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Mr Jonathan Rollings
MySuper Working Group
Treasury
CANBERRA ACT 2600

By email: StrongerSuperMySuper@treasury.gov.au
Jonathan.Rollings@treasury.gov.au

Dear Jonathan

MySuper Stronger Super Working Group - comments

As you know, the Superannuation Committee of the Law Council of Australia is represented on the Stronger Super Governance Working Group. The Committee has also provided some comments for the consideration of the SMSF Working Group. On this occasion, the Committee has prepared the following comments in relation to some issues before the MySuper Working Group.

The Committee understands that a particular matter before that Working Group is the question of whether accrued balances of existing members of default investment options should be transferred to a MySuper product by the end of a transitional period, and what if any legal implications might flow from such transfers.

In this letter, the Committee looks at the different types of agreements that might exist between the trustee of a fund and a service provider or other third party, and comment as to the legal issues that might arise in relation to those agreements if the MySuper arrangements were to include the compulsory transfer of existing member balances. The Committee has included some comments about broader issues and related practical matters where it thinks these would be helpful.

Investment management arrangements

While an investment management agreement is of course contractual and its operation will no doubt be impacted by MySuper (for example, level of funds under management covered by the mandate and the associated fees), the implications from a legal perspective may not be significant.

Market practice has developed such that the vast majority of investment management agreements (if not all) can be terminated by the trustee with or without cause at any time, usually on very short notice. If it were necessary for a trustee to terminate this type of agreement outright as a result of MySuper-related transfers, the mechanism would exist for trustees to achieve this. That said, in many cases, it would not be necessary for the

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone +61 2 6246 3788
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

agreement to be terminated in its entirety; rather, the level of funds under management covered by a mandate would simply be reduced as a consequence of funds being transferred to the investment managers responsible for managing the assets of the relevant MySuper option. The vast majority of investment management agreements (if not all) include provisions which would facilitate this kind of transfer by the trustee, because it is essential for trustees to be able to transfer funds between their various investment managers for rebalancing and cash flow purposes, and indeed this occurs all the time.

It is difficult to see how most investment managers could claim to have any contractual right which protects them from the possibility of the agreement being terminated at any time or from significant funds being removed from their portfolio.

That said, some investment management agreements do include provisions which may be activated by MySuper-related transfers. For example, many agreements include a cascading fee scale which provides for lower fee rates as funds-under-management increase in value. If funds-under-management were to decrease as a result of MySuper-related transfers, this would often involve an increase in the average rate of fees applicable to the mandate. Similarly, some investment management agreements include a minimum per annum fee which applies in the event that the ordinary percentage-based fee produces an amount which is less than the agreed minimum fee. If there were to be substantial withdrawals from a portfolio, this may cause the minimum fee arrangements to come into effect (which again has the effect of increasing the average rate of fees on a percentage basis). Large reductions in portfolio values can also give rise to a need to renegotiate performance fee arrangements where they exist. If managers have underperformed and are carrying negative performance fee balances, the probability of recouping those negative balances through future outperformance (so that they might receive a performance fee in future) is made more difficult if the level of funds under management in the portfolio has been reduced.

These are just examples of practical implications which might arise from typical legal arrangements. However, it should be emphasised that such scenarios are encountered frequently by trustees and their investment managers, so it is not suggested that any of these factors on their own should be regarded as prohibitive.

Other investment arrangements: pooled products and direct investments

It should also be kept in mind that many trustees have also arranged for superannuation fund assets to be managed via pooled products. In these cases, rather than terminating the investment management agreement, it may be necessary for trustees to redeem their interests in the pooled vehicle. Whether or not this is possible, and the necessary time-frame, will depend on the documentation governing each pooled product.

In the case of pooled funds that invest substantially in listed Australian or international equities, trustees would normally have a unilateral right of redemption, and redemption requests would typically be processed in a matter of days (subject to possible withdrawal fees, sell spreads and allocation of capital gains tax liabilities associated with the redemption).

However, in the case of pooled funds that invest substantially in unlisted assets, trustees may not have the right to redeem their investment at all (for example, in the case of private equity funds) or possibly only after substantial periods of time (for example, say, 12 months in the case of some unlisted property funds).

Similarly, some superannuation funds make direct investments in unlisted infrastructure assets. The ability to exit these investments is often restricted, either entirely during certain restricted periods (for example, during the construction phase) or through pre-emptive right regimes. The sale process for these assets inevitably occurs off-market and, unless selling to another existing investor, can be a protracted process that follows lengthy due diligence. That said, it would be unusual for a trustee to consider divesting only part of its holding in a direct asset, even in the context of MySuper-related outflows from an investment option. It seems more likely as a practical matter that a trustee would maintain its existing holdings of these assets, which would raise certain rebalancing issues, outlined below.

In cases where trustees have no or limited rights to redeem, their ability to transition effectively to MySuper will depend on the length of the transition period and the rebalancing-related issues summarised below.

Rebalancing and liquidity considerations

Section 52(2)(f) of the *Superannuation Industry (Supervision) Act 1993* (**SIS Act**) requires trustees to formulate investment objectives for each investment option and, in turn, to formulate investment strategies for achieving those investment objectives.

In the investment administration context, if there were to be substantial movements of members and funds-under-management in connection with the MySuper transition, one of the main operational and legal challenges for trustees may be to continue managing each investment option in accordance with the relevant investment strategy and product disclosure statements, especially in the case of investment options with significant exposure to unlisted or illiquid assets.

Most (if not all) superannuation funds have a strategic asset allocation for each investment option, which specifies a target or neutral allocation to each asset class. These allocations, together with permitted deviation ranges, are typically disclosed to members.

If there were to be significant movements of members and assets out of particular investment options (whether to other options within the same fund or to another superannuation fund altogether), it is conceivable that compliance with the disclosed allocations and deviation ranges may be compromised. For example, if particular asset classes were invested through pooled products or other vehicles with limited redemption rights (for example, unlisted property, private equity or direct infrastructure investments), transfers may initially have to be funded by divesting (or transferring in specie) a disproportionate amount of listed and liquid assets (for example, listed equities and cash). Depending on the circumstances, it is conceivable that this could cause the actual allocations applicable to the members remaining in the relevant option to deviate significantly from the intended allocations, possibly in breach of the fund's disclosure documents. In very extreme cases, it is conceivable that trustees may have to 'freeze' investment options as they did during the global financial crisis. Further, there may be adverse taxation consequences and difficulties in unit pricing if there is a forced divestiture or liquidation of assets in order to effect a MySuper transfer.

These risks and the associated challenges would of course be alleviated if there were to be a significant transition period.

Following the global financial crisis, APRA encouraged all trustees to formulate liquidity management plans and to conduct regular stress testing. On the assumption that trustees have done this properly, and that MySuper-related outflows from particular investment

options are less significant than those which occurred during the global financial crisis, these rebalancing and liquidity challenges may well be manageable.

Loss of statutory defence

Trustees stand to lose the limited statutory protection for "investment choice" under section 52(4) of the SIS Act for investments made in accordance with directions by members where members are transferred to a MySuper option without an express direction from the member to do so.

However, this could be somewhat mitigated if it were to be made clear in the legislation that the existing statutory protection under section 55(5) for investments made in accordance with properly formulated investment strategies applies notwithstanding the effects of a compulsory transfer made pursuant to MySuper – covering both the consequential changes to the non-MySuper investment option from which MySuper members are transferred and the new MySuper investment option to which MySuper members are transferred.

Custody agreements

The Committee expects that most custody agreements would incorporate sufficient flexibility to accommodate significant outflows from one investment option to another (or even to another superannuation fund).

In cases where the assets under custody were to decrease substantially (for example, as a result of transfers to another superannuation fund), higher fee scales may apply to the residual assets under custody.

Custody agreements (like administration agreements) sometimes have a minimum contractual term, which could make termination costly if there were to be a total transfer of assets to another superannuation fund during the first few years of the term.

Adviser agreements

Some trustees may have agreements with financial advisers for the provision of services to members (or under which certain payments are made to the adviser from the member's account with the member's agreement), and those agreements may be affected if the members in question are transferred to another option or to another superannuation fund.

However, the Committee queries the value of the contractual rights held by such advisers, noting that it is common for members of funds to transfer under the SIS Act portability provisions or pursuant to successor fund transfers. In other words, the Committee expects it would be rare to find a financial adviser with the benefit of a contract with a fund trustee under which the relevant members are 'locked in'. Similarly, it is difficult to see how a trustee might be under any contractual obligation to procure that the pool of members 'covered' by an agreement would not be diminished, as this is something generally outside the trustee's control. It may be possible that the structure of some fee arrangements are such that the members remaining in the fund, division or option after the MySuper members have been transferred incur a fee increase as a consequence of member numbers diminishing, however it is difficult to speculate on precisely what fee arrangements may exist.

The Committee suggests individual sample contracts would need to be reviewed in order to determine whether there were any provisions which might cause difficulty in the event of MySuper transfers taking place. If such provisions were identified, then, as noted below,

trustees would need statutory protection as regards any liabilities. Policy consideration might also be given to how non-MySuper members may be adversely affected.

Broader issues

Constitution

The Committee is aware that the Working Group has had the possible application of section 51(xxxi) of the Commonwealth Constitution drawn to its attention. That section provides that:

> 'The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to... the acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws'.

The Committee understands that Treasury will take its own advice on Constitutional issues, and the Committee has not sought to form a concluded view for the purposes of these comments. We do however note that Treasury's advice would doubtless consider whether laws resulting in changes to a person's entitlements under contracts of the type under consideration would be laws for the 'acquisition of property', or whether there would instead be the termination or deprivation of rights The cases distinguish between these categories of laws.

To the extent that there are concerns regarding this issue (and for other reasons), it might be that certain arrangements (contractual rights) could be transferred by force of the legislation - in the same way as Part 9 of the Life Insurance Act operates.

Empowerment and protection of trustees

More broadly, trustees which are required under the MySuper rules to transfer a member's interest to another fund should be both empowered and protected by statute.

First, if the proposed legislation is to make transfers compulsory. then trustees should be given power to do what is required to make such transfers regardless of whether such powers are contained in or are consistent with the governing rules of the fund.

Secondly, a trustee which effects a transfer in accordance with the MySuper legislation should be fully protected from claims made by or liability owed to members, the member's beneficiaries and to third parties in respect of the transfer. This will be important, because a compulsory transfer to a MySuper product might otherwise create grounds for a claim against the trustee.

For example, take a member who has contracted with a fund trustee to become a member. The member has exercised choice of fund and has asked their employer to make superannuation guarantee contributions to the fund. Upon a MySuper transition of the accrued balance of the member, they may suffer or crystallise a loss if the transfer occurs at a disadvantageous time within the investment cycle. It may also disqualify the member from valuable irreplaceable insurance cover.

As indicated above, there might also be cases where there is an adverse effect on the income or payments receivable by a third party under a contract with a trustee arising from MySuper-related transfers occurring. Again, trustees would require statutory protection against any claims which might otherwise be made by such third parties.

Protection of employers

The transition of members into MySuper products may also have an impact on employment contracts, for members of 'tailored' default options offered by superannuation funds for selection by employers.

Employers that offer their employees additional benefits if the employee joins the employer's default fund often commit to this in the employment contracts. The additional benefits might be access to a specific insurance design (that is more advantageous than the standard cover normally offered by the fund) and in some cases payment of insurance premiums.

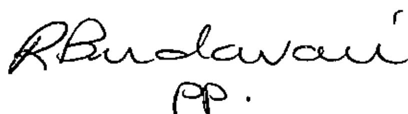
If the trustee were required to transfer all members in their tailored default options into a single MySuper option, employers may not be able to comply with their commitment to provide access to superior insurance arrangements, and may then be in breach of employment contracts in respect of MySuper and non-MySuper members. In particular, the Committee expects these issues are likely to be widespread in mastertrust arrangements.

The relevant legislation would therefore also need to protect employers against liability for any breaches of contracts of employment arising because of transfers of affected employees into MySuper products.

Please let the Committee know if you would like any further comments to be provided. Please contact the Chair of the Committee Heather Gray, whose contact details are as follows:

Heather Gray, Partner
DLA Piper Australia
T +61 3 9274 5321
F +61 3 9274 5111
M +61 411 221 858
E heather.gray@dlapiper.com

Yours sincerely



Bill Grant
Secretary-General