

Shifting Geer

Welcome to Shifting Geer, Herbert Geer's superannuation and funds management newsletter.

1. APRA AND ASIC UPDATES

1.1 Custodian operations in the superannuation industry

In its recent *APRA Insight* newsletter (Issue 1, 2011) (**Newsletter**) the Australian Prudential Regulation Authority (**APRA**) detailed its findings in respect of its examination of the Australian custodian industry as follows:

(a) Market and investment risk:

In a number of cases, trustees rely on custodian information and practices around valuation sources, tax calculation approach and unit pricing methodology without sufficient enquiry or assertion of the trustee's expectations in this area.

Further, trustees often place reliance on the fact that valuations for unlisted assets are 'sourced' from the custodian and thus assume the valuations to be both robust and independent. However, APRA found that custodians operate predominantly on client instructions and the extent of custodian input in the area of valuation was less than that expected by trustees.

Hence there is an expectations gap, which could mean that trustees are not performing sufficient checks to ensure that the data being incorporated into net asset value (**NAV**) calculations are robust and correct.

APRA also observed that the trend by custodians towards off-shoring or outsourcing parts of the unit pricing process and some aspects of price checks and price adjustments may not have been adequately considered by trustees in their assessment and monitoring of custody services.

Where trustees outsource the unit pricing function, they need to better understand the unit pricing activities that their custodians actually undertake. APRA observed that outsourced unit pricing services are less customised than it expected and trustees need to ensure that the services they get are an appropriate fit for their fund.

APRA states that it is insufficient to simply state that the NAV is obtained from the custodian and hence it is 'independent'. Trustees also need to assess the source and adequacy of valuation data used by the custodian.

Similarly, trustees should have an understanding of the controls in place at the custodian to check the reasonableness of the pricing (valuation) data received.

APRA stated that trustees should increase their understanding of the following:

- (i) custodian redemption practices and cut-off times;
- (ii) tax estimates. This should include instances where a material change to estimates may occur and how this is dealt with;
- (iii) the custodian's approach to historical price changes and the extent to which these are being reported on by the custodian;
- (iv) securities lending ; and
- (v) the use of foreign exchange products.

Trustees should also ensure that their custodians provide adequate reporting.

(b) Information technology:

APRA observed that:

- (i) IT risk management is emerging in its development and yet to be well articulated in custodians' risk registers;
- (ii) Use of data analysis to identify risk areas and improve operational efficiency is an area in which APRA considers that more work can be done by custodians;
- (iii) security controls were adequate with the expected level of access rights by users in line with the rest of the financial industry; and
- (iv) disaster recovery testing by custodians was found to be geared to whole-of-site outage scenarios. Therefore, the maximum allowable outage times for business, usually around four hours, may be unachievable in some component-based failures given the complexity of the environments.

(c) Operational risk and risk management:

Operational risk is inherently high and APRA noted different degrees of operational risk depending on the complexity of products and services and the level of automation for settlement of asset transactions and associated corporate actions. Corporate actions contribute the biggest operational risk and are the most difficult of the custodian processes to automate. It is recognised that extending automation is essential to reducing operational risk.

Overall, there are appropriate risk management frameworks and structures in place within custodians that require further maturity. Custodians tend to have a more static, compliance-focused content to their risk tools. This is perhaps not unexpected in highly operationally focused businesses such as that of custodians. Basic controls such as segregation of duties, dual controls and reconciliations are strongly manifest across the custodian industry. Although elementary, these controls are fundamental to the transactional nature of custody operations and remain the focus of the internal control frameworks APRA saw.

All custodians reviewed had a quality assurance unit in place as a principal oversight of these basic functions that were predominantly compliance-focused peer review functions. However, APRA did see some custodians becoming more active in developing quality metrics and feeding performance and process improvements back to the business. APRA encourages continued improvement in these areas to develop a more proactive, risk-focused element to risk management within custodians.

APRA considers custodians could do more to improve their own internal monitoring of performance measures.

(d) Audit and assurance

The introduction of external audit *Guidance Statement GS007 Audit Implications of the Use of Service Organisations for Investment Management Services (GS007)* has provided a greater level of transparency over custodian operations.

While the GS007 regime provides detailed reporting to trustees, APRA has identified some issues that it could look at more closely including:

- (i) there needs to be critical review by trustees to ensure GS007 reports are capturing all risk areas relevant to the trustee and so are providing the level of assurance needed in respect of operations. Custodians are encouraged to undertake testing and reporting above and beyond the minimum of GS007;
- (ii) trustees need to be mindful of the exclusion or 'carve-out' of certain functions from GS007 reporting or other limitations on the work being performed. This may include functions that are outsourced by the custodian, either to a third party or to a

global parent operation. APRA has concerns about the practice of some custodians in preparing more than one GS007 report over their business; this can be potentially misleading about the control framework of the custodian by not presenting trustees with a full picture of its overall operations;

- (iii) Any due diligence or monitoring arrangements the trustee performs should consider the risks arising from an excluded function and how such risks will be managed by the trustee. The same expectations apply to functions that may be performed elsewhere in a custodian's global organisation and not covered by the local operation's GS007. Trustees should ensure they are receiving sufficient assurance around all sub-custody functions;
 - (iv) trustees need to actively consider if they should be requesting custodians to broaden the scope of the GS007 reports being produced. As a corollary to this, custodians need to be open to additional audit work being sought by trustee clients. APRA received anecdotal evidence that, while custodian agreements provide for trustee auditor access to custodians, this is in practice resisted by custodians despite the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (**SIS Regulations**) outsourcing standard requirements; and
 - (v) APRA considers audit firms should adopt a more formal mechanism to provide comments to management, such as the equivalent of a management letter. An area for further attention in future developments of GS007 may be to enhance the way in which assurance is provided to trustees about data quality and data integrity. Generally, APRA found that internal audits were not as frequent and influential as is seen elsewhere within APRA regulated entities and groups.
- (e) Regulatory framework

APRA's expectations of both the outsourcing requirements under the SIS Regulation 4.16 and the requirements outlined in *APRA Cross Industry Circular No.1 Custodian requirements for APRA regulated entities* are generally being met. APRA has identified some aspects of the Cross Industry Circular that warrant revisiting in light of some identified inconsistencies with SIS, in particular in regard to liens. APRA has commenced review of these matters and expects to deal with them later in 2011 in conjunction with other policy reforms for superannuation.

APRA also noted some contractual developments in regard to specific assets, which have amounted to those assets falling outside a "custodially held" arrangement. This development has implications for those RSE licensees that use custodians to meet their capital requirements under section 29DA of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS**). APRA believes it is clear that the current requirement for such trustees is to ensure that all assets are 'custodially held' (as defined in their RSE licence) by a single, independent custodian unless otherwise exempted.

1.2 **Liquidity provider arrangements in superannuation**

In its Newsletter, APRA detailed its expectations in respect of liquidity provider arrangements in superannuation.

Liquidity providers

Many trustees utilise a particular investment option in a fund as a "liquidity provider" or "banker" to the rest of the fund in which the fund can trade cash for assets in order to rebalance strategic asset allocations. The liquidity provider then trades with the external market to rebalance its asset allocation.

APRA has observed that trustees have not always fully identified the risks arising from this arrangement or established sufficient controls to fully address or mitigate those risks. Specifically, trustees need to ensure that the liquidity provider is managed according to the needs of the members who have chosen to invest in it, and hence that it maintains an appropriate asset allocation.

Trustees should also be mindful that after the implementation of the Stronger Super proposals, they will need to evaluate whether use of a MySuper option as a liquidity provider will be viable or even permitted under the relevant legislation.

Operation of a liquidity provider

Each superannuation fund investment option needs to hold assets in line with its investment strategy (and asset allocation). Hence, there is a need to purchase or sell assets based on member contributions, benefit payments or switches to maintain the strategy, as well as to rebalance in response to market movements.

In many instances, the trades in different investment options can be offset, making it more cost effective to execute trades internally between the options and then make a single trade with the market for the net change in the holding. However, if a fund has many investment options, this process can be administratively difficult and there is the question of which option should be making the final net trade.

To perform internal trades between the various investment options in a more systematic way, a fund may designate a particular investment option to execute the necessary internal trades and the final external trade. This designated option becomes the liquidity provider or banker.

Risks with the liquidity provider arrangement

APRA identifies the following risks involved in liquidity provider arrangements:

- (a) an increase in operational risk for a superannuation fund;
- (b) increased risks to member equity and to the ability of the liquidity provider to achieve its own investment objectives;
- (c) the asset allocation of one investment option will also be influenced by the trades initiated by the trustee for other investment options;
- (d) there is a danger that the trustee's investment framework could become focussed on the option's function as a liquidity provider, for example by deliberately setting wide ranges so that the liquidity provider is less likely to be in "breach" of that framework;
- (e) if trustees introduced an arrangement where illiquid assets were transferred at "book value" to the liquidity provider, which then incurred a loss when selling those assets into the external market, this would be an unacceptable impost on the members of the liquidity provider;
- (f) the risk of asset allocation mismatch increases as the size of the liquidity provider contracts relative to the whole fund (or the size of the other investment options grow faster than the liquidity provider). The capacity to absorb market volatility diminishes as the relative size decreases, resulting in a larger impact on members; and
- (g) the absence of a proper cost allocation system could also result in the liquidity provider inappropriately bearing all transaction costs.
- (h) Critical factors trustee should consider in determining the ability of an investment option to function as the liquidity provider for the fund

APRA states that trustees should consider:

- (a) the liquidity provider's relative size, as scale of both the liquidity provider, the relative size of other investment options and the size of asset transactions will impact on how the liquidity provider absorbs volatility in asset movements;
- (b) the liquidity provider's maturity profile, especially when considering the likelihood of positive or negative cash flows;
- (c) variances in investment strategy between options, as the greater the difference in investment strategies, the greater the potential for the liquidity provider to move away from its own investment strategy and, accordingly, the greater care that trustees must take in adopting a liquidity provider strategy;

- (d) nature of the liquidity provider's underlying assets, as trustees should ensure that the underlying assets of the liquidity provider are sufficiently liquid to allow for frequent buying and selling - both internal and external with the market - without significantly affecting the liquidity provider's overall liquidity and performance; and
- (e) (if using a defined benefit subfund as the liquidity provider), the ongoing viability of the arrangement. In particular, trustees should determine the point, usually measured as the minimum proportion of total fund assets, at which the defined benefit subfund is no longer able to function as the liquidity provider.

APRA's expectations

At a minimum, APRA would expect to see trustees clearly ensuring the following when a liquidity provider arrangement is employed:

- (a) the liquidity provider's role is clearly documented and defined and the policy on its use is approved by the trustee. The parameters for selecting and maintaining an investment option as a liquidity provider should also be documented;
- (b) trustees should only adopt such a policy where the investment/fund structure is appropriate to allow the arrangement to operate in practice;
- (c) there is ongoing assessment of the suitability of the investment option to fulfil this role taking into account its size (in dollar terms) relative to other investment options;
- (d) materiality/tolerance levels are set against the impact on the liquidity provider option and its members; and
- (e) the investment strategy adopted and the strategic asset allocation are appropriate for the needs of the liquidity provider's members. Where there is a significant difference between the investment strategy of the liquidity provider and the other investment options, trustees needs to set appropriate controls to ensure that there is no negative impact on members of the liquidity provider; and there is on-going monitoring of the liquidity position of all investment options.

1.3 APRA Prudential standards for superannuation

On 28 September 2011, APRA released its discussion paper outlining its twelve proposed prudential standards (**Standards**) for superannuation in response to the Cooper Review's recommendation to provide APRA with standard-making powers under the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS**).

APRA expects that draft Standards will be released for consultation in early 2012 with final Standards expected to be released later in 2012.

Proposed Prudential Standard SPS 114 Operational Risk Financial Requirement

APRA proposes to address a range of issues relating to the calculation, use and maintenance of financial resources for operational risk including:

- (a) Minimum features of the operational risk financial requirement

At this time, APRA does not propose to set a minimum target level of operational risk financial resources but expects that trustee would typically have a target level of at least 0.25 per cent of funds under management. Further, trustees would be required to report the level of operational risk reserves or capital held.

However, APRA proposes to hold the discretion to set a minimum target level for operational risk financial resources in respect of trustee who are unable to satisfy APRA that an appropriate target level has been set.

APRA proposes to prohibit use of operational risk financial resources to address a failure to meet legislative requirements (eg failure to meet the SIS covenants) or other administration deficiencies that were not identified by the trustee as an operational risk.

Where operational risk financial resources are used, the trustee must have in place a plan for communicating with APRA.

- (b) Operational risk financial requirement can be met with fund reserves or trustee capital

APRA proposes that the operational risk financial requirement must be met by a specific fund reserve, trustee capital or a combination of both.

Trustee capital, built up by charging a member fee or from shareholder equity provided by a parent entity, or by way of a reduction in member returns, is appropriate to partially or wholly meet the operational risk financial requirement.

- (c) Strategy for meeting the operational risk financial requirement

Trustees would be required to maintain a strategy for managing and maintaining operational risk financial resources that covers the following matters:

- (i) identification of all relevant operational risks and the resulting residual risks, as identified in the risk management framework;
- (ii) the approach adopted to determine the size of a target amount, tailored to the circumstances of each RSE, to provide a buffer for operational losses arising from the identified residual risks of that RSE;
- (iii) an assessment of any additional amount required at the trustee level to take account of wider group needs arising from an operational risk event in one or more RSEs under its trusteeship;
- (iv) the approach adopted for maintaining operational risk financial resources at the trustee's target amount, including processes to monitor on an ongoing basis the amount of operational risk reserves or capital available relative to the RSE licensee-determined target amount;
- (v) quarantining specific operational risk reserves from general reserves and, where relevant, quarantining specific operational risk trustee capital from general trustee capital;
- (vi) if fund reserves are used, an investment strategy for the reserve that provides for adequate protection of the reserve, keeping in mind that the assets designated to meet the operational risk financial requirement must be available for use at short notice;
- (vii) policies and procedures for calling on the resources set aside to meet the operational risk financial requirement, including a clear articulation of how they will determine when operational risk financial resources can be called upon; and
- (viii) policies and plans for replenishing expanded operational risk financial resources including the identification of trigger levels that would result in action being taken to replenish resources, including an alert to the Board and communication with APRA.

- (d) Managing operational risk

When assessing exposure to operational risk, trustees would need to consider those risks that involve third parties, and those risks that are within the trustee's operations. For risks within its operations, the trustee would be expected to determine whether to insure against those risks and also consider the likelihood of full and prompt payment on any insurance claim. For risks that involve third parties, APRA would expect a trustee to perform appropriate due diligence on the third-party provider, including an assessment of the third party's risk management framework and capital and other financial resources. A trustee would also need to consider the extent of the third party's insurance coverage and whether or not that coverage provides partial mitigation against operational losses.

- (e) Transition arrangements

APRA proposes that, where reserves already held by the trustee do not already meet the operational risk financial requirement, the trustee be required to develop and implement a plan to build up the resources to the required level. Trustees would need to determine any component of those reserves specifically set aside for operational risk purposes and which would likely be eligible for meeting the operational risk financial requirement.

APRA's view is that a reasonable transition period is one that appropriately considers member equity issues such as the potentially high costs to members that would result from operational losses that may occur if operational risk financial resources are built up over a very long time period. APRA considers that a three-year transition period would be reasonable for most trustees.

Proposed Prudential Standard SPS 160 Defined Benefit Funding and Solvency

(a) Funding to vested benefit level

APRA proposes to require that the trustees take all necessary steps to ensure that the financial position of a defined benefit fund or sub-fund is such that the liabilities under the trust deed can be met as they fall due. This would include a funding plan agreed between the trustee and the employer, and suitable actuarial investigation and certification to monitor the funding level. The Standard would also set requirements in respect of restoration to a satisfactory financial position if funding falls below the vested benefit level, including requirements on agreeing restoration plans with the employer.

(b) Treatment of sub-funds

APRA proposes to apply funding requirements equally to both defined benefit funds and sub-funds, with actuaries and auditors having the same obligations regarding sub-funds as those currently in place for defined benefit funds. APRA also proposes to extend requirements for actuarial investigations to defined benefit sub-funds, including required content and timing of investigations, with relevant differences in respect of sub-funds paying pensions.

(c) Self-insurance

APRA considers it appropriate that RSE licensees of defined benefit funds be required to demonstrate the adequacy of their self-insurance arrangements in order to provide an appropriate level of protection to beneficiaries. Therefore, APRA proposes the requirement of actuarial certification of the adequacy of the self-insurance arrangements of a defined benefit fund or sub-fund.

(d) Technical insolvency and wind-up priorities

APRA proposes to require RSE licensees of technically insolvent defined benefit funds or sub-funds to actively monitor progress towards restoring solvency.

Proposed Prudential Standard SPS 220 Risk Management

(a) Risk management framework

APRA proposes that RSE licensees must develop a risk management framework that includes, but is not limited to, the following elements:

- (i) a risk management strategy (and risk management plan as required);
- (ii) Board-approved risk management policies, controls and procedures in respect of all material risks likely to be faced by the trustee and its fund(s);
- (iii) a Board-approved business plan;
- (iv) clearly defined responsibilities and reporting requirements for managing risk; and
- (v) a process for regular review to ensure that the risk management framework remains effective.

(b) Requirement to articulate risk appetite

APRA proposes to include the requirement to articulate risk appetite at both the level of the RSE licensee's operations as a whole (including all RSEs) and for individual risks. This would involve the RSE licensee:

- (i) articulating the risks that the entity is comfortable being exposed to and those that it seeks to avoid;
- (ii) estimating the possible maximum impact on beneficiaries in the event that a particular risk is realised; and
- (iii) demonstrating, where risk mitigation measures are inadequate to reduce a residual risk to below the tolerances expressed in the risk appetite, that the RSE licensee will either pursue further risk mitigation measures or remove itself from exposure to this risk.

(c) Risk management framework alignment with business strategy and plan

APRA proposes that RSE licensees must include, as part of their business planning cycle, their identification and consideration of risks. These risks are to be explicitly addressed and managed within the risk management framework.

(d) Risk management and corporate/ ownership structure

APRA proposes to include a specific requirement for all RSE licensees to ensure that they specifically consider, identify and address any risks and their management and control that might impact on their duty to members.

(e) Dedicated risk management function

APRA proposes to require that trustees maintain a specific function with direct responsibility for the management and oversight of risk management.

Trustees would need to demonstrate that they have appropriately dedicated resources to monitor current and emerging risks within the business, to develop control measures, and to assist the Board in maintaining an effective risk management framework.

Trustees that are part of a larger corporate group or who engage external service providers for risk management purposes may use a risk management function provided by such parties, provided that the trustee can demonstrate that this risk management function provides it with the necessary oversight of the risks to which it is exposed.

(f) Risk management attestations

It is proposed that the Board be required to provide a risk management declaration annually to APRA stating that:

- (i) the RSE licensee has systems in place for the purpose of ensuring compliance with the relevant legal and regulatory requirements imposed by APRA;
- (ii) the Board is satisfied with the efficacy of the processes and systems surrounding the production of financial information;
- (iii) the RSE licensee has in place a risk management framework; and
- (iv) the systems for managing and monitoring risks, and the risk management framework, are appropriate to the size, business mix and complexity of the entity.

Proposed Prudential Standard SPS 231 Outsourcing

(a) Outsourcing policy

APRA proposes that trustees must have a written outsourcing policy that focuses primarily on the trustee's material business activities.

APRA proposes that this Board-approved policy would include a detailed framework for managing all outsourcing of material business activities, possibly as a sub-set of the RSE licensee's risk management framework.

- (b) Minimum requirements for outsourcing agreements

APRA expects that the requirements currently contained in SIS Regulation 4.16(4) will be removed so they can be reflected in, and replaced by, the new Standard.

- (c) Due diligence and ongoing monitoring obligations

SIS Regulation 4.16 is silent as to the processes an RSE licensee must follow when entering into, and managing, outsourcing arrangements with a service provider.

The Standard would be designed to facilitate the RSE licensee having a greater understanding of the risks of the function itself and any further risks from outsourcing the function.

Proposed Prudential Standard SPS 232 Business Continuity Management

- (a) Oversight of business continuity management

APRA considers it appropriate to state explicitly the minimum requirements that a trustee must meet around business continuity management.

- (b) Business Continuity Plan (**BCP**)

APRA proposes that trustees develop and implement a BCP that:

- (i) is developed on a whole-of-business basis designed to maintain service levels;
- (ii) includes a Disaster Recovery Plan that seeks to keep core information technology and telecommunications functions operating, or able to be recovered in a reasonable time frame if they cease operations;
- (iii) identifies critical business functions and a range of adverse impact scenarios, and their impact on the critical business functions; and
- (iv) contains appropriate recovery arrangements that form part of the RSE licensee's BCP testing processes.

Trustees would also be responsible for making an assessment of the adequacy of the material service providers' BCP testing processes and the adequacy of the recovery arrangements in place.

Proposed Prudential Standard SPS 250 Insurance in Superannuation

- (a) Requirement to develop and maintain an insurance strategy

APRA is proposing to require trustees to develop, implement and maintain an insurance strategy that is appropriate to the fund's membership.

APRA proposes that the insurance strategy of an RSE licensee include, at a minimum, consideration of the types and default levels of insurance to be offered, and the process for selecting and monitoring an insurer.

APRA proposes to require that trustees identify particular roles with responsibility for maintaining the strategy, implementing and monitoring reporting requirements for insurance, and performing a periodic review of the insurance strategy.

In developing and maintaining an insurance strategy, trustees would be required to demonstrate that any insurance products offered are in members' best interests. This would include an assessment of the insurer that is to provide the insurance cover, the insurance policy's benefits and conditions and the cost effectiveness of the insurance coverage, among other relevant factors.

(b) Limitations on self-insurance

APRA proposes to include the requirement that trustees:

- (i) attest annually that the self-insurance continues to be in beneficiaries' best interests;
- (ii) obtain a regular independent assessment of the adequacy of resources to meet current and future self-insurance liabilities; and
- (iii) develop arrangements for an orderly transfer of insurance assets and obligations in the event that the self-insurance is deemed to be no longer in the best interests of beneficiaries as a whole.

Where an RSE licensee has determined that it is no longer in the best interests of beneficiaries to continue to self-insure, APRA proposes that they be required to develop a plan for the orderly transition to new insurance arrangements and for the equitable distribution or use of any residual self-insurance assets.

Proposed Prudential Standard SPS 310 Audit and Related Matters

(a) Internal audit function

APRA proposes to require RSE licensees to have an internal audit function that is appropriate to the nature, scale and complexity of the RSE licensee's operations. An RSE licensee may determine that it is appropriate to outsource the internal audit function, subject to APRA's approval.

APRA proposes, at a minimum, that the scope of the internal audit function be to certify all policies, processes and controls as complying with APRA's prudential requirements.

(b) Heightened minimum auditor requirements

APRA intends to include cross-references in the Standard to aid RSE licensee compliance with the auditor fit and proper and independence obligations in other proposed Standards.

Proposed Prudential Standard SPS 410 Transition to MySuper

This standard is expected to include, at a minimum, requirements:

- (a) to identify default members and their existing default balances;
- (b) to develop and execute a transition plan in respect of the transfer of existing default balances into a specified MySuper product;
- (c) to explain how the transfer will be in the best interests of members;
- (d) to develop and execute a communication plan to members and employers about the MySuper transition plan; and
- (e) reporting requirements to assist the transition to MySuper, likely to cover data items related to the member contributions and balances.

Proposed Prudential Standard SPS 510 Governance

(a) Independence of directors

APRA proposes to introduce an objective, principles-based concept of "independence" with broader application than the existing SIS definition of 'independent director'. APRA also proposes that a director may be considered independent even when they are or were a member of the RSE, as long as they meet the other criteria for independence.

(b) Independence of the Chair

APRA does not consider that the Chief Executive Officer or a former CEO (within three years of ceasing employment) would be sufficiently independent to act as Chair.

(c) Tenure and renewal policies

APRA proposes to require that an RSE licensee must put in place a Board renewal policy that would define an appropriate maximum term for its directors. Where an RSE licensee considers it appropriate for an individual director to serve a term longer than the maximum stated in its policy, the board needs to be able to demonstrate to APRA why this longer term is appropriate.

The board renewal policy would be reviewable by APRA. APRA also proposes that the minimum features of such a policy include:

- (i) a clear statement of how the trustee intends to ensure that the board remains open to new ideas and independent thinking while retaining adequate expertise;
- (ii) consideration of whether the period of service of a director could reasonably be perceived to materially interfere with their ability to act in the best interests of members; and
- (iii) the process for appointing and removing directors.

(d) Board assessment processes

APRA proposes to include a requirement that an RSE licensee maintain formal procedures for completing a regular independent and objective assessment of the board's (including any committees) and individual directors' performances at least annually.

(e) Use of Board Committees

APRA proposes that RSE licensees must have a Board Audit Committee (**BAC**), comprising only non-executive directors. The BAC would be responsible for:

- (i) monitoring compliance with the board's policies and prudential and statutory requirements;
- (ii) ensuring appropriate systems and controls are in place to identify and address the risks arising from the RSE licensee's activities;
- (iii) instilling a strong risk management culture throughout the RSE licensee; and
- (iv) overseeing financial reporting, internal and external audits and recommending external auditor appointments.

It would be open to the RSE licensee to nominate the entire board to act as the BAC, subject to discussion with APRA. Further, APRA proposes to require that the Chair of the BAC be a person other than the Chair of the board, unless the Chair was the sole independent director.

Where a board has one or more independent directors, APRA's expectation is that the BAC would include at least one of these independent directors and that at least one member with financial, auditing or accounting qualifications, skills and relevant experience.

The RSE licensee would be free to determine whether the minimum functions of the BAC might be performed in part by a Board Risk Committee, subject to the Standard's requirements.

(f) Remuneration

APRA proposes to require all RSE licensees to establish and maintain a Board Remuneration Committee. The members of the Board Remuneration Committee must be non-executive directors of the RSE licensee. Further, the Chair of the Board Remuneration Committee would be required to be a person other than the Chair of the Board unless the Chair was the sole independent director.

Each board would need to have in place a remuneration policy. This would include alignment of remuneration arrangements with the ongoing capacity of each RSE under the RSE licensee's trusteeship to meet the reasonable expectations of its beneficiaries as well as the RSE licensee's risk management framework. The remuneration policy would also cover non-executive directors.

APRA also proposes that the RSE licensee's remuneration policy is to be published in the public section of each fund's web site and that RSE licensees publicise the remuneration of responsible officers.

Proposed Prudential Standard SPS 520 Fit and Proper

APRA proposes to determine a new prudential standard largely consistent with the current SIS Regulations fitness and propriety standard.

(a) 'Responsible person'

APRA proposes to include a concept of "responsible person" that is wider than the SIS definition of "responsible officer". A responsible person would be defined to include a director, individual trustee or "senior manager" of an RSE licensee (a person who exercises the senior management responsibilities set out in the prudential standard), auditor or an actuary appointed by the RSE licensee. In some cases a consultant, contractor or employee of a subsidiary or otherwise related company may be a responsible person.

APRA would also have the right to determine that a person is a responsible person in relation to an RSE licensee or one or more RSEs.

(b) Fit and proper policy

APRA proposes that, the Standard would include a requirement for an RSE licensee to document a fit and proper policy with the following minimum requirements:

- (i) coverage of all persons acting in "responsible person" positions;
- (ii) processes to be undertaken in assessing whether a person is fit and proper for a responsible person position;
- (iii) specification of the actions to be taken where a person is assessed as not fit and proper after their initial appointment; and
- (iv) adequate provisions relating to whistleblowing.

An RSE licensee would be required not only to undertake an annual assessment of the fitness and propriety of all responsible persons, but also undertake a separate assessment as to whether the Board has the collective skill set required to effectively govern funds under new trusteeship. The Standard would also include a requirement to report to APRA about both fit and proper and board skill assessments.

(c) Criteria to determine whether a person is fit and proper

APRA proposes to include a list of criteria in addition to that under SIS Regulation 4.14 and would also apply to auditors and actuaries.

Proposed Prudential Standard SPS 521 Conflicts of Interest

(a) Conflicts management framework

APRA proposes that an RSE licensee develop and maintain a conflicts management framework, catering for any ASIC requirements (as relevant), which comprises a comprehensive system of internal controls and reporting requiring the RSE Licensee to:

- (i) ensure that all directors clearly understand the circumstances that might give rise to a conflict, the content and purpose of the conflict management policy as well as their obligations as a director of the RSE licensee;

- (ii) undertake regular and thorough enquiry to identify any conflicts arising from existing or prospective service providers to the RSE;
 - (iii) undertake regular and thorough enquiry to identify any conflicts of duty or interest for existing or prospective service providers where these have the potential to affect the service provider's performance in respect of the RSE;
 - (iv) adopt procedures to require the disclosure of interests of responsible persons on an ongoing basis;
 - (v) maintain up-to-date registers of relevant gifts, interests and benefits, and other fiduciary and non-fiduciary roles of the RSE licensee and each director; and
 - (vi) maintain a record of how actual conflicts are managed at a minimum, in the minutes of Board meetings.
- (b) Minimum requirements for a conflict management policy
- APRA proposes that the conflict management policy must contain appropriate measures to satisfy the core obligations to identify and manage conflicts and would cover, at a minimum:
- (i) effective processes to ensure the ongoing monitoring, assessment, and action in respect of all potential and actual material conflicts;
 - (ii) how the RSE licensee identifies and responds to conflicts; and
 - (iii) adequate disclosure of actual conflicts to members.
- (c) Registers of duties and interests
- APRA proposes that RSE licensees should be maintain two registers: one that outlines all duties of the RSE licensee and duties of each individual director, and the other that lists all material interests (as determined by the RSE licensee) of individual directors and senior management (where interests include matters such as gifts, emoluments and benefits).
- These registers would be subject to APRA review upon request.
- (d) Tied service provider arrangements
- RSE licensees may only use a related service provider when a wide range of potential providers has been considered and it is determined that the related service provider offers a service that best reflects the interests of members.

Proposed Prudential Standard SPS 530 Investment Governance

- (a) Articulating clear investment objectives
- APRA proposes that an RSE licensee must set clear objectives that align each investment option with its investment philosophy.
- RSE licensees would be required to articulate realistic investment objectives in a specific and measurable way, including the articulation of an expected return objective or objectives, a risk objective or objectives, and a relevant benchmark or benchmarks against which realised returns and risks may be assessed.
- RSE licensees would also be required to maintain and monitor objectives on an ongoing basis.
- (b) Formulating investment strategies
- APRA proposes that each RSE licensee must articulate the processes and criteria used to select investments to implement each investment option. RSE licensees offering choice products would be expected to be satisfied that each option is appropriate for selection by members, including where a member may choose to invest solely into a single, undiversified option.

In order to meet due diligence obligations, RSE licensees would require the ability to understand and explain to members the fundamental risks posed by any investment option. Furthermore, RSE licensees must be able to understand and explain whether these options are aligned with their investment philosophy and objectives, the nature and appropriateness of fees and charges, the liquidity of the underlying portfolio and how valuations are struck.

APRA proposes that a MySuper RSE licensee setting a single, diversified strategy would be required to give particular consideration to including an appropriate mix of assets from a range of asset classes in this option.

(c) Investment management processes for implementing investment strategies

RSE licensees will be required to document the processes and criteria used for ongoing monitoring of investments in each investment strategy. This would include obligations relating to monitoring and correcting deviations from asset allocation targets within a reasonable time, monitoring the performance of investment managers and ongoing consideration of the liquidity and cash flow needs of the investment strategy. It would also include ongoing monitoring and maintenance of diversification.

(d) Features of investment management

APRA proposes the following additional sub-covenants to section 52(2)(f) of SIS:

(i) Investment fees and costs (including performance fees)

RSE licensees will be required to consider how investment costs will impact on fund returns to members over time. Performance fees are one component of this consideration. Their relationship to manager behaviour and appropriate levels of investment risk, in the context of the RSE licensee's overall investment philosophy, is an important component of investment costs.

Requirements relating to performance fees are expected to apply only to MySuper RSE licensees. The Standard would support the SIS provision relating to performance fees. It is not APRA's intent to ban or limit investments involving performance fees but to ensure that RSE licensees clearly understand these fees and can demonstrate that they are in the members' best interests.

(ii) Liquidity management

RSE licensees would be required to consider the liquidity risks of the assets and the alignment of these risks to the cash flow needs of each investment option.

(iii) Timely and independent valuation information

APRA proposes that RSE licensees must consider the frequency of trading of assets, the independence and integrity of the provider of the valuation in determining valuation of assets, and the suitability of any valuation model when faced with extreme volatility in relevant markets. An RSE licensee would also be required to ensure that the valuation obtained can be substantiated.

Submissions may be made to APRA by no later than 23 December 2011.

1.4 ***APRA Letter to trustees: Important Changes to Administration of Early Release of Superannuation Benefits on Specified Compassionate Grounds***

On 4 October 2011, APRA wrote to superannuation fund trustees stating that from 1 November 2011 the early release of superannuation on specified compassionate grounds will become a program branded under the Commonwealth Department of Human Services (**DHS**) and accordingly:

- (a) there are no changes to the conditions of early release of superannuation benefits under SIS Regulation 6.19A;

- (b) applications for early release of superannuation benefits currently in progress will not be affected by the transfer and will continue to be assessed in the same manner; but
- (c) from 1 November 2011, letters, forms and information brochures relating to the early release of superannuation on specified compassionate grounds will be issued by DHS on DHS letterhead.

2. ATO UPDATES

2.1 ***ATO Interpretative Decision ATO ID 2011/77. Superannuation. Payment of death benefit to former stepchild: meaning of 'child' and 'dependant'***

On 21 October 2011, the Australian Taxation Office (**ATO**) released its decision that a person who was a "stepchild" of a self-managed superannuation fund (**SMSF**) member no longer would be considered a "dependant" under SIS Regulation 6.22 if the legal marriage of the person's natural parent to the member had previously ended.

In its reasoning, the ATO referred to the long-held common law notion that a child ceases to be stepchild of a step-parent when the relationship between the child's natural parent and the step-parent ends, that is, on the death of the natural parent or the divorce of the natural parent from the step-parent.

The Superannuation Complaints Tribunal has followed the common law position when dealing with complaints relating to the payment of death benefits and consistent with this approach, it is the Commissioner of Taxation's (**Commissioner**) view that the relationship of stepchild to step-parent is severed on the death of the natural parent or on the divorce of the natural parent from the step-parent.

Furthermore, having regard to the construction of the definition of "child" in section 10(1) of SIS, the Commissioner considers that the term "stepchild" in paragraph (a) is only used in relation to individuals who are legally married. This is because paragraph (b) of the definition, which refers to "a child of the person's spouse", would apply to a child of a natural parent in a defacto relationship.

2.2 ***ATO Interpretative Decision ATO ID 2011/80. Superannuation. Unclaimed money: no contact between fund and member***

On 21 October 2011, the ATO released its decision that, for the purposes of section 12(1)(d) of the *Superannuation (Unclaimed Money and Lost Members) Act 1999* (Cth), where no contact has ever been made between the superannuation provider (fund) and the member, and five years have passed since the member joined the fund, such a situation satisfy the requirement that a period of five years has passed since the fund last had contact with the member.

Section 12(1)(d) states that an amount payable to a member is taken to be unclaimed money if 'after the end of a period of 5 years since the superannuation provider last had contact with the member, the provider has been unable to contact the member again after making reasonable efforts'.

In general terms, the focus of unclaimed money is not on the contact between a fund and a member. On the contrary, it is the absence of such contact that is the purpose for section 12(1). For this reason, a purposive approach is taken in interpreting this provision, with the conclusion that a five year period without contact - regardless of whether any previous contact had occurred - will meet the first requirement within section 12(1)(d).

2.3 ***ATO Interpretative Decision ATO ID 2011/81. Superannuation. Self managed superannuation funds: meaning of 'give a charge' under regulation 13.14 of the Superannuation Industry (Supervision) Regulations 1994***

On 21 October 2011, the ATO released its decision that a SMSF trustee does not "give a charge" for the purposes of SIS Regulation 13.14 if the trustee purchases an asset subject to a charge that was established before the trustee purchased the asset.

In its reasoning, the ATO referred to circumstances where the trustee acquires real property from an unrelated party. At the time of purchase, the trustee is aware that the property is subject to a charge in favour of another unrelated party. The property remains subject to the charge after it is acquired by the trustee.

The ATO referred to *International Art Holdings Pty Ltd (admin apptd) v Adams* [2011] NSWSC 164, in which the New South Wales Supreme Court held that SIS Regulation 13.14 does not prevent a court from imposing an equitable lien or statutory lien over artwork owned by an SMSF to secure an administrator's expenses in determining competing claims. The Court distinguished the imposition of a charge or lien by the trustee of a fund, from a situation where a court imposes an equitable lien or a statutory lien arises as a matter of law. The Court stated there was no basis on which it might be said that the trustee had allowed the creation of a charge over the assets of the fund.

The ordinary meaning of the word "give" indicates that the phrase "give a charge" in SIS Regulation 13.14 requires a trustee, by some positive action, to create a charge and not merely recognise (including act on or give effect to) a previously established charge.

2.4 ***ATO Interpretative Decision ATO ID 2011/81. Income Tax Superannuation: death benefits dependant - former spouse - same sex relationship***

On 21 October 2011, the ATO released its decision that a taxpayer who, prior to the 2009 Financial Year, lived with a now deceased superannuation fund member on a genuine domestic basis in a relationship as a same sex couple, is a "former spouse" of the deceased in terms of section 302-195(1)(a) of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) for the purposes of determining the taxation treatment of a superannuation death benefit received by the taxpayer because of the death of the member during the 2011 Financial Year.

3. **LEGISLATION**

3.1 ***Superannuation Industry (Supervision) Amendment Regulations 2011 (No. 3)***

On 8 August 2011, the *Superannuation Industry (Supervision) Amendment Regulations 2011 (No 3)* (Cth) were registered. The amendments allow superannuation fund trustees to recognise forfeiture orders made under Commonwealth, State or Territory proceeds of crime legislation in respect of member benefit protection and payment/cashing requirements.

3.2 ***Corporations Amendment (Future of Financial Advice) Bill 2011***

On 13 October 2011, the *Corporations Amendment (Future of Financial Advice) Bill 2011 (FOFA Bill)* was introduced in the House of Representatives. The FOFA Bill forms the first tranche of the Federal Government's Future of Financial Advice Reforms (**FOFA**). The FOFA Bill introduces a new Part 7.7A '*Best interests obligations and fees*' into the *Corporations Act 2001* (Cth) (**Corporations Act**) which applies to all providers of financial advice to retail clients.

A breach of the proposed provisions will expose financial services licensees and their authorised representatives (**AR**) to civil penalties of up to \$200,000 for individuals and \$1 million for corporate entities, as well as banning orders for individual providers.

Best interests obligations

Subject to exemptions in respect of basic banking products (including some First Home Savings Account products), the provider must act in the client's best interests and in doing so must:

- (a) identify the client's objectives, financial situation and needs via the client's instructions;
- (b) identify the subject matter of the advice that the client has requested;
- (c) where it is reasonably apparent that the client's instructions are incomplete or inaccurate, make reasonable inquiries to obtain complete and accurate information;
- (d) advise the client in writing that it should seek additional advice, as appropriate;
- (e) assess whether it has the expertise required to give the client advice on the subject matter requested and, if not, decline to give advice;

- (f) assess whether the client's objectives could be achieved through means other than the acquisition of financial products;
- (g) either:
 - (i) conduct a reasonable investigation into the financial products that might achieve the client's objectives of which the provider is aware and assess the information gathered in the investigation; or
 - (ii) if another individual has made such an investigation and the provider has access to the results of the investigation - assess the information gathered in the investigation;
- (h) if the provider proposes to advise the client to acquire a financial product in substitution for, or in addition to, another financial product:
 - (i) weigh up the advantages and disadvantages in acquiring the product; and
 - (ii) advise the client to acquire the product only if it is reasonable to conclude that the client's objectives could be better achieved if the client acquired the product; and
- (i) base all judgements in advising the client on the client's objectives; and
- (j) with respect to approved product lists, providers:
 - (i) must advise the client in writing if it cannot recommend an approved product that might achieve the client's objectives; and
 - (ii) must not advise the client to acquire an approved product; however
 - (iii) the provider is not required to investigate products that are not on the list.

Resulting advice must be appropriate

The provider must only provide the advice to the client if it would be reasonable to conclude that the advice is appropriate to the client, had the provider satisfied the duty to act in the client's best interests.

Where resulting advice still based on incomplete or inaccurate information

If it is reasonably apparent that information relating to the objectives, financial situation and needs of the client on which the advice is based is incomplete or inaccurate, the provider must warn the client that:

- (a) the advice is, or may be, based on incomplete or inaccurate information relating to the client's relevant personal circumstances; and
- (b) because of that, the client should, before acting on the advice, consider the appropriateness of the advice, having regard to the client's objectives, financial situation and needs.

Provider to give priority to the client's interests

- (c) The provider must not act in a manner that conflicts with the client's interest when providing advice.

Responsibilities of licensee and authorised representative under this Division

If the client suffers loss or damage because of a contravention of a provision of this Division, the client may recover the amount of the loss or damage against one or more of the following persons:

- (a) if the person who contravenes the provision is a financial services licensee - that licensee;
- (b) if the person who contravenes the provision is a representative of a financial services licensee, or two or more financial services licensees - the, or a, responsible licensee in relation to the contravention.

The court may, additionally, make an order declaring void a contract entered into by the client for or relating to a financial product or service and any other order as necessary because of that order.

Responsibilities of authorised representatives

An AR may avoid liability where:

- (a) the licensee had provided the AR with information or instructions about the requirements to be complied with in relation to the giving of personal advice; and
- (b) the AR's failure to comply with the provisions occurred because the representative was acting in reliance on that information or those instructions; and
- (c) the representative's reliance on that information or those instructions was reasonable.

Charging ongoing fees to clients

An "ongoing fee arrangement" is an arrangement under which:

- (d) a retail client agrees to pay a fee (however described or structured); and
- (e) the fee cannot reasonably be characterised as relating to advice that, at the time the arrangement is entered into, has already been given.

The rules as to ongoing fee arrangements apply where:

- (a) a financial services licensee, or an AR (the "fee recipient") enters into an ongoing fee arrangement with another person; and
- (b) the arrangement has not been terminated for any reason; or where
- (c) the rights of a financial services licensee, or an AR, under an ongoing fee arrangement are assigned to another person; and
- (d) the arrangement has not been terminated for any reason.

However, these rules only apply where:

- (a) the client has not been provided with financial product advice as a retail client by the financial services licensee or the AR before the day that the rules commence; and
- (b) the client enters into the ongoing fee arrangement on or after such date.

It is a condition of the ongoing fee arrangement that the client may terminate the arrangement at any time and no termination fees are payable except insofar as they relate to the extinguishment of pre-existing liabilities and the direct costs of termination.

Client not liable to pay fee in cases of non-compliance

Clients will not be liable to pay the ongoing fee, and will not be taken to have waived their rights or entered into a new ongoing fee arrangements if the fee recipient has failed to comply with its disclosure and renewal notice obligations and in cases of non-compliance, the fee recipient must refund the client any ongoing fee if the client requests this.

Disclosure statement and renewal notice requirements

Fee recipients must provide clients with:

- (a) a fee disclosure statement, which includes the following information:
 - (i) the amount of the fee:
 - (A) paid by the client in the 12 months immediately preceding the Disclosure Day (see below); and
 - (B) that the fee recipient anticipates the client will pay in the 12 months beginning on the Disclosure Day;
 - (ii) details of the services that the client:

- (A) was entitled to receive under the arrangements during the 12 months immediately preceding the disclosure day;
 - (B) received during the 12 months immediately preceding the disclosure day;
 - (C) is entitled to receive during the 12 months beginning on the disclosure day; and
 - (D) will likely receive during the 12 months beginning on the disclosure day; and
- (b) A renewal notice, which includes a statement that:
- (i) the client may renew the ongoing fee arrangement by giving the current fee recipient notice in writing of the election; and
 - (ii) the ongoing fee arrangement will terminate, and no further advice will be provided or fee charged under it, if the client does not elect to renew the arrangement; and
 - (iii) the client will be taken to have elected not to renew the arrangement if the client does not give the current fee recipient notice in writing of an election to renew before the end of the renewal period; and
 - (iv) the “renewal period” is a period of 30 days beginning on the day on which the renewal notice and fee disclosure statement is given to the client.
- (c) Disclosure statements and fee renewal notices must be provided in accordance with the following timelines:
- (i) the fee recipient must provide a disclosure statement at least 30 days before the anniversary of either the date:
 - (A) the arrangement was entered into where no fee disclosure statement has previously been given; or
 - (B) a disclosure statement in relation to the arrangement was last given (**Disclosure Day**);
- (d) the fee recipient must provide a renewal notice (and a Disclosure Statement) at least 30 days before the second anniversary of either the date:
- (i) if the arrangement has not previously been renewed, on which the arrangement was entered into; and
 - (ii) if the arrangement has previously been renewed, last day on which the arrangement was renewed (**Renewal Notice Day**);
- (e) If the client:
- (i) notifies the fee recipient in writing within the renewal period that the client does not wish to renew the arrangement; or
 - (ii) does not notify the fee recipient in writing within the renewal period that the client wishes to renew the arrangement,
- the arrangement terminates at the end of a further period of 30 days after the end of the renewal period.
- (f) If an ongoing fee arrangement terminates, the fee recipient must not continue to charge the ongoing fee and on termination of the ongoing fee arrangement, the obligation to continue to provide the service under that arrangement also terminates.

3.3 Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011

On 28 September 2011 Treasury released the exposure draft *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* (**Exposure Draft**) as part of its FOFA. This Exposure Draft proposes to set up a framework with the following features:

- (a) a ban on conflicted remuneration (including product commissions), where licensees or their representatives provide financial product advice to retail clients;
- (b) a ban on volume-based shelf-space fees from asset managers or product issuers to platform operators; and
- (c) a ban on asset-based fees on geared funds.

A breach of the proposed provisions will expose financial services licensees and their AR to civil penalties of up to \$200,000 for individuals and \$1 million for corporate entities as well as disqualification orders.

Conflicted remuneration

“Conflicted remuneration” is defined as any monetary or non-monetary benefit given to those who provide financial product advice to retail clients that, because of the nature of the benefit or the circumstances in which the benefit is given:

- (a) might influence the choice of financial product recommended to retail clients; or
- (b) might otherwise influence the financial product advice given to retail clients.

Specifically, conflicted remuneration refers to “Volume Based Benefits” which are dependant on:

- (a) the total value or number of particular kinds of financial products recommended by the licensee or representative to retail clients, or a class of retail clients; or
- (b) the total value of particular kinds of investments made by retail clients, or a class of retail clients, to whom the licensee or representative provides financial product advice.

(collectively, **Volume Based Benefits**).

Specific exclusions from the definition of conflicted remuneration

The FOFA Exposure Draft excludes certain benefits from the definition of “conflicted remuneration”:

- (a) monetary or new monetary benefits provided by a general insurer in relation to a general insurance product;
- (b) monetary benefits provided by a life insurer in relation to a life risk insurance product, other than:
 - (i) a group life policy for members of a superannuation entity; or
 - (ii) a life policy for a member of a default superannuation fund;
- (c) monetary or non-monetary benefits provided in respect of persons who are not retail clients;
- (d) the benefit is given to the licensee or representative by a retail client;
- (e) the monetary or non-monetary benefit is a prescribed benefit or is given in prescribed circumstances;
- (f) non-monetary benefit with a value less than an amount prescribed (\$300) and is provided infrequently;
- (g) non-monetary benefits that have:
 - (i) a genuine education, training purpose or provide IT or software support;
 - (ii) the benefit is relevant to the provision of financial product advice to persons as retail clients; and
 - (iii) the benefit complies with regulations made for this purpose.

Further, benefits provided by an employer to an employee:

- (a) as remuneration (so long as is not referable to a Volume Based Benefit); or
- (b) in respect of the sale of basic banking products (of which the employer is a bank) provided that no other financial product advice unrelated to the basic banking product is not provided,

are excluded from the definition of conflicted remuneration.

Ban on the acceptance of conflicted remuneration

Financial services licensees and their representatives (other than ARs) must not accept conflicted remuneration. Where an entity is a representative of more than one licensee, the licensees may find themselves jointly and severally liable for a breach of the ban by the representative where the licensees are responsible for the representative's conduct.

A financial services licensee must take reasonable steps to ensure that representatives of the licensee do not accept conflicted remuneration.

An AR must not accept conflicted remuneration and can only defend itself against claims of breach of the ban where it has received the benefit and was provided with information, from the licensee, that the benefit was not a conflicted remuneration benefit, and it was reasonable to rely on that information.

Employers must not pay employees conflicted remuneration.

Exemptions to the ban on the provisional conflicted remuneration

Product issuers must not give monetary or non-monetary benefits to financial services licensees or representatives except for in the following circumstances:

- (a) the benefit is a fee for service and the fee reasonably represents the market value of the service;
- (b) the benefit is the purchase price for property and the benefit reasonably represents the market value of the property;
- (c) the benefit is given by a general insurer in relation to a general insurance product;
- (d) the benefit is given to the licensee or representative by a life insurer and is given in relation to a life risk insurance product, other than:
 - (i) a group life policy for members of a superannuation entity; or
 - (ii) a life policy for a member of a default superannuation fund;
- (e) benefits that satisfy each of the following:
 - (i) the benefit has a genuine education, training purpose or provides IT or software support;
 - (ii) the benefit is relevant to the provision of financial product advice to persons as retail clients; and
 - (iii) the benefit complies with regulations made for this purpose;
- (f) the benefit is a prescribed benefit or is given in prescribed circumstances.

Volume-based shelf-space fees

These rules apply in respect of a benefit given by a funds manager to a platform operator and the platform operator offers:

- (a) a facility through which financial services licensees and their representatives can obtain information about financial products; or

- (b) a facility through which financial products are issued; and
- (c) either:
 - (i) that facility includes information about financial products in which the funds manager deals (the funds manager's financial products); or
 - (ii) financial products in which the funds manager deals (also the funds manager's financial products) are issued through that facility.
- (d) A benefit is a volume-based shelf-space fee if:
 - (i) access to the benefit, or the value of benefit, is dependent on the total number or value of the funds manager's financial products of a particular kind, or particular kinds, about which information is included on the facility or which are issued through the facility; and
 - (ii) the benefit is not a discount on an amount payable, or a rebate of an amount paid, by the platform operator to the funds manager for services provided by the funds manager to the platform operator.
- (e) The benefit is also a volume-based shelf-space fee if:
 - (i) the benefit is a discount on an amount payable, or a rebate of an amount paid, by the platform operator to the funds manager for services provided by the funds manager to the platform operator; and
 - (ii) the value of the benefit exceeds the reasonable value of scale efficiencies obtained by the funds manager because of the number or value of financial products in relation to which the funds manager provides those services.

Neither party can accept a volume-based shelf-space fee.

Ban on asset based fees on geared funds

Neither financial services licensees nor their ARs can charge asset based fees on geared funds used or to be used to acquire financial products by or on behalf of the client to which the advice relates unless it is not reasonably apparent (subject to the licensee or AR making reasonable enquiries) that the funds used or to be used to acquire financial products by or on behalf of the client are geared funds.

An *asset based fee* is a fee that is dependent upon the amount of funds used or to be used to acquire financial products by or on behalf of the client.

Borrowed funds are *geared funds*. However, borrowed funds are not geared funds to the extent that the borrowed funds have been repaid.

3.4 Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2011

On 29 September 2011, the Federal Government released its MySuper core aspects draft legislation (**Bill**) that sets out:

- (a) the APRA authorisation of trustees to offer MySuper products;
- (b) the offering of separate MySuper products in the one superannuation fund;
- (c) characteristics of a MySuper product; and
- (d) MySuper fee rules.

Date of effect

The provisions amending SIS are to commence by 1 January 2013. From 1 October 2013 employers must make contributions for employees that do not have a chosen fund to a fund that offers a MySuper product.

APRA authorisation of trustees to offer MySuper products

(e) Application:

Trustees must apply to APRA for authorisation to offer a MySuper product by:

- (i) providing information in the approved form;
- (ii) the fund's trust deed and governing rules and any amended trust deeds or governing rules, if amendments are made during the application period; and
- (iii) any other information that APRA may require.

The Bill makes no mention of any fee requirement.

Subject to any extensions, APRA must decide the application within 60 days of receiving all relevant information and formally notify the trustee of its decision, and set out its reasons if it refuses an application.

If, before 1 July 2013, APRA authorises a trustee to offer a MySuper product, that authority takes effect on 1 July 2013.

(f) Cancelling authority

APRA may formally cancel an authority, and it must subsequently inform the trustee of its reasons for cancelling the authorisation as soon as is practicable.

APRA must also contact ASIC where APRA is of the opinion that the cancellation might reasonably be expected to affect the trustee's ability to provide one or more of the financial services under its Australian Financial Services Licence.

The offering of separate MySuper products in the one superannuation fund

In the event of a successor fund transfer, a trustee may seek authorisation to provide two separate MySuper products where APRA is satisfied that:

- (a) some or all of the persons whose benefits are to be transferred hold a class of interest in the original fund that is similar to the proposed MySuper product; and
- (b) there is material goodwill in that class of interest in the original fund; and
- (c) that goodwill could not be maintained unless the trustee were authorised to offer the proposed MySuper product as an additional MySuper product in the fund; and
- (d) it would be in the best interests of fund members, and those persons whose benefits are to be transferred to the fund, to maintain the distinction between the proposed MySuper product and other classes of beneficial interest in the fund that the trustee is authorised to offer as a MySuper product.

Further, trustees may seek authority (subject to a 120 day application period) to provide tailored MySuper products in respect of members of large employer-sponsors (who contribute to the fund for the benefit of at least 500 members of the employer-sponsor or its associates).

Characteristics of a MySuper product

A MySuper product must have the following characteristics:

- (a) a single diversified investment strategy;
- (b) all members under the MySuper product are entitled to access the same options, benefits and facilities;
- (c) amounts are credited to the accounts of all MySuper members in a way that does not exclude some of those members, except to the extent permitted under a lifecycle exception;
- (d) the same process is to be adopted in crediting and debiting a fund's MySuper accounts, except to the extent that a different process is necessary to allow for fee subsidisation by employers;

- (e) if an employer fee subsidisation is permitted, that subsidisation does not favour one employee-member over another;
- (f) no limitations (other than those imposed by law) are imposed on the source or kind of contributions made by or on behalf of MySuper members;
- (g) a beneficial interest of that class cannot be replaced with a beneficial interest of another class in the fund unless:
 - (i) the replacement is with an interest in another MySuper product within the fund; or
 - (ii) the person who holds the interest consents to that replacement;
- (h) a beneficial interest of that class (the old interest) cannot be replaced with a beneficial interest (the new interest) in another superannuation entity unless:
 - (i) the new interest is a MySuper product and the replacement with the new interest is legally permitted;
 - (ii) the replacement is otherwise legally permitted or required; or
 - (iii) the person who holds the old interest consents to the replacement with the new interest; and
- (i) a pension is not payable out of the MySuper product.

A *lifecycle exception* is a rule under the governing rules of the fund that allows income from different classes of asset of the fund to be streamed to the accounts of different subclasses of members of the fund who hold a MySuper product on the basis, and only on the basis, of the age of those members.

MySuper fee rules

The following fees may be charged in respect of MySuper products:

- (a) an administration fee (a fee that relates directly to the administration of the fund);
- (b) an investment fee that includes:
 - (i) management and performance fees ; and
 - (ii) costs incurred by the trustee, (that are not otherwise charged as an administration fee, a buy-sell spread, a switching fee, an exit fee or an activity fee);
- (c) a buy-sell spread (on a costs recovery basis);
- (d) a switching fee (on a costs recovery basis):
 - (i) from a MySuper product in the fund to another MySuper product or choice product in the fund;
 - (ii) from a choice product in the fund to another choice product or MySuper product in the fund; or
- (e) an exit fee (on a costs recovery basis); and
- (f) an activity fee (on a costs recovery basis) that:
 - (i) are directly related to an activity of the trustee:
 - (A) that is engaged in at the request, or with the consent, of a member; or
 - (B) that relates to a member and is required by law; and
 - (ii) are not otherwise charged as an administration fee, an investment fee, a buy-sell spread, a switching fee or an exit fee).

A trustee can only charge a fee if it satisfies one of the following charging rules:

- (a) all MySuper members charged same flat fee percentage of account balance or some combination of flat fee and percentage of account balance;
- (b) all MySuper members to whom a specific activity relates charged the same flat fee percentage of account balance or some condition of flat fee and percentage of account balance.

A Single employer exemption can apply in respect of an administration fee charged in accordance with the administration fee exemption for employees of an employer-sponsor as follows:

- (a) the fee is charged in relation to all members of the fund who hold the MySuper product;
- (b) an employer-sponsor contributes to the fund for the benefit of one or more members (the employee members) who hold the MySuper product and who are employees of the employer-sponsor or an associate, or the relatives or dependants of those employees;
- (c) the trustee has entered into an arrangement with the employer-sponsor that secures lower administration fees for the employee members; and
- (d) the fee is in accordance with one of the following requirements:
 - (i) the amount of the administration fee must be the same for each of the employee members.
 - (ii) each employee is charged the same percentage of their respective MySuper account balances;
 - (iii) each employee is charged a combination of the same flat fee (fixed administration fee) and same percentage of their respective MySuper account balance.

3.5 ***Superannuation Legislation Amendment (Early Release of Superannuation) Act 2011 (Cth)***

On 14 October 2011, the *Superannuation Legislation Amendment (Early Release of Superannuation) Act 2011 (Cth)* received Royal Assent. The Act facilitates the transfer of administration of the early release of superannuation on compassionate grounds from APRA to the Chief Executive of Medicare.

4. **OTHER RECENT DEVELOPMENTS**

4.1 ***ASFA and FSC Standard Risk Measure Guidance Paper for Trustees***

On 1 August 2011, the Association of Superannuation Funds of Australia and the Financial Services Council (**Authors**) jointly issued principles-based guidance (**Guidance**), in response to APRA's request to develop industry guidance for the disclosure of investment risk, based on a consistent methodology (**Standard Risk Measure**).

The Standard Risk Measure is to be applied in superannuation fund product disclosure statements issued on or after 22 June 2012 in order to disclose the likelihood of each of a superannuation fund's investment options yielding negative returns over a 20 year period (**NR:20YP**).

Labelling of risk measures and categories

The Standard Risk Measure provides a seven level classification system as follows:

- (a) Very Low: less than 0.5 NR:20YP
- (b) Low: 0.5 to less than 1 NR:20YP
- (c) Low to Medium: 1 to less than 2 NR:20YP
- (d) Medium: 2 to less than 3 NR:20YP
- (e) Medium to High: 3 to less than 4 NR:20YP
- (f) High: 4 to less than 6 NR:20YP

- (g) Very High: 6 or greater NR:20YP

Trustee considerations for best practice risk disclosure

The Authors remind trustees that compliance with the Guidance does not of itself fulfil a trustee's disclosure obligations. Trustees are still expected to consider all aspects of investment risk as part of their Risk Management Plan, which may include (but is not limited to) consideration of factors such as:

- (a) the size of any potential negative return;
- (b) the chance a return may be positive but less than expected (either in an absolute or a relative sense), or is insufficient to meet member expectations/needs;
- (c) the investment risks associated with each investment strategy, including market risk, hedging risks, liquidity risk, inflation risk, credit risk, valuation risk, counterparty risk and settlement risk;
- (d) whether members are treated equitably within the investment option (eg are the unit prices fair and equitable); and
- (e) other risks as identified by the trustee in formulating and giving effect to an investment strategy, such as regulatory risks, conflicts of interest and operational risks.

The Authors also state that trustees may choose to communicate their expectations as to any of the above risks in accordance with the Standard Risk Measure.

Methodology

The Guidance provides the following guiding principles:

- (a) the methodology should support the Standard Risk Measure's purpose, which is to provide members with a descriptor to assist in comparing investment options (both within and across superannuation funds);
- (b) underlying assumptions should be structured to reflect a conservative bias (ie in favour of overstating risk) and be subject to review by APRA as a normal part of its normal supervision activities;
- (c) the Standard Risk Measure is non-proprietary. No single service provider or proprietary methodology is recommended above any other in relation to constructing the Standard Risk Measure; and
- (d) trustees should be permitted to deviate from the methodology outlined in the Guidance (ie following an alternative approach to developing a risk measure) provided they document and can explain the reasons for their deviation (referred to as the "if not, why not" reporting framework).

The Authors state that a well-reasoned "if not, why not" explanation is considered a valid response to questioning from APRA. An effective "if not, why not" reporting practice involves:

- (a) identifying the trustee's calculation methodology;
- (b) explaining why the trustee has not followed the relevant approach; and
- (c) explaining how the trustee's practices accord with the Guidance's "spirit", and that the trustee understands the relevant issues and has considered the impact of its alternative approach.

The Guidance provides the following methodology:

- (a) a forward looking methodology:
 - (i) trustees would need to develop a set of capital market assumptions (return, volatility, correlation) for the asset classes which make up the investments of each investment option;

- (ii) trustees may use internal expertise or an external consultant/ adviser to develop these assumptions;
- (iii) trustees should be aware that return, volatility and correlation measures may not fully capture the characteristics of some investments for a variety of reasons, such as less frequent valuations, non-linear pay-off structures and active management. Trustees should use a conservative approach in establishing assumptions for these investments, particularly in relation to their potential to avoid short term negative returns; and
- (iv) having developed a set of asset class assumptions the trustee should then:
 - (A) calculate the forward looking return distribution of the overall investment option;
 - (B) draw from that distribution the probability of a negative return over one year;
 - (C) multiply the probability by 20 to achieve the NR:20YP.
- (b) the Standard Risk Measure should be calculated gross of administration fees but net of investment management fees. For the sake of clarity, where a fund charges an all inclusive fee with no specific administration fee then this will result in a need to write back the notional component of the fee that relates to administration for the purpose of the modelling.

Calculating the Standard Risk Measure net of administration fees would likely result in unintended differentiation of identical investment options.

Further, the Standard Risk Measure is not a tool to disclose and compare fees. The relationship between fees and risk should be disclosed by trustees with wording to the effect that, all other things being equal, higher fees will increase the probability of a negative return;
- (c) the Standard Risk Measure should be gross of tax (ignoring the impact of franking credits) due to:
 - (i) the potential confusion created by having the same underlying investment option sitting in different risk classifications for superannuation and pension options;
 - (ii) differing assumptions about various tax issues (eg the future realisation of capital gains and franking levels) impacting relative risk classifications between funds;
 - (iii) a belief that this particular assumption would not materially impact the relative risk classification of options as it would relate mainly to the size of a negative return as opposed to the incidence of a negative return; and
 - (iv) the Standard Risk Measure is likely to also be adopted for non-superannuation and pension investments;
- (d) the trustees' process and methodology should be made publicly available on their website. It is expected that APRA will review the methodology through its normal supervision activities for individual funds, and the wider benchmarking review process proposed in this guidance paper;
- (e) trustees are permitted to use alpha (active management) assumptions. However, where such assumptions are used, Trustees should be cautious about using any assumptions that materially reduce the expectation of negative returns;
- (f) asset class weights for diversified options should be based on the current strategic asset allocation parameters of the option. Where options have no specific strategic asset allocation, trustees should apply their estimate of a neutral position for each option;
- (g) trustees will need to calculate and disclose a separate Standard Risk Measure for each discrete asset allocation pool within a lifecycle and target date fund;

- (h) for the purposes of establishing assumptions, asset class granularity should be considered such that the different characteristics and drivers of sub-asset classes are reflected in the assumptions, such as government and corporate debt, or listed and unlisted assets. The use of separate assumptions for the same asset class solely on the basis of different active management approaches should only be undertaken where those active approaches are conservatively expected to substantially alter the risk and correlation expectations of the investment; and
- (i) each trustee should review the calculation of the Standard Risk Measure at least annually or earlier if and when the trustee believes there has been a material change to the underlying risk and return characteristics of the investment option. In this event Trustees will need to consider whether such a change constitutes a reportable significant event.

4.2 **AVCAL private equity governance code**

On 7 September 2011, the Australian Private Equity and Venture Capital Association (**AVCAL**) released its Governance Code for the private equity (**PE**) industry codifying many of the activities and governance mechanisms already being implemented by private equity industry participants.

The Governance Code is designed to make the activities of Australia's PE industry better understood and to help PE fund managers discharge their duties to their stakeholders and is to be read and implemented by AVCAL members in conjunction with the AVCAL Code of Conduct. Implementation of the Governance Code is to take effect from 1 July 2012.

The Governance Code is intended to provide a series of guidelines, rather than prescriptive rules. The application of the guidelines will have to be tailored to the individual circumstances and needs of General Partners, their funds and their Portfolio Companies. If a General Partner considers that any aspect of the Governance Code is inappropriate to its particular circumstances, it has the flexibility not to adopt it. However, AVCAL members who elect not to adopt any aspect of the Governance Code must be in a position to explain why – the “if not, why not” approach. Corporate governance is a dynamic concept that must necessarily evolve with changing circumstances. AVCAL's challenge is to ensure that the Governance Code remains relevant to the PE industry and AVCAL's members.

Principles of the Governance Code

- (a) Principle 1: Promote and safeguard the interests of the fund's investors, recognising the diverse nature of those interests:
 - (i) This principle recognises that a General Partner is often a fiduciary and its primary responsibility is to act in the best interests of its Limited Partners. Effective stewardship of Limited Partners' capital is the mainstay of this responsibility.
 - (ii) Limited Partners are drawn from a broad range of investor classes, including wholesale investors such as superannuation (or pension) funds, endowment funds and insurance companies. Limited Partners' interests may, during the life of a PE fund, diverge and potentially conflict with those of other Limited Partners and/or those of the General Partner.
 - (iii) Fund structures and contractual terms should align the interests of General Partners with those of the Limited Partners. In preparing fund documents and throughout the life of a PE fund, General Partners should frame their contractual obligations and put in place structures and processes which:
 - (A) are consistent with their primary responsibility to act in the best interests of their Limited Partners; and
 - (B) deal transparently and fairly with conflicts of interest.
 - (iv) General Partners should give particular attention to governance mechanisms (such as Limited Partner advisory committees), annual general meetings and to the scope and timeliness of disclosures to their Limited Partners.

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- (b) Principle 2: Embed ethical, responsible and rigorous decision-making by General Partners and Portfolio Company boards and management:
- (i) This principle draws on AVCAL's activities in encouraging greater implementation of environmental, social and governance (ESG) policies and practices in PE investment activities. It also reflects global trends, driven largely by institutional investors, in support of integration of ESG policies and practices in PE investing. AVCAL has taken on a leadership role among its peers globally, working with the United Nations-backed Principles for Responsible Investment and a working group of global PE associations to achieve consistent approaches to ESG around the world.
 - (ii) This principle must be understood in the following context:
 - (A) General Partners work towards achieving an optimal capital structure for each Portfolio Company and its shareholders and developing appropriate growth strategies, in each case for building value in Portfolio Companies.
 - (B) PE investing requires General Partners to assume and manage financial and business risks, not to avoid them. In discharging their responsibilities, General Partners often adopt a risk-return profile which might differ significantly from that of most public companies.
 - (iii) AVCAL encourages General Partners to develop responsible investment policies and practices that define their approach to managing and reporting on ESG factors within their Portfolio Companies.
 - (iv) General Partners are encouraged to disclose publicly (for example by publishing on their website) the ESG policies and practices which they have developed or adopted in the operation of their Portfolio Companies.
 - (v) AVCAL's Council encourages General Partners to consider becoming signatories to the United Nations-backed Principles for Responsible Investing.
- (c) Principle 3: Promote effective Portfolio Company board composition and structures
- (i) The directors and officers of Australian-incorporated Portfolio Companies are subject to the same statutory and common law duties that apply to directors and officers of all incorporated Australian companies.
 - (ii) Portfolio Company boards should be:
 - (A) composed of appropriately qualified, competent directors who have the resources to perform their roles. In some circumstances, this may require appointing one or more external directors with specialist industry expertise;
 - (B) sufficiently familiar with the current and emerging issues of the Portfolio Company's business to provide strategic guidance to the company and effectively supervise and review the performance of management, including oversight of risk management; and
 - (C) flexible enough to enable timely decision-making and quick responses to changing circumstances.
 - (iii) While the interests of the Portfolio Company will generally be aligned with the interests of the fund and the Limited Partners, this may not always be the case. An individual appointed to a Portfolio Company board by a General Partner will, like any director, have an obligation to act in the best interests of the Portfolio Company.
- (d) Principle 4: Respect the interests of stakeholders at both fund and Portfolio Company levels:
- (i) The primary business of General Partners is to invest in appropriate Portfolio Companies, support and, where appropriate, develop and grow the businesses of

those companies, and ultimately realise the value in those companies in a manner that provides the best returns to Limited Partners. This cannot be done consistently without respecting the interests of key stakeholders in the Portfolio Companies.

- (ii) General Partners should therefore actively seek to identify:
 - (A) key stakeholders at both the fund and the Portfolio Company levels whose relationships with the Portfolio Company are material to its long-term success (such as employees, suppliers, and customers);
 - (B) those stakeholders' legitimate interests; and
 - (C) the manner in which those interests may be affected by the business operations of the Portfolio Company and the investment decisions of the General Partner and its representatives.
- (e) Principle 5: Ensure the integrity and utility of reporting by Portfolio Companies to General Partners, Limited Partners and other stakeholder (Private Disclosure)
 - (i) Australian-incorporated Portfolio Companies are subject to the financial and administrative public reporting obligations imposed by the Corporations Act. General Partners who are AVCAL members are also required to comply with the International Private Equity and Venture Capital Valuation Guidelines (relating to the valuation of investments) and AVCAL's reporting guidelines.
 - (ii) In addition, in order to fulfil their own duties to stakeholders, Limited Partners require extensive reporting from General Partners, including reporting on risks faced by individual Portfolio Companies and aggregated risks across the fund. Typically these reporting obligations are included in the PE fund's constituent documents.
 - (iii) General Partners should embed effective reporting structures within Portfolio Companies to ensure management and boards receive the information which they require to report to General Partners, so that General Partners can in turn effectively discharge their reporting obligations to Limited Partners.
- (f) Principle 6: Be transparent in dealings with other key stakeholders in Portfolio Companies (Public Disclosure):
 - (i) The approach to this principle is aligned with similar initiatives across the world and reflects some of their language, including for example, the Walker Guidelines in the UK.
 - (ii) A General Partner should ensure that the management of a Portfolio Company communicates in a timely and effective manner with its employees, in particular at the time of a strategic initiative or a transaction involving the Portfolio Company, as soon as confidentiality constraints permit.
 - (iii) General Partners should publish and regularly update their websites to communicate the following information:
 - (A) a description of the General Partner's history and investment approach, including investment holding periods, where possible illustrated with case studies;
 - (B) information and biographies of the senior partners of the General Partner; and
 - (C) a description of Portfolio Companies in the General Partner's portfolio.
 - (iv) In the event that a Portfolio Company encounters difficulties that leave its equity investment with little or no value, the General Partner should be attentive not only to the full discharge of its fiduciary obligations to the Limited Partners but also to its responsibilities to other key stakeholders.

- (g) Principle 7: Align financial reward with financial performance;
 - (i) General Partners are charged with the stewardship of Limited Partners' capital and are obliged to act in the best interests of Limited Partners. PE funds should be established and governed in a way which is consistent with this responsibility (see Principle 1). In particular:
 - (A) fund structures and constituent documents should align the interests of General Partners with those of their Limited Partners; and
 - (B) contractual arrangements with management co-owners at Portfolio Company level should, to the maximum extent possible, align their interests with those of Limited Partners.
 - (ii) Contractual terms dealing with General Partner remuneration should be clearly drafted, readily understandable by Limited Partners and certain as to their application.
 - (iii) General Partners may wish to refer to the Institutional Limited Partners Association's Private Equity Principles for a detailed discussion on the alignment of General Partner and Limited Partner interests.

4.3 Stronger Super

On 21 September the Assistant Treasurer released final details on key design aspects of its Stronger Super reforms covering MySuper, SuperStream, SMSFs, and governance in its *Stronger Super Information Pack*.

The key designs include provisions proposed for the APRA Standards (as detailed in **paragraph 1.3** above) and in the MySuper core aspects draft legislation (as detailed in **paragraph 3.4** above) as well as the following:

MySuper

- (a) Transition to MySuper:
 - (i) in order for a superannuation fund to be named in a modern award, it will have to offer a MySuper product and will be subject to review by Fair Work Australia to ensure it offers a MySuper product; and
 - (ii) trustees offering MySuper products will need to transfer the existing balances of their default members to a MySuper product by 1 July 2017.
- (b) Pricing of MySuper Products
 - (i) the details of all separately tailored MySuper products and discounted administration fees will be required to be reported to APRA and to be separately published by trustees.
- (c) Fees:
 - (i) trustees will not be limited on the types of fees that can be charged in choice products. In any performance-based fee arrangement with a fund manager, in respect of assets of the MySuper product, trustees must include the following provisions:
 - (A) a reduced base fee that reflects the potential gains the investment manager receives from performance-based fees, taking into account any fee cap;
 - (B) measurement of performance on an after-tax (where possible) and after-costs basis;
 - (C) an appropriate benchmark and hurdle for the asset class reflecting the risks of the actual investments;
 - (D) an appropriate testing period; and

- (E) provisions for the adjustment of the performance-based fee to recoup any prior or subsequent underperformance (for example, high water marks, clawbacks, vesting arrangements and rolling testing periods); and
- (ii) if a performance-based fee arrangement does not contain each of these provisions, a trustee must be able to justify that the differing arrangement continues to be in the best financial interests of the MySuper members.
- (d) Insurance
 - (i) APRA-regulated funds must, at a minimum, allow members to opt-out of life and TPD insurance within 90 days of the member joining a fund, or on each anniversary of the member joining the fund (subject to availability). These arrangements will not apply to defined benefit funds that have insurance cover as part of the benefit design; and
 - (ii) MySuper products will be required to offer a standard, default level of life and TPD insurance. Members of MySuper products will be able to increase or decrease their insurance cover (if offered by the trustee) without having to leave the MySuper product. It will be possible for the standard insurance cover to be replaced by a default insurance strategy tailored to meet the specific requirements of the employees of a particular employer.

SuperStream

- (a) The Government will legislate the use of the new data and payment standards for superannuation transactions and reporting to Government in order to maximise the efficiencies which will provide the following benefits:
 - (i) superannuation funds will receive member information and linked payments in a standard electronic format removing substantial manual processing;
 - (ii) employers will be able to send contributions to separate funds in a standard electronic format; and
 - (iii) there will be fewer instances of lost super arising from incorrect or incomplete data being sent to funds.
- (b) The implementation of the account consolidation is as follows:
 - (i) July 2011: Funds can use TFNs as primary locator to find accounts within a fund;
 - (ii) January 2012: Funds can use TFNs to search the ATO's current service for searching for lost accounts - but only with member consent;
 - (iii) July 2012: Where a member has multiple accounts within a fund, funds would be required to consolidate these accounts, where possible. Funds will also be able to search the account information, with member consent;
 - (iv) October 2013: Funds will report all inactive, lost and active accounts to the ATO;
 - (v) January 2014: Commencement of auto-consolidation of lost and inactive accounts (two years without contributions or rollover) with a balance of less than \$1,000 and accounts in eligible rollover funds; and
 - (vi) July–December 2014: The enrolment process for new employees will be modified so that employees can actively consider account consolidation at this time. If the new employee does not exercise choice the default option would be to create a new account. Any lost and inactive accounts with a balance of up to \$10,000 will be transferred into the new account through auto-consolidation.
- (c) Enhanced new employee enrolment process:
 - (i) employees will be able to access a listing of all their superannuation accounts from ATO online to assist with exercising choice and to consolidate their other accounts.

- (d) No TFN Contributions:
 - (i) from 1 July 2013, employers will be required to forward no-TFN contributions to a fund. If the fund was unable to obtain a TFN and other identifying details within a specified time frame, it would then send the money to the ATO, as part of the unclaimed money process.
- (e) Regular information to employees on employer contributions:
 - (i) from 1 July 2012, employers will be required to report on payslips an “expected payment on or before” date in addition to the current entitlement during the pay period;
 - (ii) from 1 July 2013, subject to there being no significant payroll system costs, payslip reporting of actual contributions paid rather than just accrued contributions will commence, including the provision of information about which fund the contributions are being paid into; and
 - (iii) funds will be required to either issue six monthly statements which show contributions made or, report electronically to members on whether or not they have received any superannuation contributions for that quarter. Compulsory notification will commence from 1 July 2013.

SMSF

- (a) SMSF auditor independence:
 - (i) SMSF auditors will be required to comply with the Accounting Professional and Ethical Standards Board’s (**APESB**) *APES 110 - Code of Ethics for Professional Accountants* as a condition on their registration; and
 - (ii) related party transactions will be required to be conducted through the market where one exists. If no market exists, the transaction must be supported by a valuation from a suitably qualified independent valuer. APRA will consider whether similar restrictions should apply to APRA-regulated funds.

Governance

- (a) The Government proposes to address the following issues:
 - (i) introducing a duty for trustees and directors to give priority to fund members’ interests when that duty conflicts with other duties;
 - (ii) strengthening the requirements for individual directors in relation to managing conflicts of interest;
 - (iii) increasing the standard of care, skill and diligence required of trustees and their directors to that of a prudent person of business;
 - (iv) clarifying the duties applying to trustee directors to act honestly and to exercise independent judgment; and
 - (v) introducing a requirement for trustees to devise and implement an insurance strategy and impose a statutory duty on trustees to manage insurance with the sole aim of benefiting members.
- (b) The Super System Review also recommended directors of corporate trustees are required to include in their deliberations the impact of their decisions on the environment, the community and the fund’s reputation. APRA will consider whether this issue should be addressed through relevant guidance material.
- (c) Investment governance:
 - (i) The Government will expand the covenants to which trustees must have regard when developing an investment strategy, at either the fund or investment option

- level, to include its expected costs, expected taxation consequences, and the availability of valuation information.
- (ii) All large APRA-regulated funds should publish their proxy voting policies and procedures, and disclose their voting behaviour to members on their websites.
- (d) In addition, the Government will:
- (i) increase the time limit for members to lodge a total and permanent disability claim with the Superannuation Complaints Tribunal from two years to six years, unless they have lodged a claim with their trustee within two years of ceasing employment (in which case the time limit will be increased to four years);
 - (ii) support a voluntary code of governance developed by industry in consultation with APRA, rather than a code co-ordinated by APRA;
 - (iii) ensure that choice trustees are required to offer a range of investment options sufficient to allow members to obtain a diversified asset mix if they choose;
 - (iv) require trustees to exercise due diligence in the selection and monitoring of investment options and ensure that trustees operate in accordance with the covenants set out in subsection 52(2) of SIS (rather than just paragraph 52(2)(f)) before relying upon subsection 55(5) as a defence to liability; and
 - (v) require trustees, on request, to provide reasons for their decisions to members and eligible third parties (for example, claimants to death benefits) in relation to a formal complaint.

Proposed legislation

Legislation to implement the reforms will be introduced in tranches over the coming months subject to stakeholder consultation.

4.4 AUSTRAC Strategies for the 2012 Financial Year

In early October 2011, the Australian Transaction Reports and Analysis Centre (**AUSTRAC**) released its supervision, enforcement and intelligence strategies for the 2012 Financial Year.

AUSTRAC's Priorities for the 2012 Financial Year are as follows:

- (a) responding to anomalous compliance behaviour, especially transaction reporting and compliance reporting deficiencies;
- (b) assessing compliance with "know your customer" obligations;
- (c) implementing cost recovery for AUSTRAC's regulatory functions; and
- (d) implementing mandatory enrolment of reporting entities.

AUSTRAC states that when a reporting entity's reporting behaviour is found to be outside that expected by AUSTRAC for its industry cohort, it will engage with the reporting entity to determine the basis for this behaviour. AUSTRAC will tailor its engagement with reporting entities to reflect the type of entity and the issues identified, which may include analysis of the preceding year's activities, data and survey results and money laundering/terrorism financing (**ML/TF**) risk profiles.

AUSTRAC plans to undertake 7,000 supervision engagements with reporting entities and to develop further guidance materials and similar awareness building exercises.

Supervision Plan:

- (a) a key focus in the banks and other lenders sector continues to be reporting volumes and accuracy. For reporting entities which are less likely to incur reporting obligations, AUSTRAC will continue to test whether appropriate policies and procedures are in place to ensure that, when reporting is required, it is undertaken in a timely and accurate manner;

- (b) AUSTRAC will direct its attention to testing the effectiveness of risk-based systems and controls, especially the link between product providers and product promoters, for non-bank financial services;
- (c) AUSTRAC will continue to develop practical guidance for entities within the money services businesses sector to assist them to understand their anti-money laundering/counter-terrorism financing (**AML/CTF**) obligations;
- (d) AUSTRAC's Major Reporters team will conduct on-site assessments and reviews and shorter, more narrowly focused reviews of transaction reports. Importantly, AUSTRAC will consider the adequacy of reporting entities' ongoing assurance or "fit for purpose" activities relating to their transaction monitoring systems and AML/CTF programs generally.

Enforcement strategy and designated remittance arrangements

- (a) AUSTRAC plans to identify providers of designated remittance services whose behaviour would give AUSTRAC grounds to consider the removal of their name and registrable details from the AUSTRAC Register or, alternatively, to consider suspending or cancelling their registration on the AUSTRAC Register.
- (b) AUSTRAC and law enforcement agencies have concerns about lower levels of compliance with Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) requirements within the remittance sector and the vulnerability of reporting entities within that sector to abuse from money laundering and other criminal conduct. AUSTRAC's Enforcement team will continue to focus on investigating and taking enforcement action against reporting entities in the remittance sector which have a high ML/TF risk exposure. The Enforcement team will work with frontline Supervision and partner agencies to mitigate the ML/TF risks identified within the remittance sector using all the enforcement tools available including removing a person's name and registrable details from the AUSTRAC Register or, alternatively, suspending or cancelling a person's registration on the AUSTRAC Register.

Herbert Geer Comment

*We have acted on behalf of a number of superannuation fund trustees who have received correspondence from AUSTRAC stating that amendments, commencing as of February 2010, (**Amendments**) in respect of certain designated services listed under section 6 of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) may apply to superannuation fund trustees. The effect of the Amendments would be that superannuation funds would be required to register as a Provider of Designated Remittance Services (**PoDRS**) and therefore report transactions in addition to what they are already required to report to AUSTRAC.*

We have good reason to believe, and have written to AUSTRAC, on behalf of those trustees, that the Amendments do not apply to superannuation funds or their trustees. In the event you receive a letter from AUSTRAC confirming that you may be a PoDRS, we recommend that you seek legal advice before responding.

**These articles were produced by Herbert Geer.
They are intended to provide general information in summary form on legal issues.
The contents do not constitute legal advice and should not be relied upon as such.**

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