shares held in the portfolio. Most master custodians also provide valuations, asset performance measurement, accounting, taxation and other related services and some also provide securities lending programs, foreign exchange services, proxy voting, and compliance services.
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> Where a superannuation fund engages more than one investment manager, difficulties can arise in reconciling differences in reporting methods, keeping track of asset allocations, effecting securities settlement and safekeeping, collecting and reconciling income and other receipts, analysing asset performance and other areas.
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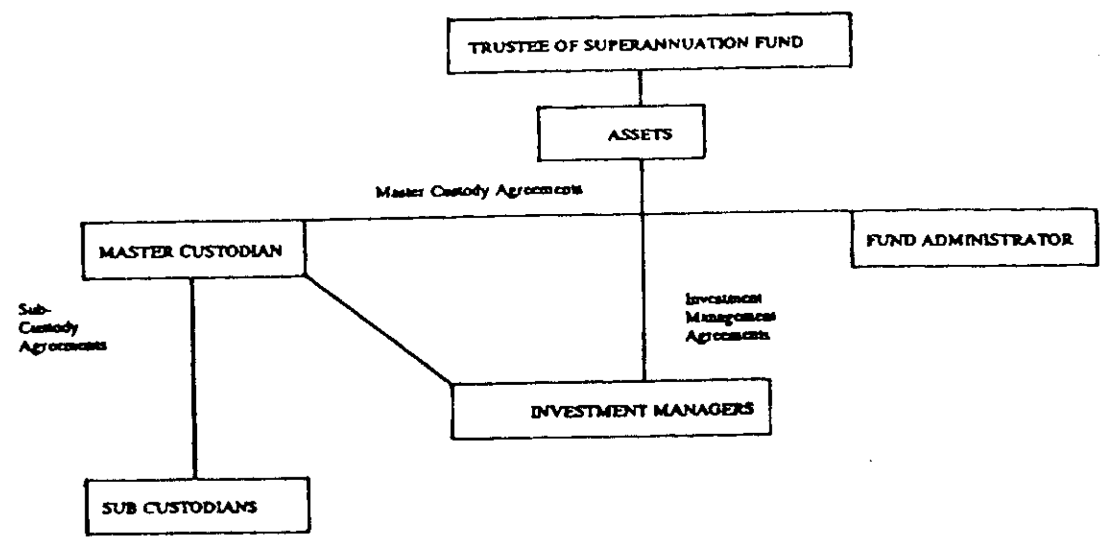
> ...around 80 Australian superannuation funds have engaged a master custodian. Most of these are superannuation funds with more than $100 million in assets and who use four or more investment managers...

> We further understand from Towers Perrin that capacity among the suppliers of custodian services for the Australian market is not sufficient to meet the present demand. As a result, Towers Perrin has found that client superannuation funds are sometimes unable to enter into custody arrangements with a preferred custodian which has had insufficient capacity to take on a new portfolio within a required time frame.[57]

The place of the master custodian and the sub-custodians in the superannuation fund structure is set out in a diagram provided by ARH and appears at Figure 1.

Figure 1:
The Place of Custodians in a Superannuation Fund



[57] SISREG Sub No 19, supplementary

3.9 ARH submitted that master custody agreements put to trustees invariably contain provisions that a charge be granted to the custodian to cover claims for payment of fees and expenses, and that these charges are required for two reasons:

(i) such a charge is customary within the custodianship industry to protect custodians from occasional substantial exposures resulting from their payment of registration fees, transaction charges, production fees, script exchange fees and the like which enable them to discharge their obligations to effect settlements; and

(ii) sub-custodians engaged by master custodians (to deal with local settlements and transactions et cetera especially in other countries) generally request charges to cover their own exposure.

3.10 The National Australia Bank's Custodian Services (NAB) expressed very similar concerns over regulation 13.14, asserting that:

> The undoubted interests of fund members in unencumbered, ungeared portfolios must be balanced against the bona fide interest of service providers to the fund or trustees in being remunerated for their services and reimbursed for expenses incurred in good faith. Protection of such interests is specifically provided in comparable regulations in other jurisdictions.[58]

The other jurisdictions referred to by the NAB include the USA, Canada, the UK and Hong Kong. The NAB submits that:

> the prudential standard applicable to Australian superannuation entities should equate to that applying in comparable jurisdictions, ie fees, costs and expenses attributable to the safe keeping or administration of fund assets should be exempted from any prohibition against encumbering fund assets.[59]

3.11 Roger Nairn of NAB reiterated that there were a number of transactions which are normal administrative management matters for which a supplier would expect to be covered, for example, on short term borrowings where fees in advance are required. Other examples given

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[58] SISREG Sub No 5

[59] SISREG Sub No 5

included within-the-day facilities to support trading activities, and forward foreign exchange dealing facilities which create obligations and which are provided against the general financial strength of the fund.[60]

3.12 The fundamental point made by NAB was that a range of transactions, which are normal to the operation of a fund, including bona fide investment activities by funds, may be severely impeded with little consequential benefit to members and trustees if regulation 13.14 prohibition was applied literally. This would also be the case if regulation 13.14 applied to fees which are payable for the safe custody and administration of fund assets. In some major jurisdictions, such fees appear to be exempt from prohibitions upon rights, charges, liens, pledges, security interest or any other encumbrances.

Possible Consequences

3.13 A possible scenario postulated by Mr Nairn was that if service providers were denied exemptions from the prohibition they would:

> ...almost certainly seek to minimise their exposures by not permitting borrowing, requiring fees in advance, the establishment of slush funds for the payment of incidental costs and expenses and/or refuse to meet such expenses until finances to cover are provided by the fund.[61]

3.14 ARH similarly submitted that it would be reasonable to expect that custodians who are asked to provide the usual range of services without the usual security will consider:

- whether fees charged to Australian superannuation fund clients need to be increased to take account of the higher level of risk (we understand that some custodians have already increased fees);
- whether trustees should be required to permit the custodian to keep liquid funds available to the extent required to enable a custodian and sub-custodians to meet transaction and other costs "up front" (with corresponding effects on the fund's rate of return);

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60 Evidence, pp 60-65

61 SISREG Sub No 5

- whether their own insurance arrangements are affected by the absence of security in respect of Australian superannuation fund portfolios, with consequential pressures on costs;
- whether, in the absence of security, custody agreements need to include stronger indemnities and other provisions aimed at strengthening the custodian's position;
- whether other jurisdictions offer business opportunities which should be pursued ahead of those available in the Australian market.[62]

Other Matters

3.15 In its supplementary submission, NAB sought to address concerns raised by the committee that the prohibition of charges over assets in relation to custodians serves as a means of enforcing rigorous control of expenditure by the custodian, thereby preventing abuse of power or the claiming of unauthorised expenditure.[63]

3.16 NAB submitted that the exemption sought in relation to custody of a fund's assets would not of itself create charges over assets, but simply provides a fund with more room to manoeuvre in negotiating investment activities.[64] NAB also maintained that allowing such exemptions would benefit members as well as custodians because many types of investments, risk management techniques, facilities and services which may well have been closed to an investor if security of the obligations involved cannot be given, would remain available. In addition, NAB submitted that custodians have no power to encourage prudence in investment as, by its nature, custody of assets occurs after the investment has been made.

3.17 The committee acknowledged the difficulties in evaluating an area of considerable financial and legal complexity. The committee understands that the prohibition in the SIS Act upon borrowings by superannuation entities did not extend to many debts and other liabilities incurred by funds

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62 SISREG Sub No 19, supplementary

63 Evidence, p 62

64 SISREG Sub No 5, supplementary

in the normal conduct of their business, for example: reimbursement of fees and advances, within-the-day settlement of transactions, and 'standard form' agreements with brokers and daily running expenses. The committee also understands that the ISC intends, in due course, to issue a Superannuation Circular to clarify this issue.

3.18 It seemed inconsistent that a range of routine transactions which incur debts and other liabilities and which are not prohibited under the anti-borrowing rules should be prevented by the operation of regulation 13.14. Given that debts and other liabilities would often only be able to be incurred upon provision of a security, in this case, the assets of a fund, the committee believes that it would be appropriate for the ISC to re-examine regulation 13.14. *But the committee wishes to reiterate its statements in previous reports on the need for a prudential regime which provides the utmost protection for superannuation funds. In particular, the committee considers that custodians should not be given the status of a preferred creditor, nor should any charge over assets exercised by a custodian significantly exceed the amount required to cover expenses outlaid by the custodian or apply at all in respect of custodian's fees.*[65]

3.19 NAB also submitted that similar problems may be associated with some conditions being drafted by the ISC for the purposes of subsection 26(3) of the SIS Act. These conditions will include the provisions which must be included in any agreement between the trustee and a custodian of assets of superannuation entities. The committee considers that the importance of proper custodial and other financial services for superannuation entities, and their possible impact on members' benefits, should not be underestimated.

65 Arthur Robinson & Hedderwick, SISREG Sub No 19, supplementary

Recommendation 3.2

The committee recommends:

(i) that, within the context of a clear need for a strong prudential supervision regime for superannuation funds, the Government review the operation of SIS regulation 13.14 to establish whether it unnecessarily constrains legitimate investment activities of superannuation entities;

(ii) that if any such unnecessary constraints are identified, they be remedied, after consultation with the major providers of financial services to superannuation entities, through appropriate amendments to the legislation; and

(iii) that the ISC publish an explanation of this review in a Superannuation Circular.

The sole purpose test and garnishee orders under the *Social Security Act 1991*

3.20 LIFA submitted that section 1233 of the *Social Security Act 1991*, which enables the Department of Social Security to serve garnishee notices on debtors, has been used by that Department to gain access to accrued entitlements of members of superannuation funds.[66] LIFA submitted that a trustee who obeyed such a notice would be in breach of:

- section 62 of the SIS Act, the 'sole purpose test', which prescribes the timing of benefit delivery and the persons to whom benefits become payable;

- SIS regulation 6.22, which limits the cashing of benefits in regulated superannuation funds in favour of persons other than members; and

[66] SISREG Sub No 17

- SIS regulations 13.12, 13.13, and 13.14, which prevent a trustee from recognising an assignment of a superannuation interest of a member or beneficiary, or from giving a charge over minimum benefits, preserved benefits, non-commutable income streams, or an asset of a fund.

3.21 A breach of these provisions can subject a trustee to monetary penalties or imprisonment.[67]

3.22 The committee notes that this issue has also arisen in considerations involving the recovery of outstanding money following bankruptcy proceedings, as well as recovery of unpaid tax. The committee understands that measures are being implemented to make the necessary changes to the SIS Act and the Bankruptcy Act which will allow the assignment of superannuation entitlements which exceed a member's RBL. In a supplementary submission, the ISC has advised that it has taken the view that superannuation assets should not be accessible by garnishee orders and other claims for indebtedness, particularly for preserved benefits.[68]

3.23 The issues involving conflicts between the SIS sole purpose test and associated SIS legislation on the one hand, and the service of garnishee orders from the Department of Social Security as well as recovery of unpaid tax by the Australian Tax Office on the other hand, appear to fall within a common category. The committee expects that these issues will be resolved through consultation with the appropriate organisations.

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[67] (i) Part 21 of the Act provides for certain criminal consequences of contravening or of being involved in a contravention of subsection 62 (1) of the Act.

(ii) SIS Regulations 6.22, 13.12, 13.13 and 13.14 prescribe standards under one or more of Sections 31, 32 and 33 of the Act, intentional or reckless contravention of which is punishable on conviction by a fine

[68] SISREG Sub No 20, supplementary

Recommendation 3.3

The committee recommends that, consistent with the policy of limiting recovery of Commonwealth debts from the members' superannuation accounts to those amounts which exceed RBL levels, the Government review and reconcile any conflict arising between:

(i) the SIS legislation; and

(ii) the tax and social security legislation which enables recovery of money.