14 February 2020

Manager
Financial Services Reform Taskforce
Treasury
Langton Crescent
Parkes ACT 2600

Dear Taskforce Members

Thank you for the opportunity to provide a submission in relation to the proposed introduction of a Financial Accountability Regime for Responsible Superannuation Entity licensees and their directors and senior executives.

Preliminary

By way of introduction, I am Director of the Centre for Law, Markets and Regulation (CLMR) at UNSW Law. The CLMR is a joint initiative of the Faculty of Law and UNSW Business School. Centre members produce high quality research on the legal, regulatory and contextual aspects of markets, corporations, finance and business transactions. The Centre's work is distinctive in the range of market institutions it studies, and its focus on understanding the nature and effects of regulation. I am also retained on a part-time basis as an External Consultant by Herbert Smith Freehills. My PhD and subsequent research have been predominantly directed towards the regulation of the Australian superannuation industry.

The views expressed in this submission are informed by my experience and research, but they are my own and ought not be taken to reflect the views of UNSW or Herbert Smith Freehills, nor any of their clients, employees, interns or associates. I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction.

This submission relates to two aspects only of the proposed Financial Accountability Regime as it pertains to the superannuation system. That ought not be interpreted as support for other design aspects of the regime, in respect of which I am aware other interested parties are making submissions. The submission is based on the information provided in the Proposals Paper dated 22 January 2020, which in many respects is lacking in detail and it may be that some of the observations made in this submission will be addressed when greater detail is made available.

Submission

I submit that the current design of the FAR displays a fundamental misunderstanding of the structure and operation of the APRA-regulated sectors of the superannuation system in Australia. This is manifest in a variety of aspects of the regime as currently proposed. I have chosen to address two aspects in this submission.

1. It misconceives the operational structure of many of the funds that constitute the system.

There is adequate empirical evidence to support the description of the superannuation system as one permeated by interconnected networks of specialised entities in which decision-making, and by extension, accountability, is distributed rather than centralised.[1] Unlike entities in the ADI and insurance sectors, superannuation fund trustees rely on a wide range of agents to administer the trust. In the 'retail' sector there are trustees whose agents are largely related parties. In those cases, restricting the FAR to RSE licensees and their corporate siblings (but notably not purely their subsidiaries) might be effective. However, in far the greater number of cases, and especially in the industry and corporate sectors, the trustees of superannuation funds employ agents unrelated by formal ownership ties to the trustee. These superannuation funds can truly be thought of as 'virtual' organisations, with the trustee at the hub of an operationally integrated but legally distinct network of other entities.[2]

The implication of this networked structure for the FAR are profound. Decisions material to the interests of members will occur in entities linked by contractual, and in some cases equitable, obligations to the trustee, rather than the trustee or one of its related parties. Important examples (in respect of the risks they represent) include asset custodians, investment managers, member benefit administrators and insurers. As currently described, the FAR would not encompass decision-makers employed by these entities despite the fact that legal liability for some of the decisions will rest in the organisations that employ them, rather than the trustee, and that in some circumstances it may even be possible for members to initiate action against those agents of the trustee.[3] Any accountability map created for such an institution that does not include this network agents and key personnel within them will be deficient because it will fail to locate accountability accurately, giving rise to a misleading impression.

This conclusion may seem counter-intuitive given the traditional understanding of the trustee as the entity solely responsible for the administration of the trust. The reason is that although the *SIS Act* locates accountability for all strategic matters in the trustee, for instance through the trustee covenants in section 52 and the operation of sections 58, 59 and 62, actual implementation of the

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1 See M. Scott Donald, Hazel Bateman, Ross Buckley, Kevin Liu and Rob Nicholls, 'Too connected to fail: the regulation of systemic risk within Australia's superannuation system' (2016) 2(1) *Journal of Financial Regulation* 56 – 78.

2 See M Scott Donald, 'The Pension Fund as a 'Virtual' Institution' in Sinead Agnew, Paul Davies and Charles Mitchell (eds), *Pensions: Law, Policy and Practice* (Oxford: Hart, forthcoming in 2020), Ch 6.

3 See M Scott Donald, 'Delegation by superannuation fund trustees' (2020) 37(5) *Company and Securities Law Journal*, forthcoming.

decisions can be, and commonly are, delegated to third parties for reasons of commercial efficiency. These 'ministerial' acts may not require exercises of discretion, but they can be very important for members individually and as a whole. Mistakes or delays by the fund administrator or the insurance provider, for instance, can adversely affect the outcome to an individual member to a material degree. Mistakes or delays by the asset custodian or an investment manager can often have a wider impact, especially in respect of cashflow management and unit pricing. Cyber fraud could affect all four types of agent.

There is another factor to be considered in addition to the risk that the current coverage by FAR will give a misleading and deficient picture of where accountability lies in each superannuation fund, undermining its efficacy as a tool of prudential regulation. As currently described, the FAR will weigh unequally on the sectors, leading (at best) to competitive distortions. APRA's mandate formally requires it to consider the competition dimensions of its activities,[4] and there does not appear to be any policy reason for this differentiation. The differentiation also creates the potential for regulatory arbitrage. As the Trio scandal demonstrated, this is not merely an aesthetic or academic question. Those who seek to perpetrate fraud will exploit loopholes, lacunae and regulatory blackspots such as this.

I submit, therefore, that the FAR should be extended to include:

- Key personnel serving a fund employed in companies that are part of the same group of companies, and not simply subsidiaries; and
- Key personnel serving a fund employed by companies providing key services on which the trustee depends for the administration of the trust, most particularly the fund custodian, member benefit administrator and insurance provider.

2. It misconceives the motivations of some (but not all) of the individuals playing key governance roles in the funds that constitute the system.

The second misconception is the attention paid in the FAR to remuneration. Remuneration is not a driver of behaviour for some of the most important decision-makers in the superannuation sector: the board members of the trustee.

Despite the build-up of internal management teams (who may have more traditional remuneration motivations), the Board plays a larger role in the decision-making of most superannuation funds than in the typical ADI or insurer. This is relevant here because research I conducted with Professor Le Mire in 2015-16 found, amongst other things, that many of the directors of superannuation fund trustee companies were not remunerated at all, passing their directors' fees back to their

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4 Section 8(2) of the *APRA Act* provides that:

> In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, *competition*, contestability and *competitive neutrality* and, in balancing these objectives, is to promote financial system stability in Australia. (emphasis added).

nominating body.[5] In bank-operated funds, these directors were typically remunerated by the banking group, in respect of which a deferred remuneration model plus clawback might be expected to be effective. In industry and corporate funds, the directors typically earn a flat fee based on the number of committees on which they served (including the main Board) and pass that remuneration back to the union or employer body that nominated them. A regulatory regime that relies upon curtailing flexible remuneration arrangements as a deterrent will self-evidently be ineffective in that latter context. Similarly, prohibiting the trustee from indemnifying its directors in respect of penalties under the regime may miss the mark, as this would appear to permit the nominating body to continue to provide such an indemnity. A sanction better tailored to the circumstances would seem to be preferable.

I submit therefore that it is crucial that the sanctions available under the FAR extend, as currently proposed, beyond remuneration measures and that nominating bodies also be prohibited from indemnifying directors from penalties.

Concluding comments

The Hayne Royal Commission uncovered misconduct falling short of community expectations and the law in a wide range of organisations in the superannuation sector. In so doing it has brought into question the effectiveness of both the regulators and trustees in protecting adequately the interests of members. The Financial Accountability Regime is one element of a suite of initiatives designed to address that shortcoming

Unfortunately, I doubt that the Financial Accountability Regime as currently described will achieve its objectives. I believe it must accommodate the de-centralised operating model prevalent in the industry to be effective in promoting accountability across the sector. To do otherwise will blind the regime to key vulnerabilities, promoting a false sense of confidence and distorting the market. The suggestion that extension of the regime to a wider range of AFSL holders will be deferred ought to be reconsidered so that there is a uniform application of the regime across the superannuation sector regardless of operating model.

I would be happy to answer any questions you or your colleagues may have on this submission.

Yours sincerely

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[5] M. Scott Donald and Suzanne Le Mire, 'Independence and the governance of Australian superannuation funds' (2016) 31 *Australian Journal of Corporate Law* 80 – 106; M. Scott Donald and Suzanne Le Mire, 'Independence in Practice: Superannuation Fund Governance through the Eyes of Fund Directors' (2019) 42(1) *UNSW Law Journal* 300 - 334