Law Council
OF AUSTRALIA

10 April 2015

Senior Adviser
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: fsi@treasury.gov.au

Dear Sir/Madam

Financial System Inquiry Final Report

I am pleased to enclose a submission prepared by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia.

The Committee would welcome the opportunity to discuss the submission further. In the first instance, please contact:

- Ms Michelle Levy, Chair, Superannuation Committee Tel: 02 9230 5170
  Email: michelle.levy@allens.com; or

- Mr Tony Nemec, Chair, Legislation and Policy Subcommittee Tel: 02 8864 6974
  Email: anthony.nemec@mercer.com.

Yours sincerely

MARTYN HAGAN
SECRETARY-GENERAL

Financial System Inquiry Final Report and Recommendations

Financial System and Services Division

The Treasury

Submission by the Superannuation Committee of the Legal Practice Section of the Law Council of Australia

10 April 2015

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Introduction

1. This submission was prepared for the Law Council of Australia by the Superannuation Committee of the Legal Practice Section. The objectives of the Superannuation Committee are to ensure that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. The Committee makes submissions and provides comments on the legal aspects of virtually all proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.

2. The Law Council of Australia is the peak national representative body of the Australian legal profession and represents 60,000 legal practitioners nationwide. Attachment A outlines further details in this regard.

3. This submission responds to the Treasury primarily to recommendation 13 'Governance of superannuation funds' of the *Financial System Inquiry Final Report* (2014).

4. Recommendation 13 provides:

   Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements. (emphasis added)

5. This submission recommends:

   (a) removing the current limits on the appointment of independent directors to standard employer-sponsored funds under s 89 of *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act);

   (b) removing the voting restrictions on independent directors;

   (c) that the policy rationale for the appointment of independent directors be better articulated so that the attributes of an 'independent director' can be clarified to assist with the development of an appropriate definition;

   (d) that the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) be amended as an interim measure to permit the appointment of more independent directors with full voting rights to public offer standard employer-funds;

   (e) that the proposed "alignment" of directors' penalty provisions under the SIS Act with managed investment schemes (MIS) be reconsidered. Such a measure would in fact extend superannuation directors overall liability exposure beyond that for directors of a MIS and is unduly onerous in the context of the greater liability exposure already imposed on superannuation trustee directors as part of the recent "Stronger Super" reforms.

Majority of independent directors – need for interim and transitional relief

6. If recommendation 13 is to be accepted by the Australian Government, s 89 'Basic equal representation rules' of the SIS Act will need to be amended.

7. To facilitate an orderly transition to any new mandatory requirement for a majority of independent directors to be appointed to public offer standard employer-sponsored funds, we suggest that consideration be given in the interim to:

- removing the current limits on the appointment of independent directors to those funds under s 89 of SIS Act; and

- removing the voting restrictions on independent directors.

8. The Australian Prudential Regulatory Authority (APRA) is understood to already permit a number of standard employer-sponsored funds to appoint up to one-third of independent directors consistent with s 89.

Definition of "independent director" of a super fund and interim relief

9. The question of how an independent director should be defined is currently in debate, with the current SIS Act definition not necessarily appropriate for today. The FSI suggested that an independent director should be "at arm's length"[1] which does not provide sufficient definitional certainty for industry participants and the regulator, and is more appropriate to use as a legal criteria in relation to contracting requirements rather than director eligibility criteria.

10. 'Independent' can mean different things for different purposes. For example, for an ASX listed company, independence from management is important, whilst for a super fund trustee it may mean independence from service providers, related bodies corporate and other funds.

11. The Law Council suggests that the policy rationale for the appointment of independent directors warrants further consideration and articulation as this will assist in defining the attributes that are required for a director to be 'independent'.

12. Similarly, removing the current restriction on the number of independent directors is suggested as an interim measure that can be implemented by statutory amendment now, while the more complex definitional issues are being resolved.

Aligning the director penalty regime with Managed Investment Schemes – reconsideration required

13. The Law Council does <u>not</u> agree with the FSI recommendation that the SIS Act director penalty regime should be "aligned" with MIS or considered in isolation from the other liability exposure of such directors. To do so appears unnecessary given the extended liability exposure of superannuation fund trustee directors as a result of the recent "Stronger Super" reforms. The proposal would expose superannuation trustee directors in practice to greater (rather than "aligned") overall liability exposure for breach of their duties than directors of a MIS. If the proposal is adopted, a breach of the superannuation fund director covenants would expose a director to both:

    (a) direct liability to individual members for loss arising from a breach of the covenant (unlike a director of a MIS); plus

    (b) liability for civil penalties.

14. If such an onerous exposure were to be imposed on superannuation trustees, this may well detract from the feasibility of implementing the FSI recommendation for a majority of independent directors on public offer superannuation fund boards. It is difficult to

[1] Australian Government, The Treasury, *Financial System Inquiry Final Report*, November2014, p 133.

envisage highly skilled professional directors being willing to assume such levels of exposure to liability.

Detailed comparison

15. The penalty regime for managed investment schemes is constructed differently than that operating under the SIS Act. Under Chapter 5C of the *Corporations Act 2001* (Cth), a breach of a director's statutory duties is a civil penalty provision.[2] In addition, an intentional or reckless breach of a director's statutory duties is an offence carrying 2000 penalty units, 5 years' imprisonment or both.[3]

16. However, under the managed investment scheme regime, directors of a responsible entity (RE) have no direct liability to individual scheme members for a breach of their statutory duties.

17. Rather, once the court makes a declaration that a civil penalty provision is breached, the Australian Securities and Investments Commission (ASIC) can seek both a pecuniary penalty (up to $200,000 payable to ASIC) if the breach is serious and materially prejudices the interests of the scheme or its members. In addition, the court may order compensation to be paid to the scheme on application by the responsible entity.[4]

18. As such, there is no direct civil liability to members of the scheme. Instead, if a court finds that an RE director has breached his or her statutory duties, the court may award compensation to the scheme (but not to individual scheme members).

19. Under the SIS Act there is civil liability for loss (owed directly to members) for breach of a covenant. This means that a superannuation director could be sued by an individual member or by a class of members who allege that they have suffered loss as a result of a breach of covenant.[5] However, breach of a SIS Act director covenant is not itself a civil penalty provision and therefore a pecuniary penalty cannot be sought by APRA for breach. Superannuation trustee directors can be deemed to have breached a civil penalty provision if they are involved in a contravention of a civil penalty provision by the trustee. Hence superannuation trustee directors already do have exposure to civil penalties, just not for penalties as a result of a breach of their own personal director covenants.

20. If the FSI recommendations are adopted in relation to the SIS Act director covenants, superannuation trustee directors will have not only direct civil liability to members for loss (and exposure to class actions as at present) but will also face the prospect of pecuniary penalties payable to the regulator and criminal sanctions for intentional or reckless breach of the covenants.

21. If the Government does want to impose pecuniary penalties exposure for breach of the SIS Act director covenants, then we believe that it should align all aspects of the SIS Act liability regime with the managed investment scheme regime by, at the same time, removing the direct liability to members that superannuation directors currently have. In other words, fund members would no longer be able to sue a director personally, but rather any compensation would be awarded by the court on application by the trustee and such compensation would be payable to the fund.

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[2] These duties also apply to other 'officers' of the RE: see s 601FD *Corporations Act 2001*.
[3] Section 601FD and Schedule 3 Penalties *Corporations Act 2001.*
[4] As with the SIS Act, there are powers for the court to give judicial relief to persons who have acted honestly and ought fairly to be excused having regard to all the circumstances.
[5] This threat of class actions is already a deterrent and many professional directors are seeking extensive indemnities before they are prepared to assume office.

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- The Large Law Firm Group (LLFG)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of more than 60,000 lawyers across Australia.

The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive members, led by the President who normally serves a 12-month term. The Council's six Executive members are nominated and elected by the board of Directors.

Members of the 2015 Executive are:

- Mr Duncan McConnel, President
- Mr Stuart Clark, President-Elect
- Ms Fiona McLeod SC, Treasurer
- Dr Christopher Kendall, Executive Member
- Mr Morry Bailes, Executive Member
- Mr Ian Brown, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.

Law Council OF AUSTRALIA
Business Law Section

Mr David Crawford
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: fsi@treasury.gov.au

14 April 2015

Dear Mr Crawford,

Final Report of the Financial System Inquiry

The Corporations Committee of the Business Law Section of the Law Council of Australia ("**BLS**") makes this submission on certain aspects of the Final Report of the Financial System Inquiry (November 2014) **("Final Report")**.

Chapter 4: Consumer Outcomes – Product design and intervention

The Final Report recommends what it describes as a targeted and principles based product design and distribution obligation (Recommendation 21) and a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment (Recommendation 22). The BLS believes such an obligation and power would operate very differently to the description used in the Final Report.

The BLS continues to oppose the introduction of a product intervention power even if it is limited to circumstances where there is risk of significant detriment to a class of consumer and with regulator accountability. See our submission dated 26 August 2014. We consider that ASIC does not have the cultural and skills mix to exercise this power, the power risks constraining innovation and the threat of the power may increase costs. We consider that the introduction of the power could be extremely intrusive to the financial markets in the way in which it is exercised and have far reaching consequences for Australian regulation. We also consider that the power is incompatible with other Australian policies such as reducing red tape and building Australia as a competitive international financial centre.

The product design obligation is expressed to be a fuzzy and benign obligation that should impose minimal costs on firms with good practices. However, even simple financial products may not be suitable for all investors, depending on their risk profile.

We do not consider that the FSI has adequately tested and evaluated its recommendations in this area. The benefits of the proposal are described in the Final Report to be substantial but we do not consider that the Final Report adequately substantiates that.

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BLS

If despite our views it is proposed to introduce a product design obligation and a product innovation power in the Corporations Act we strongly submit that caution should be exercised in the development of the legislation, with the benefit of a proper review and analysis of past regulatory failures and detailed ongoing consultation with all stakeholders. Having regard to the profound policy shift that these changes would represent and their potential impact on the Australian regulatory regime the BLS submits any regulatory change should be implemented with the utmost care. The proposed reforms set out in the Final Report are some of the most dramatic and significant proposals for reforming the financial services sector for some time.

The BLS is concerned that there has not yet been enough research and evaluation of a proposed product design initiative and outcome as suggested in Chapter 4 of the Final Report. The fact that a similar system is operating in the United Kingdom, whilst interesting, and clearly something to be considered, should be just one of a number of matters that should be assessed.

Reference is made in the Final Report that the availability of these provisions at the time may have assisted in mitigating the consumer detriment caused by the failure of agribusiness schemes and financial collapses such as Storm Financial and Opes Prime. We strongly encourage government to undertake a careful review of those case studies to assess how behavioural biases may have influenced investors and regulators at the time, how the obligations and powers that are proposed may have mitigated loss and to assess what features that these recommended obligations and powers should consequently have. Having regard to its remit the FSI could not undertake work of this nature.

In addition, we note that enforcement and damage recovery proceedings have not concluded in relation to all of these collapses. We believe it would be useful to defer final design of any legislation until there is a fuller resolution of these proceedings (including the action commenced against ASIC arising from the Storm Financial collapse).

The Final Report makes a number of observations concerning safeguards that are not fleshed out In any detail (judicial review mechanism, consultation with other regulators, engagement with affected parties, post implementation reviews, formal review after 5 years, etc). It would be very important that the safeguards are fully developed with appropriate consultation so as to ensure that the power has the limited role that is suggested.

One area where we believe that it would be desirable for further debate is the question of what body should exercise such a power. Giving the power to ASIC to act as investigator, prosecutor, judge and jury is problematic as a matter of policy, as has proven to be the case in other contexts (e.g takeovers and the development of an independent Takeovers Panel). We submit that serious consideration be given to the establishment of an independent body if this proposal is pursued.

As always, the BLS would be keen to assist and work with government on these issues if it chooses to proceed with regulatory reform in these areas.

Chapter 5: Regulatory tools – ASIC sanctions

The Final Report comments on the scope of ASIC enforcement powers and the quantum of maximum penalties (Recommendation 29).

As noted in the Final Report we supported ASIC's submission seeking an increase in maximum penalties.

In that regard:

- We agree with the comment in the Final Report that Australia should not introduce the extremely high penalties for financial firms recently seen in some overseas jurisdictions.

- We agree with the observation in the Final Report that stronger enforcement of the current framework can reduce demands for more rules and regulations. In that regard we agree with many of the observations of the 2014 Senate Economics Reference Committee Report concerning reforms that ASIC should introduce into its operations to improve its enforcement record.

Again we submit that government should exercise care in developing any new legislation in this area, including undertaking a proper study of the background and features of the financial collapses of recent years and assessment of the lessons learned from the final result of the proceedings that have commenced following those collapses. Any increase in sanctions, and other initiatives linked to the recommendation on penalties needs to be carefully assessed.

Appendix 1: Significant matters – Simple bonds

The Final Report recommends (recommendation 33) reduced disclosure requirements for large listed corporates issuing simple bonds and the development of standard terms for simple bonds.

The BLS strongly supports this recommendation. Legislative action to make retail issuance competitive with wholesale issuance for ASX 150 companies would increase investor choice and improve market efficiency.

Appendix 1: Significant Matters – MIS regulation

The Final Report picks up on the work done by the Corporations and Markets Advisory Committee (**CAMAC**) on the regulation of managed investment schemes (**MIS**) in 2012 and 2014. In Recommendation 42, the FSI supports the Government's review of the CAMAC recommendations on MIS, giving priority to matters relating to:

- Consumer detriment, including illiquid schemes and freezing of funds; and
- Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.

The BLS strongly encourages the Government to continue to progress the work done by CAMAC in the area of MIS regulation. It is particularly important that this remains a priority if the proposed legislation to abolish CAMAC is passed by the Senate.

While some of CAMAC's recommendations are far-reaching and raise complex tax considerations, there are several reforms that could practicably be implemented within the existing framework, to strengthen the sector and reduce the risk of consumer detriment arising from the legal design (as distinct from the investment performance) of MIS. Also, reform could better integrate the Australian managed investment sector with global CIS markets, improving export prospects and increasing competition for funds management services here in Australia.

These include:

- Limiting the circumstances in which ASIC must register an MIS under Chapter 5C, so that MIS can no longer be used as vehicles for entrepreneurial activities rather than as passive investment vehicles. This would involve legislation to prohibit the creation of new 'common enterprise' schemes (see CAMAC, July 2012, 11). Post-GFC experience in the agribusiness sector demonstrated that the legal structure of a registered MIS is not adequate to resolve the respective rights and entitlements of investors and financiers in situations where the scheme involves trading activities as distinct from passive investment in financial instruments or real property. Trading enterprises should be carried on by companies;

- Tightening the rules relating to redemptions, so that only MIS whose investments are truly liquid can offer redemption facilities on an ongoing basis. The problem with 'frozen funds' was that MIS with underlying investments that were illiquid (for example, loans made to property developers) were permitted by the legislation to offer investors the opportunity to redeem their investments at short notice (see CAMAC, March 2014, 132-3); and

- Allowing for MIS that are structured to conform to the regulatory requirements of appropriate transnational 'passport' regimes, such as UCITS, to register under Chapter 5C without having to change their structure to meet our jurisdiction-specific requirements. An additional alternative form of investment structure may enhance access by the Australian funds industry to foreign markets and offer more product choice for Australian investors. A structure that is modelled on an established and globally recognised structure (such as UCITS funds with their specific investor protection features) may attract investors that prefer highly regulated investments and enhance the ability of industry to compete for fund-related business from foreign investors (see CAMAC, March 2014, 210-211).

The Final Report also includes Recommendation 43 to 'introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors'.

The BLS strongly supports this recommendation. This would involve the Government finalising and implementing the work done with industry between 2007 and 2010 on a mechanism to facilitate the rationalisation of genuine legacy products (that is, not simply those that are performing poorly), subject to a 'no disadvantage test' for relevant consumers. The mechanism included providing tax relief to ensure consumers were not disadvantaged as a result of triggering an early capital gains tax event. Like the FSI, the BLS sees significant benefit in adopting such a mechanism to improve efficiency and consumer outcomes.

If you have any questions regarding the submission, in the first instance please contact the Chair of the Corporations Committee, Bruce Cowley, on 07-3119 623 or via email: bruce.cowley@minterellison.com.

Yours sincerely,

John Keeves, Chairman
Business Law Section