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By online submission form

Dear Secretariat

Review of Your Future, Your Super Measures Consultation Paper

1 Introduction

This submission is made by Herbert Smith Freehills (**HSF**) in response to the Review of Your Future, Your Super Measures (the **Review**) consultation paper *Quality of Advice Review – Proposals for Reform* (**Consultation Paper**), which was open for consultation on 7 September 2022.

HSF is an international law firm with 25 offices located around the globe and which specialises in, amongst other things, superannuation and financial services regulation. HSF has significant experience in advising clients on the impact of the Your Future Your Super (**YFYS**) reforms and the impact of the annual performance assessment (**APA**).

2 Executive summary

Given our role as legal advisers, we have limited our response to addressing only those consultation questions which, in our view, give rise to specific legal issues. In summary:

(a) We consider the measures to resolve underperformance are overly prescriptive in the context of MySuper products and not 'fit for purpose' in the context of Trustee Directed Products (**TDPs**). We submit that APRA should be given discretion to alter the lookback period where APRA considers it appropriate to do so - e.g. where the Trustee has taken steps to resolve historical underperformance concerns to APRA's satisfaction.

(b) We see significant issues when extending the APA to trustee directed products (**TDPs**). In our view, the definition of what is and is not a TDP is unclear as currently drafted and challenging to apply in practice. We recommend amending the definition of a TDP so that it clearly applies at an investment option level rather than at the product level.

(c) We also see conceptual issues with extending the APA to TDPs due to the nature of TDPs as choice products. Given a member has made an active decision to hold a TDP, investment performance may not be the sole justification for acquiring the product (e.g. for insurance cover, or as part of a broader advised strategy). We recommend requiring publication of the results of the APA for TDPs, but not requiring trustees to close a TDP as a result of failing the APA.

(d) We consider the reversal of the onus of proof imposes an undue burden on trustees and is disproportionate to the potential harm of not complying with the best financial interests duty (**BFID**). Traditionally, reversing the burden of proof has been reserved for matters of national security and counter-terrorism legislation, where the burden of the reversal of onus of proof is justified by the benefit of maintaining national security. We recommend reverting this change so that the ordinary presumption of innocence should apply.

We expand on each of these points in more detail below.

3 Question 7: Are the measures in place to resolve underperformance sufficient given the potential for members to be stapled to these products? Are there ways this could be improved?

The APA currently operates with a "one size fits all" response to underperformance, and the consequences that follow. This approach, in our view, can result in undesirable outcomes. In particular, we are concerned that the current formulation of the APA can result in products which have performed well for an extended period being forced to close as a result of historical underperformance issues that have since been addressed.

We are aware of numerous examples of trustees who have, in response to historical underperformance issues, undertaken significant work to address those issues, such as by overhauling their investment strategy, appointing entirely new asset consultants or investment managers or lowering investment or administration fees.

In many of these circumstances, modelling suggests that the investment option is likely to perform well in the longer term as a result of these changes but is equally likely to fail the APA in future given the length of the lookback period.

In our view, it would not be in the best financial interests of members to require a product to close due to historical underperformance issues where the root cause of historical investment underperformance has clearly been addressed. Equally, we submit that it would be detrimental to members invested in such a product to require that trustee notify its members that their product has failed the APA, given that the evidence to date suggests that issuing such a notice leads to significant and rapid member attrition.

To resolve this issue, we recommend further amending the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) to provide APRA with discretion to vary the length of the lookback period where it considers it reasonably appropriate to do so.

In our view, where a trustee has implemented sufficient reforms to resolve the causes of past underperformance, APRA should have the power to exclude that historical performance from consideration under the APA. This is because that underperformance is no longer relevant to members, given that the root causes of underperformance have been addressed to APRA's satisfaction.

We also note that the APA creates distorted outcomes where a trustee chooses to increase administration fees during the lookback period. We are aware, for example, of some trustees who have sought to increase fees in recent years to enable them to adopt a less conservative investment strategy and pursue improved returns for members. Those trustees are unfairly punished under the APA because those higher fees are treated as having applied for the entire lookback period. This means members might be notified of underperformance and encouraged to roll their super over to an alternative product when, in fact, their product has not historically underperformed at all, when measured relative to the fees that the member actually paid over the lookback period.

4 Question 8: Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?

Definition of a Trustee Directed Product

In our view, the definition of what constitutes a TDP under regulation 9AB.2 of the *Superannuation Industry (Supervision) Regulations 1993* (**SIS Regs**) is confused and overly complex. We recommend that this definition be revised as a matter of priority before expanding the APA, so it is clear to trustees which products are in scope for being TDPs.

Our primary concern is that the definition of a TDP conflates the concept of a "class of beneficial interest" with an "investment option". APRA has publicly stated in FAQs that the test is intended to apply at the investment option level, however this does not reflect the wording used in the SIS Regulations.[1]

[1] https://www.apra.gov.au/your-future-your-super-frequently-asked-questions.

In particular, the SIS Regulations define a TDP by reference to a "class of beneficial interest" in the fund. This is a nebulous term that is contingent on the individual drafting of the relevant trust deed.

We recommend amending the definition of a TDP to remove references to a class of beneficial interest, and to clarify that it applies at an investment option level.

In our view, there are a range of other technical issues with the definition of 'trustee directed product'. For example, at a conceptual level it appears that the intention of the legislation is that 'platform' style investments be exlcluded from the regime on the basis that the trustee does not direct the investment strategy for such options. However, the exemption in SIS Regulation 9AB.2(7) only applies where the entity that is managing the investment is not a related party to the trustee, meaning that some platform options are caught under the APA when offered by one trustee but the same option is not an APA when offered by another trustee. This, in our view, results in unintended consequences and may lead to platform operators feeling the need to restructure their investments so that the exemption applies at it appears intended to operate.

Further, the consequences of failing the APA do not appear to us to be 'fit for purpose' which considered in the context of a TDP. In most cases, trustees have broad power under their trust deeds to open new or replacement investment options and to move members as between investment options without requiring the member's express consent. Theoretically, if a TDP was to fail the APA, a trustee could be expected to be able to easily open a replacement investment option, and then move all affected members to that replacement investment option without needing to obtain the consent of the affected members.

We recommend changing the consequences of an TDP failing the APA twice so that there is no requirement to close the TDP. Rather, we submit that a trustee should be required to send a notice to members with modified content, to reflect the product is a choice product, as we set out later in our submission.

Appropriateness of the APA for choice products

We also consider that extending the APA to TDPs will have adverse consequences for members, as members may have chosen to acquire a product for reasons other than investment performance. For example, it is not uncommon for members of a superannuation fund to retain a minor interest in a superannuation fund solely to enable the member to retain the benefit of insurance cover they receive through the fund. Other considerations such as faith-based investment products and environmental, social or governance (**ESG**) considerations may also be relevant to the member's investment decision.

For example, a member who chooses to open a self-managed super fund may retain a small interest in their existing super fund to maintain their insurance cover. In this scenario, the investment performance of their existing fund is not a primary consideration for that member. If their existing fund failed the APA, that member would receive a mandatory notice telling them to switch superannuation funds. A member who acted on the recommendation of this notice could experience significant harm, as they would lose their existing insurance cover, for no material benefit (a change in investment performance may be negligible in this example given their small balance in the fund).

Despite the issues above, we see merit in applying the APA to investment options in which a trustee has control over the investment strategy for the option. One method to preserve the policy intent while mitigating potential harm would be to remove the requirement for TDPs to close after two consecutive fails of the APA and modify the prescribed notice to members for underperformance so that it is 'fit for purpose'.

As noted above, we submit that legislating for the closure of a TDP is problematic, given members have made an active decision to join that product. Further, such a consequence may be ineffective in practice given that a trustee would typically have the power to simply open a new replacement investment option and to move members to that new option unilaterally. Keeping the notice to members requirement preserves the intention that underperformance has consequences, however this notice should clarify

that the test has only assessed investment performance, and there may be other reasons to hold a choice product such as insurance or ESG considerations.

5 Question 9: What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

In response to the retirement income covenant superannuation trustees are developing novel retirement products with highly bespoke characteristics. These products inherently target a broad market and are often highly customisable by members to align with their retirement goals (e.g. different drawdown rates and income requirements between members at different stages of requirements). Attempting to include retirement products in the APA is problematic due to a lack of comparability between products available in the market and given the nascent market for these products. In addition, these products are often obtained as a result of receiving personal advice due to their complex and customisable nature. Where a customer has already obtained advice, an APA notification may cut across the advice strategy recommended to the client. We recommend not expanding the APA to include retirement products at this point in time.

Including single sector options in the APA is technically feasible, subject to our comments above regarding the inappropriateness of mandating the closure of TDPs. However, further to our comments above, requiring a trustee to close a single sector investment option may have unintended consequences as it may result in a member being unable to obtain an appropriate level of diversification through the range of single sector options offered through a fund. This is contrary to member interests and would require the member to either move away from investing through single sector options or to invest through multiple superannuation funds (and, therefore, incur additional fees) in order to get exposure to the full range of single sector options which may be necessary to meet the member's needs. We note this issue would be resolved if the requirement to close choice products as a result of failing the APA were removed, as suggested above.

6 Question 19: Is the reverse onus of proof the most appropriate way to achieve the objective of improving member outcomes?

We consider the reverse onus of proof is not the most appropriate way to achieve the objective of improving member outcomes. Reversing the onus of proof places a significant burden on superannuation trustees by reversing the legal presumption of innocence, requiring trustees to provide evidence that a decision was in the best financial interests of beneficiaries. There is an existing precedent for reversing the burden of proof in the Australian legal system, however the starting point is that it should be avoided unless there is a compelling justification for the reversal. Various justifications have been put forward for why the burden of proof should be reversed for certain offences, we set out these justifications, and why they would not apply to the BFID as below:

(a) **Proportionality**: One of the accepted justifications for reversing the burden of proof is proportionality, where the burden on the person affected is proportionate to the benefit gained in pursuing the objective of the legislation.

For example, in national security and counter terrorism legislation, the reversal can be seen as proportionate due to the benefit provided to the state in preserving national security.[2] We submit that the same considerations do not apply in the actions of a superannuation trustee. In our view, the burden imposed on trustees by the reversal of the onus of proof is not proportionate to the benefit gained by doing so, and is not comparable to the benefit gained by preserving the national security of Australia.

(b) **Seriousness of the offence:** Another potential justification that is offered for reversing the burden of proof is the seriousness of the offence. For low level offences, the degree of injustice due to a potential wrongful conviction through the reversal of the burden of proof is mitigated due to the less serious consequences for wrongful conviction. For example, certain traffic offences

[2] *AG Ref 04/2002,* [2004] UKHL 43, [50], [71].

have been accepted to justify a reversal of the onus of proof due to the low level nature of the offence.[3]

In our view, the consequences in the SIS Act for a breach of the BFID cannot be described as anything other than serious. The BFID contained in s52 of the SIS Act is a civil penalty provision and provides for civil and criminal consequences for superannuation trustees.[4] Civil consequences may arise from an act or omission resulting in the contravention of the BFID, regardless of whether or not the act or omission was intentional. Criminal consequences require proof of dishonesty or intention in relation to the BFID and currently the criminal penalty for contravention of the BFID is up to 5 years imprisonment.[5] The injustice of a wrongful penalty being imposed on a superannuation trustee is not mitigated by the low level nature of the offence. The seriousness of the offending is not a justification for reversing the burden of proof.

(c) **Difficulty of proof**: Another factor a Court will consider in determining whether a reversal of the burden of proof is justified is the degree of difficulty faced by a prosecutor in proving the defendant's guilt in criminal matters, relative to the defendant. Where a defendant faces little difficulty in proving their own innocence, or where the burden on the prosecution is beyond an ordinary criminal standard, a proof imbalance can exist which may justify a reversal of the burden of proof.

Assessing whether a trustee has complied with BFID is inherently difficult for both a trustee and a regulator seeking to prove the opposite. While this is challenging on both parties, there is no substantial proof imbalance between the parties which, in our view, provides reasonable justification for a reversal of the burden of proof.

In summary, the starting point in assessing a reversal of the burden of proof is that is an imposition on the legal presumption of innocence and should be avoided. However, there can be factors to justify reversing the burden, such as proportionality and seriousness as above. In our view, none of these factors are made out in relation to the BFID, and so the reversal of the burden of proof is not justified. We recommend this reversal of the burden of proof be removed through legislative amendment, and the ordinary legal evidentiary burden should apply.

7 Conclusion

Thank you for providing us the opportunity to comment on the Consultation Paper. If you would like to discuss the matters raised in this submission, please contact one of the superannuation partners at the details below.

Yours sincerely

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[3] *Sheldrake v Director of Public Prosecutions* [2004] UKHL 43

[4] *Superannuation Industry (Supervision) Act 1993* s54B(3).

[5] Ibid s202(1).