

20 October 2017

Insurance in Super Working Group (ISWG)
Project Management Office

By email: ISWG-PMO@kpmg.com.au

Dear Sir/Madam

ISWG Consultation: Draft Insurance in Superannuation Code of Practice

Thank you for the opportunity to make a submission in relation to the ISWG Consultation: Draft Insurance in Superannuation Code of Practice.

Please find attached the Law Council of Australia's submission in relation to the KPMG's ISWG Consultation: Draft Insurance in Superannuation Code of Practice which was prepared by the Superannuation Committee which is part of the Law Council's Legal Practice Section.

The Law Council would welcome the opportunity to discuss the submission further. In the first instance, please contact: Mr Luke Barrett, Chair, Superannuation Committee T: 03 8831 6145 E: luke.barrett@unisuper.com.au.

Yours sincerely



Jonathan Smithers
Chief Executive Officer



Law Council
OF AUSTRALIA

ISWG Consultation: Draft Insurance in Superannuation Code of Practice

Insurance in Super Working Group (ISWG)

20 October 2017

Telephone +61 2 6246 3788 • *Fax* +61 2 6248 0639
Email mail@lawcouncil.asn.au
GPO Box 1989, Canberra ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612
Law Council of Australia Limited ABN 85 005 260 622
www.lawcouncil.asn.au

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About 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 Law Firms Australia, 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
- Law Firms Australia
- 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 2017 Executive as at 1 January 2017 are:

- Ms Fiona McLeod SC, President
- Mr Morry Bailes, President-Elect
- Mr Arthur Moses SC, Treasurer
- Ms Pauline Wright, Executive Member
- Mr Konrad de Kerloy, Executive Member
- Mr Geoff Bowyer, Executive Member

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

Acknowledgement

The Law Council is grateful for the assistance of the Superannuation Law Committee (**the Committee**) of the Legal Practice Section in the preparation of this submission.

The Committee's objectives are to ensure that the law relating to superannuation in Australia is sound, equitable and 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.

Executive Summary

- As a fundamental threshold point, a superannuation trustee (**trustee**) cannot agree to be bound to the draft Code because this is inconsistent with its trustee duties and decision-making obligations at law.
- The Code should include a full “compliance with law” clause and expressly permit trustees to act consistently with their duties at law (e.g., to act in members' best interests), even where this is inconsistent with the draft Code.
- The regulatory-like system of governance outlined in the Code is inappropriate for trustees, and trustees should not be subject to the sanction of a code administrator.
- There is a significant lack of clarity about the interaction of the Code with existing law, including the role of APRA.
- As an alternative to a binding Code a more complete solution is that the Code represents best practice and industry guidance. The importance of the Code in setting industry best practice and industry benchmarks should not be overlooked. Industry benchmarks are an important factor in a trustee’s decision-making process.
- For the draft Code to have binding effect on trustees, a legislative solution is required (although this too would require significant amendment to the draft Code).

Binding Superannuation Trustees and Compliance with Law

The Committee consider that:

It is of the view that trustees cannot, consistent with trustee duties and covenants, voluntarily agree to be bound by the draft Code in its current form.

Trustees may (subject to the additional concerns re governance outlined below) be in a position to voluntarily agree to be bound by the draft Code if the Code included a specific carve out to recognise that any of its terms are subject to law and specifically a trustee's duty to make decisions in the best interests of its members. The Committee is of the view that the proposed "Status of Law" paragraphs are insufficient for this purpose. Consideration would also need to be given to the concerns raised in the remainder of this submission.

Other than adopting this approach, the Committee is of the view that binding trustees is only possible via legislative intervention. Even in this situation, the Code, and its obligations, would need to sit consistently with existing law (unless existing law is also amended).

Detailed Concerns

1. The nature of a trustee's role, and its obligations under trust law and the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**), dictates that a superannuation trustee cannot voluntarily be bound by the Code.
2. Central to a trustee's role is its fiduciary obligation to hold and manage the assets of the fund for the benefit of members and beneficiaries. It is fundamental that a trustee in making decisions regarding the fund has a duty to act in the best interests of members. This duty is also extended directly and personally to directors of a corporate trustee.
3. Trustees must exercise this duty and administer superannuation trusts "personally" and cannot "fetter" their discretion and decision-making ability. In trust law this is called the duty not to fetter discretion. This is also encapsulated in the trustee covenants in the SIS Act where it is stated that a trustee must:¹

not enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising the trustee's functions and powers

4. Both the trust law duty and the SIS Act mean that a trustee must not permit or agree to be directed in their decision making or have the scope of future decision making limited in some way unless the relevant trust deed provides otherwise. To do so is a breach of trust and also means that a trustee is unable to fulfil its decision-making responsibilities.
5. To agree to the draft Code trustees would be specifically limiting decisions around the scope of insurance design and terms and conditions of insurance (with the primary

¹ SIS Act s 52(2)(h). Directors of a corporate trustee must similarly not enter into a contract, or do anything else, that would ... prevent the corporate trustee from, or hinder the corporate trustee in, properly performing or exercising the corporate trustee's functions and powers as trustee of the entity: SIS Act s 52A(e)(ii).

reason being that those limits are in the Code). Even if a trustee could conclude that the limits contemplated by the Code are in the best interests of members “today” (which for the reasons given below would be difficult), it does not follow that this will always be the case in the future. This can only be determined by a consideration of the interests of beneficiaries at that relevant time. Trustees can only make that determination by exercising their conscientious judgement at that relevant time.

6. Critical to a trustee exercising decision making power appropriately is the need to consider all relevant factors, both for and against a proposal, having regard to the nature of the fund and the demographic composition of the members. Added to this, trustees must also specifically have regard for the factors listed in the insurance covenant in the SIS Act² and in SPS 250 Insurance in Superannuation.³ For example, if a trustee is considering proposed changes to a fund’s insurance design (whether including limits on, or different levels of, insurance offered or new terms and conditions for a policy of insurance) the trustee would need to consider factors relating to:
 - the nature and demographics of the affected members or class of members;
 - any advantages or detriments (such as exclusions, reducing existing cover or making eligibility more onerous, or cessation of cover);
 - the relevance of any special characteristics of a class of members;
 - the premium cost (and any potential changes to premium cost);
 - whether the cost of insurance inappropriately erodes the retirement income of beneficiaries;
 - any fairness impacts between different classes of members (particularly where terms and conditions are changed or potential benefits are reduced); and
 - any impact on the fund as a whole.
7. This will often be supported by external evidence or advice (for example consulting advice on the premiums and how the proposed terms and conditions sit comparatively in the market).
8. Given the range of the factors that a trustee must consider in its decision making, and that these factors need to be assessed and considered at the time the decision must be made (either now or in the future), a trustee cannot consistent with its duties agree to be bound by the draft Code and the contemplated limits and caps. These matters must be considered against all relevant factors, and the impacts must be considered for the members (both the members affected, and also any impacts on all the members of the fund) each time a proposal or change is proposed to the trustee board.
9. For these same reasons, the Committee is also of the view that trustees cannot agree to a system of subjecting itself to the sanction of a code administrator. The effect of para 4.10 of the draft Code is that trustees can only commit to providing automatic cover with premiums that exceed 1% of an earnings cap if it can satisfy the code administrator of certain factors. If a trustee, appropriately exercising its discretion, has determined that such premiums are appropriate (having regard to the particular class of members), seeking sanction of a code administrator is a breach of its duty to exercise its powers personally and not fetter its discretion. The trustee is permitting itself to be directed by the code administrator. Added to this, if the code administrator

² SIS Act s 52(7).

³ See SPS 250 Insurance in Superannuation, paras 17-19.

(which has no liability to the relevant members) takes a different view to the trustee and insists on Code compliance, the trustee (and its directors) are left in an untenable position that is not solved by the proposed “status of law” clause in para 3.15 (discussed further below).

10. The Committee has a further concern about a trustee’s ability to agree to a ‘resettling’ of an existing insurance design to comply with the proposed Code. Where terms and conditions are long standing, (and potentially relied upon by beneficiaries), a change for the purpose of complying with the Code (rather than a change relating specifically to the affected class of members, the characteristics of those members, and the nature of the insurance cover held) is problematic and carries a strong risk of decision making on the basis of irrelevant factors.
11. For example, take a scenario where an insurance design automatically defaults members to smoker status (which is common in legacy plans), and the trustee considers changing this default (consistently with the Code) or wishes to implement a member engagement strategy to actively request members to identify their true status. If after discussions with the insurer the effect of this change would be to increase premiums across the whole legacy plan, the trustee is in a difficult position. A “best interests” decision may require a different outcome to the proposed Code in this instance.

Carve Out?

12. Subject to the further concerns set out below, it may be possible for a trustee to agree to the Code if there is a clear preservation of trustee’s decision-making rights. This could be achieved by a clear carve out acknowledging that trustees must comply with the law, which specifically includes acting in the best interests of members (whether or not that is consistent with the Code).
13. The Code currently includes a modified “compliance with law” clause in paragraphs 3.14 and 3.15 (termed “status of law”). In the Committee’s view, these paragraphs are not sufficient to permit a trustee to act consistently with its duties at law, or encapsulate the carve-out proposed above.
 - **Paragraph 3.14:** The intention of this paragraph appears to be to confirm to members that their rights under law are not altered in any way, and any rights in the Code apply in addition to rights at law. It does not, in the Committee’s view, confirm or contemplate that trustees should comply with law, including acting in the best interests of members.
 - **Paragraph 3.15:** the effect of this paragraph is to require that where a standard imposed by the Code is “higher” than the law, that trustees will apply the “higher” standard and comply with the law and the Code. In the Committee’s view the effect of this clause is very unclear. Presumably the introduction of any limit or cap is a more stringent standard than the “law”, and so compliance is required with such “higher standards”. However, the concept of “higher standards” carries an assumption that the limits and caps included in the proposed Code “will always be better” for members. This simply reinforces the difficulty identified above that this type of Code obligation is inconsistent with a trustee’s decision-making obligations. If a trustee (properly exercising its discretion and considering all relevant factors) determines that a certain insurance design (that is inconsistent with the Code) is in the best interests of the members - it is nonsensical to argue that the Code has “higher standards”. The question is not whether the Code obligations are “higher standards” but whether Code

obligations are appropriate given the nature of the members and the fund. This decision can only be vested in the trustee.

14. It is acknowledged that a full “compliance with law” clause would effectively mean that the Code would have the status of industry guidance. However, it is important to note that industry practice and benchmarks are important factors for a trustee to consider. To the extent that there is evidence of industry best practice or benchmarks these factors should also be considered by a trustee. It should not be overlooked that there is significant value in standard setting and providing evidence of industry practice and thinking. This is particularly the case in areas such as “erosion” where there is currently no accepted industry “wisdom”.

Structure of the draft Code should contemplate existing law

15. In summary the Committee is strongly of the view that trustees cannot, consistent with trust law and the SIS Act trustee covenants, voluntarily agree to be bound by the proposed Code.
16. Binding trustees is only possible via legislative intervention. Even in this situation, the Code, and its obligations, would need to sit consistently with existing law. Currently there is a lack of clarity about the interaction of the Code with existing law for matters such as the insurance covenant in the SIS Act (s 52(7)) and the accompanying prudential standards (SPS 250), the MySuper insurance obligations, and the Superannuation Guarantee obligations (re minimum requirements for death cover in MySuper products). Indeed, the intended role of APRA is also unclear (with a possible view being that the Code may be seen to oust the jurisdiction of APRA). Inconsistency and uncertainty in how Code obligations “fit into” existing law risks uncertain application, duplication and inconsistency.

Governance

The Committee consider that:

There are strong concerns regarding the governance aspects of the Draft Code (sections 14 and 15) and is of the view that:

- trustees cannot, consistently with their obligations at law agree to be bound by the governance aspects of the Code;
- the regulatory like nature of the Code is inappropriate in that it does not contain the required “checks and balances” that are implicit in a regulatory system, including recourse to a system of review;
- the intended “independence” of the code administrator is questionable; and
- the anticipated governance arrangements can only be appropriately implemented via a legislative means.

17. The Committee recognises the underlying intent of the Code is that industry is seeking to define standards for the purpose of self-regulation. To this end the governance aspects of the draft Code appear to create a regulator-like role for the code administrator. The draft Code imposes functions on the code administrator relating to

monitoring and compliance, breach reporting, investigations, imposition of sanction and reporting.

18. The full extent of the functions and powers are not yet apparent as these will be set out in a Charter (yet to be provided). While it is recognised that the draft Code is intended to follow the guidance in ASIC Regulatory Guide 183 (relating to the approval of Codes for financial services licensees) and lead to ASIC approval, that approval is premised on compliance of a draft Code with existing law. In this context the Committee raises the concerns that follow.

Trustees cannot agree to be bound

19. Consistent with the comments set out in the section above, the Committee is of the view that the nature of a trustee's role, and its duty to act personally and not be subject to the direction of another person or entity, means that a trustee cannot agree to be bound to the proposed governance aspects of the draft Code. The effect of the Code is that trustees are subject to direction by the code administrator in respect of determinations, sanctions and rectification. The Committee notes that the trustee role is fundamentally different to that of an insurer where the relationship with a customer is based on contract law. In this case an insurer is free (regulatory provision aside) to agree to be subject these types of governance arrangements.
20. If the nature of the governance arrangements in the draft Code were more akin to a dispute resolution process, where a trustee is agreeing to the resolution of a dispute via an independent party (the code administrator), then there would be scope for a trustee to agree to the arrangement. Trustees can consistently with their trust law obligations agree to settle disputes. While this is anticipated by the draft Code, the functions of the code administrator extend much further to investigation, determination and imposition of sanctions.
21. A further difficulty for trustees is that a code administrator is not judicial in nature and its determinations have no force in law. As a consequence, if a determination is made and a sanction imposed or rectification required, that determination or sanction may not strictly accord with the relevant trust deed or indeed be, in the trustee's view, in the best interests of beneficiaries. If so, the trustee is left in an untenable position regarding compliance with the Code, and compliance with its obligations at law.

Regulatory like nature

22. The regulatory like nature for the code administrator's functions and powers are of concern to the Committee. The imposition of powers to investigate, make determinations and impose sanctions requires legislative intervention. Where such powers are conferred on an individual or an entity by Parliament it is always in the context of there being a system of "checks and balances" on the exercise of power, and an ability to seek review. In addition to the scope of the powers of the code administrator not being defined with specificity, there is no appropriate system of checks and balances, and the ability to seek review of decisions contemplated.
23. Added to this, the draft Code contemplates that significant information would be communicated to the code administrator by trustees, including via breach reporting. The Committee strongly questions the appropriateness of trustees disclosing confidential information, and potentially personal information, in a non-regulatory setting where the usual concerns around provision of such information are in place. This is exacerbated by reporting of information to the Code Owners, including a failure

to remedy a Code breach by a trustee. This will likely result in confidential information regarding a fund being reported to other industry participants.

Independence?

24. The draft Code designates the code administrator as an independent body (para 14.1). The Committee questions the level of “independence” achieved where only 1 of the three representatives is intended to be independent. The process for appointing the representatives (to be set out in the Charter) will also impact on the assessment of independence.

Summary

25. Ultimately the Committee is of the view that the type of governance arrangements contemplated by the draft Code can only be achieved by legislative intervention, and in such case significant amendment would be required.

Contacts

The Committee would welcome the opportunity to discuss its submission further and to provide additional information in respect of the comments made above.

In the first instance, please contact:

- Mr Luke Barrett, Chair, Superannuation Committee T: 03 8831 6145 E: luke.barrett@unisuper.com.au.
- Dr Lisa Butler Beatty, Deputy Chair, Superannuation Committee T: 0477 753 941 E: BeattyLi@cba.com.au.