

## **Chapter 4**

### **Trustees obligations: the financial interests of beneficiaries, the 'scale test' and investment strategy**

4.1 This chapter examines the provisions in proposed section 29VN of the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012. They impose additional obligations on the trustees of MySuper products to help improve trustee decisions regarding these products. These provisions require trustees to promote the financial interests of beneficiaries, assess the appropriate scale of the funds (in terms of both members and assets), and execute an appropriate investment strategy on behalf of these members.

4.2 Proposed section 29VN would establish the following additional obligations on trustees of a superannuation fund that includes a MySuper product. Trustees must:

- (a) promote the financial interests of the beneficiaries of the fund who hold the MySuper product, in particular returns to those beneficiaries (after the deduction of fees, costs and taxes);
- (b) determine on an annual basis whether the beneficiaries of the fund who hold the MySuper product are disadvantaged, in comparison to the beneficiaries of other funds who hold a MySuper product within those other funds. This disadvantage should be assessed on the basis of whether:
  - (i) the number of beneficiaries of the fund who hold the MySuper product is insufficient; or
  - (ii) the number of beneficiaries of the fund is insufficient; or
  - (iii) the assets of the fund that are attributed to the MySuper product are, or are to be, pooled with other assets of the fund or assets of another entity or other entities—because that pool of assets is insufficient; or
  - (iv) the assets of the fund that are attributed to the MySuper product are insufficient;
- (c) include in the investment strategy for the MySuper product the details of the trustee's determination on matters relating to (b) above;
- (d) include in the investment strategy for the MySuper product (with an annual update) the investment return target over a period of 10 years for

the assets of the fund that are attributed to the MySuper product and the level of risk appropriate to the investment of those assets.<sup>1</sup>

4.3 These provisions were referred to in this inquiry as 'the scale test'. Proposed section 29VO of the Bill states that each director of a corporate trustee must exercise 'a reasonable degree of care and diligence for the purposes of ensuring that the corporate trustee carries out the obligations referred to in section 29VN'. Proposed subsection 29VP(1) states that a person must not contravene section 29VN or 29VO.

4.4 There is important detail contained in the Explanatory Memorandum (EM) to the Trustee Obligations Bill on proposed section 29VN. The committee commends the government on the quality of the EM in this regard.

#### ***The financial interests—proposed paragraph 29VN(a)***

4.5 In relation to paragraph 29VN(a), the EM to the Trustee Obligations Bill notes that 'a trustee must promote the financial interests of members of a MySuper product', the most significant component of which are the returns to those beneficiaries.<sup>2</sup> Significantly, the EM adds:

While this will lift the standard required of trustees, it is not a requirement that trustees generate certain level of returns. Sustained low returns may indicate a failure to promote the financial interests of beneficiaries, but low returns, on their own, will not necessarily involve a breach of this obligation. The obligation does not imply that members of a MySuper product should be given preference over other members of the fund, for example, by the trustee in allocating investment returns, or in any other way.<sup>3</sup>

4.6 The EM also notes that the obligation to promote the financial interests of beneficiaries:

...necessarily includes consideration of the level of investment risk appropriate for these members, recognising that different groups of members may have a different risk tolerance and there is a trade-off between investment return and investment risk.

To be clear, this requirement does not prevent trustees from offering advice, insurance or services to members that do not directly improve returns to those beneficiaries (after the deduction of fees, costs and taxes). However,

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1 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, proposed subsection 29VN. The wording has been paraphrased: it is not the exact wording of the bill.

2 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, Explanatory Memorandum, p. 13.

3 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, Explanatory Memorandum, p. 13.

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the trustee must consider whether the benefits of offering the advice or service is appropriate having regard to the impact on members' returns. For example, financial advice (including intra-fund advice) to members on contributions may not directly promote returns to beneficiaries (after the deduction of fees, costs and taxes), however, offering this financial advice may be in the financial interests of members.<sup>4</sup>

#### ***Annual determination of scale—proposed paragraph 29VN(b)***

4.7 In relation to subparagraph 29VN(b)(i), the EM states that a relevant consideration for trustees is whether the number of beneficiaries is sufficient to ensure those costs for each beneficiary are not so high as to place the financial interests of the beneficiaries of the MySuper product at a disadvantage compared to beneficiaries of other RSEs holding a MySuper product.<sup>5</sup>

4.8 In terms of investment scale, the EM outlines that a trustee's determination must consider the sufficiency of assets that are relevant to the investment for the MySuper product, which includes the effect of scale on costs and investment opportunities. In considering whether the MySuper product does have adequate assets, a MySuper trustee can have regard to the extent to which the MySuper assets are pooled with other assets of the fund.<sup>6</sup>

4.9 In terms of those cases where there is a judgment by the trustee that the number of members or assets of the MySuper product is insufficient, the EM advises that:

It will be incumbent upon a trustee that determines that assets or members are insufficient to take appropriate action to rectify the insufficiency so they continue to meet their general obligation to promote the financial interests of beneficiaries. APRA will provide prudential guidance on processes trustees could adopt to form a determination and relevant considerations for trustees in rectifying insufficient scale.<sup>7</sup>

#### ***Targeted investment return & level of risk for MySuper product—proposed paragraph 29VN(d)***

4.10 In relation to proposed paragraph 29VN(d), the EM notes that 'in determining the risk appetite for the investment of its MySuper assets, a trustee may consider the

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4 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, Explanatory Memorandum, p. 14.

5 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, Explanatory Memorandum, p. 14.

6 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, *Explanatory Memorandum*, p. 14, paragraph 1.26.

7 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, *Explanatory Memorandum*, p. 14, paragraph 1.27.

age of members as well as other relevant factors'. It identifies the trustee's obligation as managing the trade-off between the investment return target and the level of risk for a MySuper product. The trustee will have to 'clearly articulate and justify the investment return target and level of risk they have adopted for the MySuper product'.<sup>8</sup>

### **Submitters' views on the scale test**

4.11 Several submitters expressed concern with the scale test in proposed paragraph 29VN(b) of the Trustee Obligations Bill. Their basic argument was that scale—the number of members and the size of assets—are not the only metrics and should not be main metrics to assess whether a fund is failing to promote the best interests of its members.

4.12 The Association of Superannuation Funds of Australia (ASFA), for example, told the committee that size of portfolio and number of members are only two determinants of the reason why a MySuper product trustee may underperform. Ms Pauline Vamos, Chief Executive Officer of ASFA, told the committee:

...there are other factors as well. In our view, fund trustees, as part of their best interest duties, have to look each year at whether or not they are able to provide services in the best interests of their members. So our initial view is very much that the...whole scale test may produce the wrong results.<sup>9</sup>

4.13 The AIST told the committee that while it does not necessarily propose abolishing the Bill's scale test, it would not be disappointed if the test was omitted. It told the committee that the 'number of members... has no relationship whatsoever to the ability of the fund to perform'. It argued that any test other than the financial interests test for members runs the risk of 'clouding or distorting' this key focus.<sup>10</sup> Moreover, it added that that net returns are not necessarily correlated with questions of size.<sup>11</sup>

4.14 The Financial Services Council argued that while it is 'comfortable with the idea that the trustee should consider scale...a scale test should not be in law'. It added:

Not only is it a barrier to entry but the test, as suggested in the current drafting, is very subjective, very open. We are not sure how one would be required to perform the scale test. I am not sure what sort of data you would

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8 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, *Explanatory Memorandum*, p. 14, paragraphs 1.30 and 1.31.

9 Ms Pauline Vamos, Chief Executive Officer, Association of Superannuation Funds of Australia, *Proof Committee Hansard*, 2 March 2012, p. 32.

10 Mr David Haynes, Project Director, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 2 March 2012, pp 51–52.

11 Mr David Haynes, Project Director, Australian Institute of Superannuation Trustees, *Proof Committee Hansard*, 2 March 2012, p. 52.

be asked to use. Presumably, it is a comparative test. So I am not sure how you test scale.<sup>12</sup>

4.15 The Corporate Super Association had similar reservations about how the scale test would work in practice. Mrs Elizabeth Goddard, the Association's Research Officer, suggested that:

It is very difficult to know how a trustee will form a view and it is very difficult to determine whether APRA will agree with their view. So there is subjectivity in the requirement on the trustee and we submit that there will be a degree of opinion from APRA as to whether the trustee's judgment is appropriate. So we think the scale test is going to be a difficult one.<sup>13</sup>

4.16 Dr David Knox, Senior Partner at Mercer, told the committee:

[T]he scale tests are problematic and may not end up with the best outcomes. They are very prescriptive and they do not necessarily deliver what may be in the members' best interests.<sup>14</sup>

...

Whilst I can understand where Jeremy Cooper was coming from in wanting larger funds...I think with the current direction of scale the scale test is not needed if trustees have that responsibility to act in the member's best interest...The problem with the prescriptive scale test as it is at the moment is that it cannot possibly consider every situation.<sup>15</sup>

4.17 Dr Knox also indicated the difficulty of comparing MySuper products' offerings in terms of meeting the requirements under proposed paragraph 29VN(b). He told the committee:

[W]e are now going to be comparing MySuper products. Some MySuper products will be offering better member education, intra-fund advice, a large range of services, whereas other MySuper products may not choose to do those. Our issue here is that we need to compare like with like.<sup>16</sup>

4.18 Dr Knox did note that APRA has been working on the investment risk metric which, while 'not perfect', is at least a measure that seeks to establish the risk or volatility within a particular investment.<sup>17</sup>

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12 Mr Andrew Bragg, Senior Policy Manager, Financial Services Council, *Proof Committee Hansard*, 2 March 2012, p. 5.

13 Mrs Elizabeth Goddard, Research Officer, Corporate Super Association, *Proof Committee Hansard*, 2 March 2012, p. 30.

14 Dr David Knox, Senior Partner, Mercer, *Proof Committee Hansard*, 2 March 2012, p. 38.

15 Dr David Knox, Senior Partner, Mercer, *Proof Committee Hansard*, 2 March 2012, p. 42.

16 Dr David Knox, Senior Partner, Mercer, *Proof Committee Hansard*, 2 March 2012, p. 40. See Mercer, *Submission 13*, p. 23.

17 Dr David Knox, Senior Partner, Mercer, *Proof Committee Hansard*, 2 March 2012, p. 41.

4.19 The Industry Super Network's (ISN) commented that 'there are undoubtedly benefits which flow from scale'. It told the committee:

We published research previously...on analysis of APRA fund level data and it shows among industry funds there is in fact a strong relationship between the size of the fund—that is, member assets—and net returns; however, for retail funds, that is not the case. In retail funds, the larger the fund is, in fact, it could be argued that the returns actually fall. That is an unusual circumstance. There may well be scale benefits for those particular funds but it appears as if it is not making its way through to members.<sup>18</sup>

...

There is not an automatic correlation to the scale with providing a financial interest to members. But there is a sufficient link between scale and returns to members for that to be appropriately considered. It is a proper duty that a fund consider whether it has sufficient scale to operate in the financial interests of its members. How it does that is going to be a problematic exercise because, no doubt, a smaller fund may be of sufficient scale to perform well.<sup>19</sup>

### ***The AIST's recommendation on the scale test***

4.20 The AIST drew the committee's attention to its 13 January 2012 submission to the Treasury on the exposure draft of the Trustee Obligations Bill. This submission, also attached to its submission to this inquiry, made four key recommendations relating to the scale test in proposed section 29VN of the Bill.

- The first is that the legislation should require the annual determination of scale as an integrated exercise forming part of a super funds risk management process. In other words, proposed paragraphs 29VN(b) and 29VN(c) of the bill should be merged.
- Second, the legislation should clarify the conduct that would be in contravention of scale requirements.
- Third, the financial interests comparison of MySuper products should be 'totally or overwhelmingly' based on net returns to members together with a standardised risk measure. The AIST argued that while the range of member services offered by superannuation funds (such as access to financial advice, insurance and online services) are important ancillary services, they do not directly improve net returns, and should not form part of a member's financial interests.<sup>20</sup>

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18 Mr Matthew Linden, Chief Policy Advisor, Industry Super Fund Network, *Proof Committee Hansard*, 2 March 2012, p. 14.

19 Mr Richard Watts, External Relations Manager and Legal Counsel, Industry Super Network, *Proof Committee Hansard*, 2 March 2012, p. 15.

20 Australian Institute of Superannuation Trustees, *Submission 9*, supplementary, p. 6.

- Fourthly, a breach of proposed sections 29VN or 29VO should not result in cause of action for loss or damage by fund members or beneficiaries.<sup>21</sup> (Proposed subsection 29VP(3) of the Trustee Obligations Bill states that a person who suffers loss or damage as a result of the conduct of another person in contravention of section 29VN 'may recover loss or damage by action against that other person or against any person involved in the contravention.)

4.21 In terms of the last point, Mercer seems to share the AIST's apprehension. Dr Knox told the committee that trustees' obligations are to act in the best interests of all members. However, in acting in the best interests of all members, an individual member may be disadvantaged. Mercer expressed concern that because of the way in which proposed subsection 29VP(3) of the Bill is currently worded, the disadvantaged member could take action against the trustee.<sup>22</sup>

### ***Treasury's view on the scale test***

4.22 In evidence to the committee, Treasury defended the scale test in the Bill. It noted that the purpose of the test was to indicate that where there are some small funds that are not performing well, scale may be one of the reasons why they are not. A Treasury officer told the committee:

I was a little surprised that some people felt the provisions were prescriptive. In fact, the intent here is that the provisions are quite principle based, in a sense. What is being required here is simply for trustees to ask themselves the question: is the scale of my fund disadvantaging my ability to promote the best interests of my members? That is simply the requirement—to ask that question and answer that question. You could imagine that, for a very large number of funds that clearly have sufficient scale, it would be pretty easy for them to answer that scale is not a factor for them. There would be another large number of funds that are performing quite well and it is quite clear that scale is not a problem. There is no element of this test that is concluding that bigger is necessarily better. It clearly gives room for small, well-performing funds to conclude that being small is not impacting on their ability to deliver good outcomes for their members.<sup>23</sup>

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21 Australian Institute of Superannuation Trustees, *Submission 9*, supplementary, p. 3.

22 Dr David Knox, Senior Partner, Mercer, *Proof Committee Hansard*, 2 March 2012, p. 38.

23 Mr Jonathon Rollings, Principal Advisor, Superannuation, Financial System Division, Treasury, *Proof Committee Hansard*, 2 March 2012, p. 65.

## Committee view

4.23 The committee believes that witnesses' concern with the scale test in proposed paragraph 29VN(b) of the Trustee Obligations Bill is misplaced. The test is not intended to be absolute: importantly, paragraph 29VN(a) provides trustees with an obligation to promote the financial interests of beneficiaries of the fund. As Treasury has explained, the reference in proposed paragraph 29VN(b) to the number of members and size of assets of the fund is simply to indicate that one of the reasons that a small fund may not be performing is that it may not have sufficient scale. It is not, as some have argued, to claim that all small funds underperform because of their size or even to suggest there is strong correlation between these factors.

4.24 The committee notes the concerns of Mercer and the AIST relating to possible actions against a trustee where it is alleged that proposed sections 29VN or 29VO have been breached. However, it does draw attention to the defences in proposed subsections 55(5) and 55(6) of the Bill. These subsections state that it is a defence if the defendant establishes that they have complied with the covenants in sections 52 to 53 and prescribed under section 54A, and the obligations referred to in section 29VN and 29VO that are relevant to the circumstances.