



Investment & Financial Services Association Ltd

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Mr David Rush
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Dear David

Re: Conflicts of Interest

We refer to APRA's Prudential Guide Draft and Discussion Paper released on 3 April 2009 and request for submissions on potential conflicts of interest for RSE licensees - Discussion Paper *Management of conflicts of interest – RSE licensees* and Prudential Practice Guide Draft *SPG 521 – Conflicts of Interest*. The following comments reflect IFSA members review of the relevant documents.

As you are aware, IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over \$1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

General comment

We understand APRA's concerns from a prudential perspective with superannuation fund governance arrangements. It is, however, disappointing that APRA did not take advantage of the invitation in our submission dated 18 July 2008 on the *draft Prudential Practice Guide – Superannuation – Conflicts of Interest*, to further discuss and work with IFSA in developing clearly expressed principles to underpin the conflicts management obligations on entities providing financial services, in particular, RSE licensees. Attached for your information is a copy of that submission.

Our primary concerns with the draft documents are:

1. an apparent bias against and implications for **conglomerate financial services groups**.
2. unnecessary **duplication of regulatory guidance** around conflicts of interest obligations and resulting inconsistencies and confusion;
3. prescription of **governance and conflicts policy**;
4. interpretation of **trustee legal requirements** in administering the fund;

1. Conglomerate financial services groups – paragraphs 15 to 17

Much of the focus of the draft Prudential Guide appears to be on conglomerate group structures. We note that conflicts may arise under a number of different arrangements for conglomerate structures.

The commentary in paragraphs 15 to 17 seems to contemplate the possibility of two broad models for the governance of funds and, subtly promotes one of these models as the superior model but without (explicitly at least) requiring the adoption of that model. In practice, this potentially creates confusion and uncertainty for trustees and a risk that trustees will be subject to legal and other risks if they do not adopt APRA's (apparent) preferred model.

The two models can be summarised as follows:

"APRA's Preferred Model" – under which, the trustee has an over arching obligation to source the "best available" service providers as an outworking of its "best interests" duty. In our view this model does not reflect the legal position, however it seems nonetheless to be postulated by APRA as a "best practice" model. Under this model, there would be no preferred status conferred on any one provider (including a related party of the trustee) and the expectation of APRA and investors would be that the trustee should periodically review the arrangements, potentially conducting tenders and the like in order to secure the "best available" services at the "best available" price. This model is predicated on the trustee having to undertake significant ongoing work in relation to the appointment of service providers, for which the trustee will require additional resources and potentially fees.

The "Embedded Service Provider Model" – under this model, the understanding and expectation of members is that a particular service provider would be appointed, as disclosed when the member joined the fund. The trustee's role is a more limited one of oversight in terms of ensuring that prescribed standards are met, as opposed to having the service provider in effect under continual review as against alternative service providers. Under this model, the trustee is not obliged to compare the embedded service provider against the universe of alternative service providers. Accordingly, the trustee's role is more limited. By implication, the trustee requires fewer resources and should be able to offer a reduced trustee fee. (Some evidence to support this can be found in APRA's own research¹ which suggests that on average, directors of trustees of retail superannuation funds spend fewer hours per year in performing that role, relative to directors of other types of fund.)

The draft guide at paragraph 15 seems to acknowledge the legitimacy of the Embedded Service Provider Model and does not expressly require funds to be restructured to conform to APRA's Preferred Model. On the other hand, paragraphs 16 and 17 infer that the trustee 'may' have an obligation to in effect restructure funds that have the Embedded Service Provider Model to conform to APRA's Preferred Model. Implicit in these paragraphs is the suggestion that trustees who fail to do this may not be meeting their obligations to act in the best interests of members.

By recognising elements of both models, we submit that the draft guide will potentially create confusion in the industry. On the one hand, the draft guide seems to be promoting APRA's Preferred Model, but on the other hand, there is some recognition that fund members have chosen the product on a particular basis and that this ought to be respected. As previously stated (IFSA submission dated 17 July 2008):

"....., The financial services market in Australia is characterised by a significant degree of horizontal and vertical business integration in addition to boutique operations.

Related party arrangements within conglomerates have been a common feature of the Australian financial services industry for some time. The diversity within our industry is a significant strength and offers investors a wide range of investment choices. Taken to its extreme, avoidance of conflicts would have the effect of undermining existing industry structures and operations. These structures have delivered significant industry efficiencies and benefits to customers. "

The vertical integration of financial services provides fund members with efficient and cost effective access to various investment products and services. Vertical integration is a

¹ "Working Paper – Superannuation fund governance: An Interpretation", Wilson Sy, August 2008, Figure 4 on page 10

problem only in a poorly contested market where it can result in less competition and market manipulation. This is not the case in the Australian superannuation market which is well contested, highly competitive and delivers significant financial and economic benefits to customers. In the process of making a purchase decision customers are influenced by factors such as brand, reputation, utility, efficiency, reliability, risk as well as current and past relationships.

The draft guide seems to envisage some kind of "halfway house" where a trustee can continue to operate on the basis of the Embedded Service Provider Model so long as it changes to APRA's Preferred Model if **at any time** it considers this to be "in the best interests" of members.

It is untenable, in IFSA's view to require superannuation trustees to be considering, on a continual basis, whether and if so when, to switch between two completely different models of operation. How, in practical terms can a trustee discharge its obligations under such a regime? Must the trustee periodically conduct tenders to assist it in determining whether to change models? What guidance can APRA give trustees as to the triggers that should prompt a trustee to restructure an Embedded Service Provider Model fund to conform to APRA's Preferred Model?

The approach in the draft documents appear to assume that a trustee will readily be able to ascertain the "best" service provider at any time. This is a simplistic view which assumes that the "best" service provider can readily be identified (presumably on the basis of price and, for an investment manager, historical investment performance). There are, of course, many other factors to consider.

Although for example it is acknowledged that there are potential conflicts of interests under the Embedded Service Provider Model, it also needs to be recognised that in most circumstances the interests of the relevant service provider and the trustee are actually aligned. The service provider has often invested significantly in its brand and reputation. This can be a factor in a service provider agreeing to pay ex gratia compensation to a fund trustee where errors occur, even though there may be no legal liability on its part to do so. Similarly, the fact of the parties being related tends, in practice, to give trustee directors greater access to, and influence in relation to, the service provider. In many cases, a large part of the service provider's business is based on offering its products and services through the related superannuation fund. Accordingly, the trustee is likely to be in a much stronger bargaining position with a related party service provider than it would be in dealing with an arm's length service provider who may simply walk away from the relationship if the commercial terms no longer suit.

At an operational level it is common for employees of corporate financial services groups to wear several hats in the course of providing services to the Trustee entity. The inherent conflicts should be managed via robust governance procedures and internal controls.

Paragraph 7 refers to conflicts arising as a result of directors of an RSE or responsible persons to also hold office as directors and responsible persons of another entity(s). Does APRA expect RSE's to go so far as to remove such conflicts? Such measures would require conglomerates to change their organisation and governance structures and would not benefit member's interests practically or in terms of the costs involved.

IFSA recommends that paragraphs 15 to 17 be deleted from the draft guide.

IFSA notes that Senator Sherry, the Minister for Superannuation and Corporate Law announced on 28 April 2009 a review into the structure, operation and efficiency of the superannuation system. We consider that review of fundamental issues about the current structure, operation and efficiency of superannuation are more appropriately dealt with in the context of that review and rather than APRA guidance.

2. Duplication of regulatory guidance

SPG 521 recognises that guidance on conflicts of interest is currently provided in a number of regulator publications. In particular, in

- Fit and Proper Standard SGN 110.1
- Outsourcing Standard SGN 130.1
- Risk Management Standard SGN 120.1
- ASIC RG 181 (for dual regulated entities)

The draft guide tends to focus on related party conflicts. For the majority of corporate superannuation trustees, the management of appointments of related party service providers is addressed through Superannuation Guidance Note 130 - Outsourcing and as such the considerations outlined in paragraph seven are addressed throughout existing governance processes. Clearly the management of conflicts of interest is of vital importance and trustees are obliged to manage conflicts in a manner which is in the best interests of beneficiaries. It is not clear how the draft guide complements or provides further clarity in respect of existing approaches and systems designed to manage conflicts of interest.

Typically monitoring of conflicts, especially in relation to related parties, forms part of the ongoing review of service providers as discussed in SGN130. Further monitoring generally takes the shape of seeking annual confirmations from the Directors and Officers in relation to any personal conflicts they may be exposed to.

As stated in our submission of 18 July 2008, while we acknowledge the fundamental role of APRA in the prudential regulation of superannuation funds, we do not believe that regulated superannuation entities that are licensed by both APRA and ASIC require additional guidance to that provided by ASIC in Regulatory Guide 181 *Licensing: Managing Conflicts of Interest (RG181)*. At a practical level, dual regulated entities already have a conflicts policy in place to comply with RG 181, and actively address conflict of interest issues.

We consider that RG 181 is comprehensive in providing regulatory guidance on managing conflicts of interest. While RG 181 is not exclusively focussed on superannuation trustees, the common law principles applying to trustees are no different in a superannuation context than in a non-superannuation context. In fact, having an additional source of guidance to that provided under RG181, as is contemplated by the PPG, will be counter productive. It will introduce another level of regulation for dual regulated entities and a potential for different and inconsistent interpretation of legal obligations. Complementary guidance will only succeed in increasing costs and introducing uncertainty for no net gain to either the RSE or its customers.

IFSA recommends that the proposed guidance be limited in its application to entities that do not hold an Australian Financial Services Licence.

3. Governance and Conflicts Policy

Effective management of conflicts of interest is dependent on the quality and robustness of the RSE's governance practices, compliance monitoring and supervision procedures.

SPG 521 indicates APRA's expectation that the RSE Licensee's Conflicts of Interest Policy should be contained within the trustee's Risk Management Strategy (**RMS**) - paragraphs 8, 9, 11. The Guide suggests that all or part of the trustee's corporate governance requirements need to be documented within the RMS. While we agree that conflicts management should be appropriately documented, we do not see the benefit in detailing at a micro level in the RMS how conflicts are managed. Rather the RMS should refer to the existence of policies and procedures.

We note that these requirements form part of the existing prudential framework, are set out within the Corporations Act, and are ordinarily documented in the trustees' Fit and Proper Policy or similar. Although the trustee manages conflicts in accordance with existing

regulatory and legal requirements, we point out that these may not be documented in the RMS itself.

In practice, many trustees have a stand-alone “Conflicts of Interest Policy” and a “separate Fit and Proper Policy”, amongst other policies in place to meet regulatory obligations. To require trustees to reproduce these existing policies in the RMS would be inefficient, impractical, and would impose an undue regulatory burden on trustees for which no public interest benefit can be demonstrated.

IFSA recommends that conflicts management should be appropriately documented by the trustee and not required to be contained in the trustee’s Risk Management Strategy.

4. Legal requirements - paragraphs 13-15

IFSA acknowledges that it “is not the purpose of [the] prudential practice guide to provide a restatement of the content of the law or to outline provisions ... which are particularly relevant to the management of conflicts of interest ...”. However, in places the guide does purport to state what the law requires and how a particular statutory provision operates.

IFSA submits that a number of statements in paragraphs 13 – 17 of the Guide, dealing with situations where the trust deed or the governing rules embed certain arrangements do not correctly reflect the legal principles that are relied on as authority for APRA’s policy position. One statement, in particular, about the application of the outsourcing standard to investments by a trustee, is erroneous.

We request that APRA reconsider the statements in paragraphs 13-15 in light of the following comments.

4.1 The investment of fund assets with a related party does not by itself constitute a “material outsourcing agreement” within SIS regulation 4.16

In the second sentence of paragraph 14 of the draft guide, APRA notes that:

“... a trust deed might provide that the trustee can only invest in financial products marketed by a specified party or parties.”

At paragraph 16, APRA goes on to state that:

“the provisions of the trust deed ... do not release the trustee from its obligation to manage and monitor the outsourced arrangement, which should comply with the outsourcing standard in SIS regulation 4.16.”

The statement at paragraph 16 implies that the outsourcing standard applies to the mere investment of fund assets with, for example, a related party. **This is not correct.** The investment of fund assets by a trustee is clearly a “material business activity” within SIS regulation 4.16(1). However, investment of those assets does not by itself involve a “material outsourcing agreement” as defined in that regulation.

That concept is relevantly defined as meaning an agreement or arrangement “under which a person other than the RSE licensee ... is to perform a material business activity” (see paragraph (a) of the definition).

The outsourcing standard would not apply to the trustee acting in accordance with the deed’s requirements. It would not, for example, apply where a trust deed requires the trustee to invest fund assets in an investment life policy issued by a related party life insurance company. The investment activity is performed by the trustee, not by some other person. The trustee, not anyone else, would have invested fund assets by entering into and maintaining the policy. Therefore, the policy is not a “material outsourcing agreement”.

This legal conclusion is reflected in practice by the fact that life policies of the kind under consideration do not purport to comply with the form and content requirements of regulation 4.16(4), (5) and (6). The situation must be distinguished from a situation where the trustee appoints an investment manager or an implemented consultant.

The appointment of an investment manager or an implemented consultant do, typically, constitute material outsourcing agreements, but they are legally distinct from the situation under consideration. Investing fund assets under a life policy does not make the life company the investment manager of the trustee. Further, the life company may employ an investment manager in connection with the management and investment of the life company's assets, but again that does not make the life company's investment manager the investment manager of the trustee.

IFSA recommends that APRA recognise that the outsourcing standard does not apply in the specific circumstances identified in the second sentence of paragraph 14 of the draft guide, as extracted above. The outsourcing standard provides no foundation for challenging, and is not otherwise relevant for, a trust deed requirement to invest fund assets with a related party.

4.2 APRA's characterisation of trustee duties overstates legal position

In the first sentence of paragraph 14 of the draft guide, APRA notes:

"The fund trust deed might purport to require the trustee to outsource particular functions exclusively to specified service providers such as entities within the trustee's corporate group."

Take the situation of a trust deed that requires a trustee to appoint a related party life insurance company as the administrator of the fund. In contrast to the investment activity situation discussed earlier, the outsourcing standard would likely apply, as the life company, not the trustee, is to perform the administration activities. Accordingly, IFSA acknowledges that, in this case, the outsourcing standard would be relevant. However, we are concerned that the statements at paragraph 16 of the draft guide overstate a trustee's legal duty under the outsourcing standard.

The most directly relevant requirements in the outsourcing standard are that a material outsourcing agreement must "contain audit, monitoring and assessment procedures in relation to the performance of the material business activity" (regulation 4.16(4)(h)) and must "contain ... termination provisions" (regulation 4.16(4)(c)). There is separate guidance from APRA on these and the other form and content requirements, setting out APRA's expectations about how they may be satisfied and what is "best practice". Whilst not diminishing the status of the guidance, IFSA considers that it is necessary to bear in mind that the relevant legal requirements are, as identified in this paragraph, to have contractual provisions dealing with particular topics, but not necessarily mandating any particular standards or outcomes in respect of those topics.

In this context, we consider that stating that a trustee has "*an ongoing **duty** to assess any such outsourcing arrangements in response to changes in market conditions over time*" (see paragraph 16 of the draft guide - emphasis added), to the extent that this comment suggests a duty to consider whether or not to continue with the arrangement, overstates the legal position. It is difficult to see how a trustee that is bound to comply with a trust deed requirement to appoint a particular party as a service provider has, as a matter of trust law or under SIS, discretion to depart from that requirement notwithstanding "changes in market conditions". It follows that if no such discretion exists, then there can be no duty attaching to the exercise of the discretion.

4.3 Interaction between SIS, trust law and "best interests" obligation

The SIS regime enacted by Parliament is predicated on superannuation funds that fall within the regime being structured as trusts. Parliament clearly intended that, to a great extent, the general law of trusts would apply to regulated superannuation funds.

The general tenor of APRA's statements at paragraphs 13-17 of the draft guide does not pay appropriate regard to the general law of trusts and the primacy to be given to the terms of the trust instrument.

A trustee must know the terms of the trust and must adhere to, and carry out, those terms. As stated by the learned authors of *Jacobs' Law of Trusts in Australia* (at [1704]):

"The rule that the trustee must strictly conform to and carry out the terms of the trust modifies all other rules because these other rules are applied subject to any

provisions contained in the trust instrument itself."

The above principle is particularly relevant to the statement at paragraph 17 of the draft guide that there may be "circumstances where such arrangements may not be in the **best interests** of members and beneficiaries" (emphasis added). What constitutes the "best interests" of members/beneficiaries is necessarily largely defined by reference to, and is subordinate to, the terms of the trust. This is because the trustee's duty to act in the best interests of members applies to the trustee in relation to the exercise of powers and discretions conferred on the trustee by the trust deed. If the trustee has no power to select a service provider (ie because the trust deed itself makes that choice) then there is no relevant power or discretion to which the duty can attach.

4.4 Amending the governing rules

At paragraph 17, APRA suggests that where the trustee has the power to amend the governing rules, it should "consider exercising" that power "with a view to widening the choice of investments or service providers". This comment fails to take account of the complexity, from a legal perspective of such a proposal, having regard to the need for the trustee to take account of the interests of a range of stakeholders, including the parties referred to in the trust deed and members who have invested on the basis of a particular fund structure.

APRA acknowledges at paragraph 15 that where the arrangements were disclosed to members when they joined the fund, it "may be more reasonable" for the trustee to simply comply with the governing rules, however paragraph 17 seems to undermine this by implying that trustees should amend their governing rules if they have the power to do so.

4.5 Applying to Court seeking power to depart from governing rules

In a similar vein, at paragraph 17, APRA further suggests that where the trustee does not have the power to amend the governing rules, "it may be appropriate for the trustee to approach the Court, for example for an order conferring power to invest in a wider range of products".

The court does have jurisdiction to insert additional powers into trust deeds - see, for example, section 81 of the *Trustee Act 1925* (NSW). However, the reference in the last sentence of paragraph 17 is not particularly helpful for a trustee looking to APRA's written policy for guidance.

The policy glosses over the fact that there may be countervailing factors mitigating against applying to the court in the first place. For example, applying to the court could be time-consuming and expensive. Independent assessments comparing the terms offered by the related party with the terms reasonably available in the market may be inconclusive. Should a trustee seek judicial advice on the question of whether it should apply to the court for an expansion of its powers? These are but a few of the many questions that are posed (but left unanswered) by APRA's statement about approaching the court.

Conclusion

Conflicts management is an integral part of the operation of IFSA member companies. The conflicts management obligation is predicated on the licensee being best placed to judge:

- when its interests and those of its customers are not aligned;
- the potential negative results that may arise from any misalignment of interest; and,
- how best to prevent any negative results or behaviour occurring.

It is the responsibility of management to ensure systems and controls are in place to manage potential conflicts of interest. Failure to do so is itself a breach of the law.

IFSA members are concerned about the possibility of unnecessary duplication of requirements and statements in proposed guidance that does not properly reflect or is contrary to existing legal requirements. As stated in our earlier submission, to the extent that APRA is concerned with the potential for conflicts within the public offer superannuation fund sector, it should work more closely with ASIC in ensuring that an RSE has arrangements in

place to manage its obligations under the law to manage conflicts of interest and to act in the best interests of the customer. If it is believed that further guidance is necessary, IFSA will work with each of the regulators to develop clearly expressed principles to underpin the conflicts management obligations on entities providing financial services, in particular, RSE licensees.

We would be pleased to provide you further information or explanation of our concerns and to meet with you to discuss any of the issues identified. Please contact me directly if you wish to discuss.

Yours sincerely



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