

Shifting Geer

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

1. APRA AND ASIC UPDATES

1.1 APRA warning on the valuation of unlisted assets

On 4 August 2010 the Australian Prudential Regulation Authority (APRA) wrote to superannuation fund trustees (Trustees) in order to remind Trustees of their obligations and to raise awareness of the risks involved in valuing unlisted assets.

In its letter, APRA has stated that trustees should ensure that:

- (a) there is a strong governance framework for valuations which includes:
 - (i) oversight by Trustees and relevant committees(s);
 - (ii) clear segregation of duties;
 - (iii) soundly developed and documented policies and procedures; and
 - (iv) robust implementation; and
- (b) the valuation process should take into account the risks posed by:
 - (i) the valuation methodology;
 - (ii) the underlying assumptions; and
 - (iii) the use of modelling; and
- (c) they understand, and where necessary query, the underlying bases for valuation, even when valuations are furnished by experts.

The letter also recommends that Trustees consider the equity issues between members when determining the suitability of an unlisted investment and its ongoing place in the portfolio of either a particular fund or an investment option within that fund.

The letter states that Trustees should consider, as part of their due diligence process:

- (a) the extent to which the layers of investments downstream can be monitored by the Trustee;
- (b) the transparency, independence and robustness of the valuation process;

- (c) the reduced transparency of holdings and the valuation bases used for offshore investments;
- (d) implications of downstream managers employing "confidentiality" as a reason for not revealing the actual underlying assets of downstream investments;
- (e) the adequacy of the trustee's resources to evaluate and manage such investments;
- (f) the adequacy of the trustee's understanding of the nature and characteristics of the downstream investments; and
- (g) the capacity of trustees to drill down to the level of constituent assets, documented triggers for such drill down to occur and evidence of such occurrence.

The letter further states that in some cases it may be necessary to rely on valuations provided by the relevant asset manager and therefore Trustees must be comfortable with the manager's valuation principles and processes, including a plan to deal with the valuation where it is considered unsuitable. Given the reliance on the monitoring and controls of the manager, Trustees should assess in their operational due diligence of managers:

- (a) the quality of the manager's risk management framework;
- (b) the adequacy of resources and infrastructure of the manager;
- (c) the standards of conduct and investment discipline applied by the manager;
- (d) the adequacy of (or controls to mitigate the lack of) segregation of duties within the manager's operations;
- (e) the relationships and/or capabilities of the manager to regularly source details of underlying assets; and
- (f) the level of disclosure provided by the manager.

Where external audit reports of downstream investments are used to provide assurance around valuations, Trustees should be mindful of the type of

report that has been issued. Trustees should pay close attention to:

- (a) the scope of the audit;
- (b) the basis of the opinion;
- (c) the exceptions within a qualified opinion report and their significance to fund members;
- (d) any other regular reviews conducted outside of the audit process;
- (e) any possible impediments to the auditor's independence and how they were addressed; and
- (f) any risk of "forum shopping" to smooth reported outcomes.

APRA also reminds Trustees that reliance on audited values does not by itself lessen their responsibilities for determining the accuracy of investment values when determining members' entitlements during the financial year. APRA expects Trustees, their valuation experts and auditors to exercise increased vigilance to protect member interests, and would be looking to see corroborating evidence during its prudential reviews.

1.2 **APRA release of superannuation Prudential Practice Guides**

In August 2010, APRA produced the following superannuation Prudential Practice Guides (SPGs):

- (a) **SPG 110 - 'Capital'** which:
 - (i) replaces SGN 150.1 'Capital requirements - net tangible assets'; and
 - (ii) incorporates information previously contained in 'Frequently Asked Questions - Capital';
- (b) **SPG 200 - 'Risk management'** which:
 - (i) replaces SGN 120.1 'Risk management';
 - (ii) incorporates information previously contained in APRA Circular II.D.7 'Derivatives'; and
 - (iii) incorporates information previously contained in 'Frequently Asked Questions - Risk Management Statements/Risk Management Plans';
- (c) **SPG 230 - 'Adequacy of resources'** which:
 - (i) replaces SGN 140.1 'Adequacy of resources'; and
 - (ii) incorporates information previously contained in 'Adequacy of Financial Resources'; and

- (d) **SPG 520 - 'Fitness and propriety'** which:
 - (i) replaces SGN 110.1 'Fit and proper'; and
 - (ii) incorporates information previously contained in 'Frequently Asked Questions - Police Checks'.

New content contained in the superannuation Prudential Practice Guides

The new SPGs differ considerably to the previous superannuation guidance notes that they replace. Among the amendments contained in the new content are amendments to APRA's guidance as to:

- (a) **SPG 110 - 'Capital'**:
 - (i) interaction with the adequacy of resources operating standard;
 - (ii) definition of net tangible assets;
 - (iii) small APRA funds;
 - (iv) satisfaction of the capital requirements by using a custodian; and
 - (v) approved guarantees;
- (b) **SPG 200 - 'Risk management'**:
 - (i) legislative requirements;
 - (ii) considerations relevant to both risk management strategies and risk management plans;
 - (iii) considerations particularly relevant to risk management plans;
 - (iv) derivatives;
 - (v) fraud;
 - (vi) audit of the risk management framework; and
 - (vii) trustee attestation;
- (c) **SPG 230 - 'Adequacy of resources'**:
 - (i) financial resources;
 - (ii) technical resources; and
 - (iii) human resources; and
- (d) **SPG 520 - 'Fitness and propriety'**:
 - (i) APRA's assessment of compliance with the standard;
 - (ii) the trustee's fit and proper policy;
 - (iii) responsible officers;
 - (iv) determining if a person is fit and proper;
 - (v) fitness;

- (vi) propriety;
- (vii) equal representation requirements and assessment of individuals under the trustee's fit and proper policy; and
- (viii) key persons.

1.3 **Hedge fund investment by superannuation funds**

In September 2010 APRA released an article outlining its expectations of how Trustees should act when they choose to invest in hedge funds. According to the article, APRA expects Trustees to:

- (a) ensure the investment is consistent with the fund's investment strategy and risk appetite;
- (b) conduct the appropriate due diligence; and
- (c) continually monitor the hedge fund investments.

Consistency with the fund's investment strategy

Trustees need to determine the purpose of their allocation to specific hedge fund strategies and how those strategies are expected to behave in various market conditions. This extends to how they are expected to interact with the broader investment portfolio of the fund as a whole. Critical to this assessment is an understanding of the strategies that the investee hedge funds are pursuing;

Appropriate due diligence

Trustees should conduct the appropriate due diligence of:

- (a) the investment's strategy, specifically how it generates returns and adds value;
- (b) the risks inherent in that strategy;
- (c) the markets covered and instruments used;
- (d) the research process;
- (e) the key investment staff's track record;
- (f) performance through market cycles;
- (g) segregation (and effectiveness) of reporting and valuation;
- (h) the key service providers' operations (for example, the administrators);
- (i) the relevant jurisdictional issues;
- (j) the use of leverage;
- (k) the liquidity issues – given the strategy pursued; and
- (l) the collateral management – where collateral is required for trading activities.

For Fund of Hedge Funds (FoHF) investments, the ability of the investment manager to evaluate and

monitor constituent hedge funds requires assessment, as does the manager's ability to construct portfolios of hedge funds by considering multi-factor exposure and even complementarity analysis. FoHFs also require that the systems and processes can combine positions from hedge funds and to take action as needed; there needs to be a clear management process when investments are not meeting expectations.

One lesson from the global financial crisis is the criticality of understanding where money is actually invested, what the underlying exposures and risks are, and how they may behave in a crisis. This applies irrespective of whether an investment is in a structured investment (such as a collateralised debt obligation) in a "traditional" investment fund, or in a direct or intermediated hedge fund; and

Continual monitoring of hedge fund investments.

Trustees have an obligation to understand how funds are being invested and despite the fact that third party administrators may provide position or exposure data, however this does not obviate the need for Trustees themselves to understand what is happening.

Further, Trustees require appropriate benchmarks that reflect the investment universe and the market risk of the opportunity set in order to measure performance.

While performance measurement will often be retrospective, effective performance measurement can often highlight areas of style drift or more insidious conduct. When performance is inconsistent to the underlying conditions and the declared strategy (even if performance is inexplicably positive), this must be viewed by Trustees as a flag for further investigation.

Additional risk information is often required, highlighting exposure to specific factors, extent of leverage or details on liquidity. While Trustees may legitimately make deliberate decisions regarding these parameters, it is important that they are constantly monitored. Trustees also need a clear process for acting on information received; while knee-jerk reactions are counter-productive, action needs to be taken when responses are not forthcoming or when performance cannot be explained adequately.

1.4 **APRA letter to trustees: managing the risk of rollovers and transfers to SMSFs**

On 28 October 2010, APRA wrote to Trustees to provide an update on its guidance for verifying the validity of transfers and rollovers to self-managed superannuation funds (SMSFs).

As of 3 November 2010 the Australian Taxation Office's (ATO) SMSF member verification system (**the Verification System**) has been operational, providing greater transparency for Trustees and their administrators when performing transfers and rollovers into SMSFs. The Verification System is accessible via

an ATO Business Portal in which Trustees are required to register for an AUSkey or ATO digital certificate to access the ATO Business Portal.

The Verification System will allow Trustees to complete an online search to confirm if an individual is a member of a nominated SMSF as part of the rollover process. However the Verification System does not override a Trustee's responsibilities in the processing of a transfer or rollover request, such as conducting adequate Proof of Identity (POI) checks.

APRA's guidance

APRA provides guidance to Trustees when processing a transfer or rollover request to an SMSF by suggesting a specific process Trustees should follow. The process is summarised as follows:

- (a) the Trustee should firstly:
 - (i) conduct a POI check to confirm it is dealing with the relevant member;
 - (ii) confirm the SMSF is a regulated SMSF on the ATO's *Superfund Lookup* website;
 - (iii) confirm SMSF membership using the Verification System;
 - (iv) check the payment systems; and
- (b) if no issues are identified, the Trustee should complete the transfer or rollover; however
- (c) if an issue has been identified, the Trustee should contact the member in order to resolve or verify the relevant issue before completing the transfer or rollover; unless
- (d) the issue is not resolved, in which the Trustee should:
 - (i) contact the ATO and the Australian Transaction reports and Analysis Centre (AUSTRAC) to report illegal early release of superannuation;
 - (ii) contact the ATO, APRA and AUSTRAC in the case of identity fraud; or
 - (iii) advise the member to contact the State Police in the event the member has been the victim of identity fraud.

APRA has also provided a template letter of advice that Trustees could consider forwarding to members where the information in the member's application does not match the data contained in the Verification System. The purpose of this advice is to advise members of how to update their relevant information.

1.5 **Updated ASIC Regulatory Guide 168: Disclosure: Product Disclosure Statements (and other disclosure obligations)**

On 6 September 2010, the Australian Securities and Investments Commission (ASIC) released its updated *Regulatory Guide 168: Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168), superseding its previous Regulatory Guide 168, dated 5 July 2007.

In response to its *Report 201: Review of disclosure for capital protected products and retail structured or derivative products*, dated July 2010, RG 168 now addresses:

- (a) the requirement that issuers of capital protected products adequately disclose the effects of early termination;
- (b) the requirement to provide better disclosure of break costs (or an indication of the factors that may affect the quantum of those costs, if break costs cannot be calculated) that may apply where an investor seeks to terminate or redeem a product before its maturity date; and
- (c) the requirement to clearly explain counterparty risk and to include supporting financial information to ensure that retail investors can assess the issuer's financial ability to meet its counterparty obligations.

1.6 **ASIC Consultation Paper 140: Responsible entities: Financial requirements**

ASIC has released *Consultation Paper 140: Responsible entities: Financial requirements* setting out its proposals on the financial requirements to apply to responsible entities of registered managed investment schemes. The proposals would replace the cash needs requirement in ASIC's *Regulatory Guide 166: Licensing: Financial requirements* (RG 166), however, the base level financial requirements would remain unchanged.

RG 166 states that ASIC imposes financial requirements on Australian Financial Services Licence (AFSL) holders to ensure that:

- (a) they have sufficient financial resources to conduct their financial services business in compliance with the *Corporations Act 2001* (Corporations Act) (including carrying out supervisory arrangements);
- (b) there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and
- (c) there are incentives for owners to comply with the *Corporations Act* through risk of financial loss.

These proposals align with the underlying principles outlined in RG 166. Specifically, these proposals seek to:

- (a) ensure a responsible entity has adequate financial requirements to meet its operating costs (for example, the costs of ensuring compliance with the *Corporations Act*) throughout the life of its schemes;
- (b) align the interests of responsible entities and scheme investors by ensuring that responsible entities are entities of substance and that shareholders in responsible entities have sufficient equity in the business to have a real incentive to ensure its success;
- (c) limit the risk that a responsible entity will become insolvent because it has assumed liability for the debts of others, including members of its corporate group (for example, under a guarantee, indemnity or tax-sharing arrangement);
- (d) ensure Australia provides comparable investor protection to other leading financial centres and comparable regulatory regimes; and
- (e) provide some level of assurance that, if the responsible entity does fail, there is sufficient money available for the orderly transition to a new responsible entity or to wind up the scheme.

ASIC's proposals

ASIC proposes:

- (a) that an AFSL holder operating as a responsible entity should:
 - (i) be prohibited from providing guarantees in its capacity as the responsible entity of a scheme;
 - (ii) where the responsible entity manages more than one scheme, be prohibited from providing guarantees in their personal capacity;
 - (iii) be restricted from providing indemnities in its capacity as the responsible entity of a scheme other than indemnities in relation to that scheme's default; and
 - (iv) in the event that it is part of a tax consolidation group, be required to execute a tax sharing agreement that ensures that the responsible entity can only ever be liable for its portion of any group tax liability;
- (b) that responsible entities be required to prepare, and make available to ASIC upon request, rolling cash flow forecasts with anticipated

revenue and expenses over at least 12 months, to be approved by the directors of the responsible entity;

- (c) that:
 - (i) one of the following 2 options be adopted as the method for calculating the amount of net tangible assets (**NTA**) a responsible entity is required to hold:
 - (A) the greater of:
 - (1) \$150,000;
 - (2) 0.5% of the average value of such scheme property (capped at \$5 million); and
 - (3) 10% of its average gross revenue (with no maximum); or
 - (B) 10% of its average gross revenue with a minimum of \$500,000 and no maximum;
 - (ii) if the average gross revenue of a responsible entity is below a minimum percentage of the average value of scheme property, that a minimum percentage, set at between 1% and 2%, be used to calculate the required NTA; and
 - (iii) eligible undertakings that may be included in the NTA calculation be limited to those provided by an authorised deposit-taking institution or which are otherwise approved by us; and
 - (iv) the amount of funds under management and NTA held by a responsible entity be submitted to ASIC annually;
- (d) that responsible entities be required to hold:
 - (i) 50% of the required NTA as cash or cash equivalents with a minimum of \$150,000; and
 - (ii) the balance of the required NTA in liquid assets, with 'liquid assets' being defined as assets that are:
 - (A) money in an account or money on deposit with a bank that is available for withdrawal immediately, or otherwise upon maturity of a fixed term not exceeding 6 months during the normal business hours of the bank;

- (B) a bank bill with a maturity date not exceeding 6 months; or
 - (C) an asset the responsible entity can reasonably expect to realise for its market value within 6 months; and
 - (D) free from encumbrances and, in the case of receivables, free from any right of set off; and
- (e) that the reforms will be effective for new responsible entities as of 1 July 2011; and
- (i) to implement a transition period for existing responsible entities of either:
 - (A) 12 months until 1 July 2012; or
 - (B) 24 months until 1 July 2013.

New regulatory guide and submissions

ASIC proposes to release a regulatory guide in March 2011 and interested parties are invited to comment by 15 November 2010.

2. LEGISLATION

2.1 Superannuation Industry (Supervision) (related party assets) determination No. 1 of 2010

On 23 August 2010 APRA released its determination that a regulated superannuation fund could acquire units held in a related party unit trust without contravening section 66 of the *Superannuation Industry (Supervision) Act 1993 (SIS)* where:

- (a) the unit trust is registered as a managed investment scheme under section 601EB(1) of the *Corporations Act*;
- (b) the trustee of the unit trust is the responsible entity of the registered scheme;
- (c) the trustee of the unit trust is a related party of the regulated superannuation fund; and
- (d) the units are acquired at market value.

2.2 Superannuation Legislation Amendment Bill 2010

The *Superannuation Legislation Amendment Bill 2010 (the Bill)* was passed on 25 October 2010 and now awaits Royal Assent. The Bill was previously introduced on 24 June 2010, however it lapsed on the calling of the August Federal Election.

This Bill proposes to amend:

- (a) the *Superannuation (Unclaimed Money and Lost Members) Act 1999*;
- (b) the *Income Tax Assessment Act 1997 (ITAA 1997)*;

- (c) the *Income Tax (Transitional Provisions) Act 1997*;
- (d) SIS;
- (e) the *Tax Laws Amendment (2009 Measures No. 6) Act 2010*; and
- (f) the *Taxation Administration Act 1953*,

for the purposes of:

- (a) facilitating both the transfer of unclaimed superannuation money held in prescribed state and territory superannuation schemes to the Commissioner and the payment of that money when it is claimed;
- (b) requiring unclaimed superannuation money held in Commonwealth public sector superannuation schemes to be transferred to the Commissioner, and to allow the Commissioner to pay these amounts out when claimed;
- (c) providing relief to superannuation trustees in respect of income tax deductibility of premiums paid in respect of a superannuation fund's total and permanent disability insurance policies;
- (d) allowing regulated superannuation fund (primarily SMSFs) trustees to acquire an asset in-specie (that is, an asset in a form other than cash, such as shares or property) from a related party of the fund, following a relationship breakdown of a member of the fund;
- (e) allowing the equitable application of transitional arrangements in relation to in-house assets where an asset transfer occurs as the result of a relationship breakdown of a member of that fund. Again, this particular set of amendments is most likely to be used in respect of SMSFs; and
- (f) implementing a number of minor superannuation-related amendments.

3. CASES

3.1 *Finch v Telstra Super Pty Ltd [2010] HCA 36*

On 20 October 2010, the High Court of Australia allowed an appeal by a former member of the Telstra Superannuation Scheme against the trustee's decision to reject his claim for a total and permanent invalidity (TPI) benefit and, accordingly, has remitted the matter back to the trustee.

Facts

The applicant, who had undergone male to female gender reassignment surgery in 1988, commenced employment with Telstra in 1992. The reassignment surgery turned out to have been unsatisfactory and distressing to the applicant who, in 1996 took sick

leave and underwent surgery to reverse the gender change as far as possible. He returned to work with Telstra in 1997, but ceased employment with Telstra just under a year later in 1998. Following this, he was employed by Foxtel for one month in 1999 and by QANTAS for five months in 1999-2000. From 2000, the applicant has sought a TPI benefit from the trustee.

Under the fund's deed, "Total and Permanent Invalidity" was defined as:

'disablement as a result of which –

- (a) *unless otherwise agreed between the Trustee and the Principal Employer from time to time either generally or in any particular case, the Member has been continuously absent from all active Work for a period of at least six months and has been required by the Employer [in the applicant's case, Telstra] to participate in a Rehabilitation Programme; and*
- (b) *in the opinion of the Trustee after consideration of any information, evidence and advice provided to the Trustee by the Employer and any other information, evidence and advice the Trustee may consider relevant, the Member has ceased to be an Employee and is unlikely ever to engage in any gainful Work for which the Member is for the time being reasonably qualified by education, training or experience.'*

"Work" was defined as meaning *'engagement in any business, trade, profession, vocation, calling, occupation or employment'*.

Despite medical opinion suggesting that the applicant was unlikely to engage in gainful work ever again, the Trustee rejected his claim for a TPI benefit on an initial assessment (in September 2002) and a subsequent reassessment (in March 2003). The applicant had been continuously absent for a period of marginally less than 6 months; however, he contended that the relevant period was 6 (continuous) months by the time of the trustee's determination (which would include the period subsequent to the termination of his employment at QANTAS up until March 2003).

There was no dispute about the applicant's satisfaction of the Rehabilitation Programme requirement in limb (a) of the TPI definition. The dispute was whether the applicant satisfied the requirement in limb (a) of having been continuously absent from "all active Work" for 6 months.

The Supreme Court of Victoria

In the Supreme Court of Victoria, the trial judge held that the Trustee failed to give genuine consideration to the matter in that it had failed to pursue sufficient inquiries into certain aspects of the claim. The trial judge remitted the matter to the Trustee for reconsideration.

The trustee's appeal to the Court of Appeal

The trustee successfully appealed to the Court of Appeal to set aside the trial judge's orders. In this case, the Court of Appeal held that for the applicant to meet a requirement in the definition of TPI he was required to be absent from active work for at least six months (**the Active Work Requirement**) *with* Telstra as at the date that the applicant ceased to work for Telstra. The Court of Appeal actually narrowed the scope of the trustee's interpretation of the TPI definition (in the trustee's favour) as the trustee accepted the Active Work Requirement with respect to absences from Telstra or any other employer, provided that the absence existed before the member left Telstra.

The applicant's first period of absence in 1996-1997 had been 6 days short of the required 6 month period. On this basis, the Court of Appeal considered that the issue of genuine consideration did not arise, but in any event disagreed with the trial judge's conclusion on that issue.

The High Court's decision

The High Court unanimously allowed an appeal against the decision of the Court of Appeal, and has remitted the matter to the Trustee. The High Court rejected the Court of Appeal's construction of the Active Work Requirement on the basis that such an approach involved unnecessarily reading words into the relevant clause. Put simply, there was no requirement under limb (a) that a member was required to be continuously absent from work *with Telstra or as a Telstra employee*; a member who ceased employment with Telstra (for example a contractor) but maintained membership in the fund and who subsequently became continuously absent from work for a period of six months with an alternate employer (as in the applicant's case) would be eligible for TPI in the event of meeting the Active Work Requirement after ceasing work with Telstra.

On the question of genuine consideration, the High Court noted that the duty of trustees to inform themselves properly is particularly intense in respect of superannuation trusts, and considered that the determination of the question of whether an applicant fell within the definition of TPI was not a matter of discretionary power but rather an aspect of the performance of a trust duty. The Court upheld the finding of the trial judge that the Trustee did not comply with its duty of inquiry. It was not appropriate for the Court to substitute its own decision for that of the Trustee, as it had not been shown that the Trustee was incapable of approaching the task of forming its opinion satisfactorily.

3.2 ***Sadleir v Motor Trades Association of Australia Superannuation Fund Pty Ltd [2010] FCA 930***

On 27 August 2010, the Federal Court dismissed an appeal against a decision of the Superannuation Complaints Tribunal (SCT) which had affirmed that a trustee's apportionment of a death benefit in favour of the deceased member's de facto spouse was fair and reasonable in the circumstances.

In this case, the Court found that the applicant had failed to raise a question of law to appeal the SCT's determination as required under section 46 of the *Superannuation (Resolution of Complaints) Act 1993*.

The Court stated that its jurisdiction, in relation to appeals against an SCT decision, does not arise unless an appellant can identify a question of law and a mixed question of fact and law will not suffice. The Court explained that an appellant must identify an error of law which amounts to a question of law. Further a finding of fact which is said to be erroneous will not be a question of law if there is some evidence upon which the finding is based unless there is no evidence to support the finding.

3.3 ***Machin v Board of Trustees of the State Public Sector Superannuation Scheme [2010] FCA 969***

On 3 September 2010, the Federal Court set aside a decision by the SCT which had affirmed a trustee's decision to reject a member's claim for a disablement benefit.

The applicant submitted that the SCT majority, on affirming the trustee's decision, misconstrued the relevant provisions of the deed and failed to address the right questions, and therefore addressed the wrong questions or took into account irrelevant considerations.

Relevant provisions under the deed and their interpretation

The applicant was diagnosed with a medical condition that prevented her from performing her job as a psychologist. Under the deed, two different types of disability benefit were provided:

- (a) total and permanent disablement benefits (TPD); and
- (b) permanent and partial disablement benefits (PPD).

The term "total and permanent disablement" was defined as *'disablement of a degree which, in the opinion of the board after obtaining the advice of not fewer than 2 medical practitioners, is such as to render the member unlikely ever to be able to work again in a job for which the member is reasonably qualified by education, training or experience'*.

The term "permanent and partial disablement" was defined as *'disablement of a degree which in the opinion of the board is such as to render an employed member permanently unfit to discharge or incapable of discharging the duties of the member's office efficiently, but is not total and permanent disablement'*.

The trustee, in determining whether the applicant was eligible to receive disability benefits interpreted the two definitions (and therefore the disablement benefits) as being different degrees of the same form of incapacity. The trustee firstly considered whether the applicant was *permanently disabled*. Upon its consideration, the applicant was not deemed to be permanently disabled, and therefore the trustee considered that there was no requirement to consider whether the applicant was eligible for total and permanent disablement or permanent and partial disablement benefits.

Appeal from the SCT

The applicant sought a determination from the SCT of which the SCT majority affirmed the trustee's decision. The applicant appealed to the Federal Court, submitting that:

- (a) the SCT majority failed to address the correct questions and instead addressed the wrong questions or took into account irrelevant considerations;
- (b) the SCT erred in law in approving and applying a potentially two-stage test, with a preliminary precondition of permanent disablement which, if not satisfied, dispensed with the need to consider the definitions of TPD and PPD;
- (c) the SCT majority also erred by considering only the applicant's eligibility for TPD and failing to consider her eligibility for PPD. The majority compounded the error by applying the wrong tests for TPD and considering irrelevant matters, including whether a condition were irreversible (thus failing to distinguish between the underlying condition and the disability) and that few of the doctors considered the applicant to be TPD (although the doctors did not address that question but were directed to different questions by the trustee). The majority misinterpreted the medical reports and relied on statements therein out of context. Further, the SCT majority (as did the trustee and its delegate) merely set out extracts from various medical reports in its reasons, without any analysis or exposed path of reasoning; and
- (d) the SCT majority expressed their determinations in a number of ambiguous and inconsistent ways, and failed to characterise the decision they were reviewing accurately, evincing a fundamental confusion that persisted

in the SCT's reasons and the deliberations of the majority.

The Court's decision and interpretation of the deed

The Court held that the SCT majority erred as the applicant alleged.

In interpreting the deed, the Court stated that the deed neither used nor defined the composite term "permanent disablement" or variants such as "permanent disability". Neither did the deed define the word "permanent". It did not provide that any benefit was payable if an employed member became "permanently disabled". Rather, the Deed required the trustee to credit the member's account if they satisfied, *inter alia*, the criteria of the relevant TPD or PPD definitions.

Although the word "permanently" was included in the definition of PPD to define the duration of the member's unfitness or incapacity to discharge the duties of office efficiently, the word was not an element of the definition of TPD, where different language ("unlikely ever again") described the duration of the inability to work in a relevant job. The different language to describe duration in each definition indicated that the meaning of "permanent" differed from that of "unlikely ever again". "Disablement" is defined under the deed to mean any mental or bodily injury, illness, disease or infirmity.

On the Court's analysis, the temporal element in the definitions of TPD and PPD was not directed at the injury, illness, disease or infirmity but at the member's likely or actual resultant unfitness, incapacity or inability to perform various specified occupations, roles or functions. The categories of TPD and PPD were labels identifying a degree of disablement which was defined, *inter alia*, by the duration or likely duration and extent of its effects, on which eligibility for a benefit depended.

The permanence or other duration of the member's degree of disablement was, despite potential overlap, distinct from, and did not necessarily coincide with, the permanence or duration of the resulting unfitness, incapacity or inability to work or discharge duties.

It did not necessarily follow that because a disablement was not "permanent", the resultant unfitness or incapacity to fulfil the duties of office efficiently would not be permanent or that the claimant would not be unlikely ever again to work in a suitable job.

The Court stated that eligibility under each category must be separately considered as the definitions are mutually exclusive and contain significantly different elements. The failure to satisfy the requirements of eligibility for a TPD benefit would not *ipso facto* exclude eligibility for a PPD benefit. Further, although the PPD definition apparently contemplates a lower

level of incapacity, it is not clear that a failure to satisfy its requirements would, in every case, exclude eligibility for a TPD benefit.

3.4 ***ExxonMobil Superannuation Plan Pty Ltd v Esso Australia Pty Ltd & Ors [2010] VSC 357***

On 25 August 2010, the Supreme Court of Victoria approved the rectification of the ExxonMobil Superannuation Plan's trust deed pursuant to a deed of compromise between Esso Australia Pty Ltd and other associated companies in the Exxon Mobil group (**the Company**) and various sub-groups within each class of members.

In December 2001, the trustee commenced the proceeding seeking answers from the Court to questions concerning the proper construction of certain provisions contained in the trust deed, and whether those provisions should be rectified.

The two primary issues in the proceeding were amendments, made in 1990:

- (a) in respect of the payment of death benefits of retired former contributors (**Death Benefit Entitlements**), of which the Company contended were neither authorised nor intended; and
- (b) to the definition of "final average pay".

Both amendments had the effect of increasing the Company's liability to meeting members' superannuation benefit entitlements. The deed was subsequently amended and consolidated over the ensuing years, however the effect of these 1990 amendments were maintained.

During mediation in 2009, it was estimated that the Company's liability, as a result of these amendments, was approximately \$510 million, of which approximately \$462 million was attributable to the amendments to the Death Benefit Entitlements. From the mediation, a compromise was reached between the relevant parties in which the Company would contribute an amount of \$135 million (calculated to be 26.47% of the Company's estimated liability) and agree to a fixed and higher interest rate being used to calculate the payment of Death Benefit Entitlements in return for member representatives consenting to the rectification of the relevant deeds.

The Court approved the rectification of the trust deed after satisfying itself that:

- (a) the overall settlement sum was reasonable in light of the Company's chances of success in respect of its claims for rectification; and
- (b) the compromise was fair and reasonable as between:

- (i) each representative party and the represented class members;
- (ii) the various classes of members;
- (iii) the various sub-groups within each class of membership; and
- (iv) the members within each sub-group.

3.5 *Opus Capital Limited v Australian Securities and Investments Commission [2010] AATA 723*

On 20 September 2010, the Administrative Appeals Tribunal (**AAT**) ruled that an entity's deferred tax assets (**DTA**) should be included in the calculation of the entity's net tangible assets for the purposes of satisfying a condition of its AFSL.

The applicant, Opus Capital Limited (**Opus**), operates as the responsible entity of twelve managed investment schemes pursuant to an AFSL. On 26 August 2010 ASIC determined to cancel Opus' AFSL on the basis that Opus had breached, and was continuing to breach, a condition of its licence which required it to hold NTA of a particular level.

In April 2009, Opus reported to ASIC that it was in breach of its condition to hold net tangible assets of 0.5% of total assets. In May 2010, Opus advised ASIC that the breach was rectified as a consequence of an alteration in the accounting treatment of its deferred tax losses. However, ASIC did not accept the entity's contentions and cancelled the entity's AFSL under section 915C(1)(a) of the *Corporations Act*.

The AAT set aside ASIC's decision to cancel Opus' AFSL after ruling that its DTA should be included in the NTA calculation. The AAT rejected ASIC's argument that, having regard to the entity's recent past performance, it was not probable that there would be future taxable profits available to enable the recognition of DTAs in Opus' financial statements under the Australian Accounting Standards Board's standard *AASB 112: Income Taxes*. The AAT stated that there was no evidence or reason to doubt the opinion of the Opus's Chief Executive Officer that Opus would return to profitability in the future.

The AAT also dismissed ASIC's submission that deferred tax assets are an "intangible asset" and thus expressly excluded from the calculation of NTA. The AAT determined that a DTA is a "monetary asset" (money held and assets to be received in fixed or determinable amounts of money) under the Australian Accounting Standards Board's standard *AASB 138: Intangible Assets*.

3.6 *Natalie Newton (Trading as 'Combined Care for the Elderly') and Commissioner of Taxation [2010] AATA 725*

On 23 September 2010, the AAT has set aside the Commissioner of Taxation's (**the Commissioner**) objection that a taxpayer had failed to make superannuation contributions on behalf of 21 workers. The taxpayer provided community support services to the disabled, infirm and elderly who required physical assistance in the home.

On 28 June 2010, the AAT found that the taxpayer's workers were paid to do work wholly or principally of a domestic and private nature, in accordance with the first element of section 12(11) of the *Superannuation Guarantee (Administration) Act 1992 (the SG Act)*. The AAT stated that the question does not concern itself with the nature of the services the workers provide to the taxpayer; but rather whether the workers are 'paid to do work wholly or principally of a domestic and private nature'.

However the AAT could not make a finding of fact of whether the workers satisfied the second element of section 12(11) of the SG Act by working for not more than 30 hours per week.

A finding that the workers met both elements of section 12(11) of the SG Act would mean that they would not be deemed to be "employees" under the SG Act and therefore the taxpayer would not be liable to make superannuation contributions on their behalf.

The AAT therefore remitted the Commissioner's objection under section 42D of the *Administrative Appeals Tribunal Act 1975 (the AAT Act)* providing the Commissioner with 42 days to reconsider the taxpayer's objection and either affirm, vary or set aside and make a new decision. In accordance with section 42D(2) of the AAT Act.

The Commissioner, in failing to take any action under section 42D(2), was considered to have affirmed his previous decision, meaning that the proceeding was to resume in the AAT, under section 42D(8) of the AAT Act. However, the Commissioner appealed to the Federal Court against the AAT's decision, in which a hearing is set down for 9 November 2010. The AAT noted that the appeal may not be competent, on the basis that the AAT had not finally disposed of the proceeding.

During the 23 September hearing, counsel for the Commissioner did not oppose the taxpayer's contention that the workers worked for less than 30 hours per week. Accordingly, and based on the Commissioner's failure to reconsider its decision in accordance with the 28 June decision, the AAT determined that the taxpayer's workers met both elements of section 12(11) and therefore decided to allow the taxpayer's objection in full. Therefore, the

AAT decided that the workers were not deemed to be “employees” for the purposes of the SG Act.

3.7 *Superannuation Complaints Tribunal D10-11019*

On 21 September 2010, the SCT affirmed a trustee’s decision to refuse to pay a member (**the Member**) the difference between the value of an estimate of the member’s benefit provided to her and the amount of the actual benefit paid.

The Member was a member of a defined benefit fund who had previously requested leave without pay (**LWOP**) for the period of one year. Her membership record reflected this request, but in the event, she did not proceed with the LWOP and contributory service accrued to her account.

Subsequently, because the LWOP was not taken, the period of LWOP was reinstated, resulting in an erroneous crediting to the Member of an additional 48 months’ service. This resulted in incorrect benefit statements being issued to the Member commencing with her 30 June 2005 statement (and including each subsequent 6 monthly statement until her final statement as at 30 June 2007) and incorrect account balances being provided to her in the trustee’s financial planning sessions that she attended. Each of the benefit statements received by the Member contained disclaimers to the effect that benefits can only be paid in accordance with the SIS and the SIS Regulations and that the trustee accepted no liability for any loss as a result of any person relying on the information.

In November 2007, approximately two weeks after the Member had retired and applied for her benefit, the fund telephoned the Member and advised that her benefit would be approximately \$777,000 which was in line with the Member’s expectations as a result of receiving the benefit statements. The trustee subsequently audited the Member’s record and two hours later contacted the Member to advise her that the correct benefit payable was approximately \$736,000.

Accordingly, the SCT in making its determination considered the issue of whether the Member relied on the information and suffered a loss as a consequence of that reliance.

In the SCT majority’s view, there was no loss suffered by the Member in the sense of entering into commitments that could not be altered. The Member was carefully planning her retirement, attending seminars and receiving numerous benefit statements. Her benefit entitlement in statements up to 31 December 2004 were increasing by between \$6,000 and \$9,000 (approximately) every six months, but increased by \$54,000 (as a result of the trustee’s error) between 31 December 2004 and the estimate prepared on 19 April 2005. The Member does not

appear to have queried this large change. If she had, her record could have been checked prior to her retirement.

Accordingly, the trustee was considered to have acted fairly and reasonably in relation to the Member because, although the Member’s expectation was that she would receive a higher benefit, she was advised of the correct benefit amount before she had entered any financial commitments, the statements contained disclaimers, and the trustee advised her of the correct amount of the benefit as soon as the audit of her benefit was conducted.

A dissenting SCT member considered that the trustee’s decision was unreasonable in the circumstances on the basis of:

- (a) the number of significant errors made by the trustee;
- (b) the incorrect account balance advice provided to the Member over a number of years through five statements, at least four benefit estimates, the website and three one-on-one interviews (including further benefit advice) with trustee staff;
- (c) the trustee’s stated procedure that it relies on members to identify and raise any errors and it takes no responsibility for identifying errors in the data held on its systems until it is required to pay a benefit;
- (d) the trustee’s lack of advice to the Member that it does not check any details that impact on account balances and that it relies on members to pick up any errors. In particular the disclaimers do not state this and neither does the product disclosure material issued to members;
- (e) the trustee did not point out to the Member in the one on one interviews that the data checking onus was her responsibility;
- (f) on the day the benefit was paid to the Member, she received confirmation of the benefit, only to be phoned two hours later with a revised amount;
- (g) the circumstances of the Member, particularly as she was in her 60s and planning for retirement;
- (h) the disparity between the trustee’s expertise (and access to experts, if required) and the Member’s inability to understand the complexities of a defined benefit fund; and
- (i) the trustee’s power to compromise the claim under the deed.

3.8 **Superannuation Complaints Tribunal D10-11022**

On 24 September 2010, the SCT affirmed a trustee's decision to reject a former member's (**the Former Member**) request that the trustee compromise his complaint in relation to loss claimed to have been suffered. The Former Member alleged to have suffered loss due to the trustee's failure or delay in reporting information in connection with an Eligible Termination Payment (**ETP**) received by the Former Member in 1997 under the *Income Tax Assessment Act 1936* to the ATO. Upon receiving the Former Member's complaint, the trustee reviewed its earlier decision and affirmed it.

The principal argument advanced by the Former Member is that, as a result of the trustee's failure to report the ETP withdrawal made by him from the fund on 13 February 1997 (when he was a member), he made withdrawals from a subsequent fund in excess of his low rate threshold (**LRT**) in early 2007. The Former Member stated that, as a consequence of his having exceeded the LRT, he suffered loss by way of additional tax in the amount of \$6,052.37. It is this loss in respect of which he sought a compromise by the trustee.

The SCT affirmed the trustee's decision not to compromise the claim on the basis that, despite any potential breach of the ITAA 1936 by the trustee, it was the Former Member who had the primary obligation to maintain his own accurate and complete financial and taxation records and therefore make the appropriate investigations with the trustee and the ATO before making the relevant withdrawals.

4. OTHER RECENT DEVELOPMENTS

4.1 **Auditing and Assurance Standards Board: Re-issue of Guidance Statement GS 002 Special Considerations in the Audit of Risk Management Requirements for Registrable Superannuation Entities and Licensees**

On 29 September 2010, the Auditing and Assurance Standards Board (**AUASB**) has re-issued GS 002 (**the Guidance Statement**) which replaces 'Guidance Statement GS 002 Special Considerations in the Audit of Risk Management Requirements for Registrable Superannuation Entities and Licensees', previously issued in July 2007.

This Guidance Statement has been formulated by the AUASB to provide guidance to auditors on matters relating to:

- (a) the audit of compliance with Risk Management Strategies (**RMS**) for Registrable Superannuation Entity (**RSE**) Licensees;
- (b) the audit of compliance with Risk Management Plans (**RMP**) of RSEs; and

- (c) the review of risk management systems (being the relevant processes and procedures) to maintain future compliance with the RMS and RMP.

The Guidance Statement provides guidance on the existing responsibilities placed on auditors of RSE Licensees and RSEs, as imposed by Australian Auditing Standards, Standards on Assurance Engagements, Standards on Review Engagements and the requirements of SIS and the SIS Regulations but otherwise does not add to the auditor's responsibilities contained therein. The Guidance Statement only applies to APRA-regulated superannuation entities.

The Guidance Statement provides guidance with respect to:

- (d) the approved auditor's role including outlining:
 - (i) the RSE Licensee's role;
 - (ii) the approved auditor's role;
 - (iii) the inherent limitations of auditing compliance with the RMS and RMP; and
 - (iv) the inherent limitations of reviewing systems to ensure future compliance with the RMS and RMP;
- (e) the planning of the audit and review including:
 - (i) explaining the meaning and concept of "materiality"; and
 - (ii) outlining other planning considerations;
- (f) those matters requiring consideration during the audit and review including:
 - (i) providing reasonable assurance on compliance with the RMS and RMP; and
 - (ii) providing limited assurance on the adequacy of systems to ensure future compliance with the RMS and RMP; and
- (g) the audit report and review report.

4.2 **The Board of Taxation Review of the taxation treatment of Islamic finance**

The Board of Taxation (**the BoT**) has released a discussion paper in relation to its review of the taxation treatment of Islamic finance, banking and insurance products. The BoT has been asked to review the taxation treatment of Islamic finance products and to make recommendations (for Commonwealth tax laws) and findings (for State and Territory tax laws) that will ensure, wherever possible, that Islamic finance products have parity of tax treatment with conventional finance products.

The terms of reference ask that, if the BoT concludes that amendments to the tax law are required, the BoT

should consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic financial products. In this regard, the terms of reference recognise that there are various tax frameworks or regimes in the current law that specifically deal with financial products.

In conducting the review, the BoT has been asked to have regard to the following principles as far as possible:

- (a) the tax treatment of Islamic finance products should be based on their economic substance rather than their form;
- (b) where an Islamic finance product is economically equivalent to a conventional finance product, the tax treatment of the two products should be the same; and
- (c) if the BoT concludes that amendments to the tax law are required, the BoT should consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic finance products.

The BoT has been asked to report to the Assistant Treasurer by June 2011 and accordingly has requested submissions regarding the review to be made by 17 December 2010.

Herbert Geer Comment

Islamic finance may provide emerging investment opportunities for superannuation funds, and therefore their taxation (and how their taxation affects investors) is likely to be of interest to Trustees and investment managers.

4.3 ***Proposed Asia Region Funds Management Passport***

The Assistant Treasurer announced, on 25 October 2010, its proposal to establish a pilot Asia Region Funds Management Passport (**the Passport**) with interested Asia-Pacific Economic Cooperation (**APEC**) countries including Singapore, Hong Kong, Korea and Japan.

The Passport will establish a multilateral framework allowing the cross border marketing of funds across participating countries. Fully implemented, the Passport will allow fund managers based in Passport countries to sell their investment management products in all Passport participating countries, without needing to meet different regulatory requirements.

The Passport may benefit fund managers in participating countries by enabling them to manage a larger regional pool of funds from their home base. Investors in Passport countries may benefit by having a greater range of investment products to choose from with the protection of a robust licensing regime.

The proposed Passport will be under discussion at various APEC meetings over Spring 2010.

**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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