25 May 2021

Director
Retirement Income Policy Division
Treasury
Langton Cres
PARKES ACT 2600

Via email: superannuation@treasury.gov.au

Dear Sir/Madam

Re: Your Future, Your Super Regulations and associated measures

CPA Australia and Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ) welcome the opportunity to provide comments on the *Your Future, Your Super Regulations and associated measures* consultation.

CPA Australia and Chartered Accountants ANZ represent over 200,000 professional accountants in Australia and New Zealand. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

In this submission, we welcome the clarity provided by the exposure draft regulations to the *Treasury Laws Amendment (Your Future, Your Super) Bill 2021* (the "Bill"), presently before Parliament. However, we have significant reservations regarding a number of matters contained in this consultation, including:

- The absence of draft regulations in this consultation, which will be required to implement the proposed best financial interests duty measure contained in the Bill
- That the *Exposure Draft Regulations: Addressing Underperformance in Superannuation* contain significant shortcomings and require substantial amendment to be fit for purpose.
- While the *Exposure Draft Regulations: Improving Accountability and Member Outcomes* gives long-awaited effect to several legislated provisions awaiting regulations, the legislation's exclusion of non-associated entities could potentially leave a large void with respect to providing full transparency to fund members, and
- The *Exposure Draft Regulations: Single default account* do not address the situation where an employer could be penalised for making superannuation contributions in good faith to a fund which they have been advised by the Australian Taxation Office (ATO) is a stapled fund.

Our comments are contained in the attachment to this letter.

For further information in relation to our submission, please contact Richard Webb, Policy Advisor Financial Planning and Superannuation at CPA Australia at richard.webb@cpaaustralia.com.au or Tony Negline, Superannuation Leader at Chartered Accountants ANZ at Tony.Negline@charteredaccountantsanz.com .

Yours sincerely

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Attachment

Response to consultation

Executive summary

The exposure drafts in this consultation are required to implement the pending *Treasury Laws Amendment (Your Future, Your Super) Bill 2021* (the "Bill"), presently before Parliament. Additionally, draft regulations have been proposed which would finalise the portfolio holdings disclosure requirements and other matters, previously legislated.

CPA Australia and Chartered Accountants ANZ generally support the Bill, with the exception of the proposed best financial interests duty. However, we do have significant reservations in relation to various other matters.

In our joint submission to the Senate Economics Legislation Committee, CPA Australia and Chartered Accountants ANZ pointed out that due to the lack of consultation in relation to the regulations which would give effect to the Bill, it is very difficult to form an opinion in relation to various matters contained in the Bill. While we welcome the release of the exposure draft regulations in this consultative package, we consider that, for best results during parliamentary deliberations, these regulations should have been provided for consultation at an earlier date.

We also welcome the amendments to the performance test to include administration fees, noting that performance should ultimately reflect the member experience.

We note that the draft regulations clarify various provisions in the Bill, however we continue to have substantial reservations in relation to how the regulations will work.

In the following pages we highlight the absence, in this package, of draft regulations to give effect to the best financial interests duty proposed in the Bill. This is a measure which CPA Australia and Chartered Accountants ANZ do not support. Nevertheless, we note that in the interests of full transparency, the measures being considered need to be clarified, including the proposed power of the Treasurer to ban certain investments by trustees.

In relation to the exposure draft regulations forming part of this consultation themselves, we provide a number of recommendations.

Exposure Draft Regulations: Addressing Underperformance in Superannuation: We consider that the proposed regulations have significant shortcomings, and recommend that Treasury make the following amendments:

- Ensuring that single-sector and income stream investment options are performance tested
- Considering a future performance testing system for defined benefit products especially those which include an accumulation portion of their fund
- The weighted average method for performance testing lifecycle products is inappropriate and should be changed to a system which reflects the actual experience at a member's age
- Ensuring that trustees with products currently subject to a prohibition notice are required to disclose this information

- Seek a positive affirmation regarding performance from trustees prior to allowing prohibited products to accept new members, when lifting prohibitions, and
- Correcting the assumed taxation present in the performance test to ensure that an appropriate rate of taxation is factored in. In particular, tax credits such as dividend franking do not reduce tax payable, merely the timing of when that tax is paid.

Exposure Draft Regulations: Improving Accountability and Member Outcomes: We note that under portfolio holding disclosure the contents of investments held within non-associated entities will continue to be opaque until legislative change is undertaken to mandate full look through.

Exposure Draft Regulations: Single default account: We continue to have concerns that employers may be unfairly penalised, and we make the following recommendations:

- Employers should be deemed to have complied with the choice of fund requirements if they rely on representations made in error by the Commissioner in respect to notification of stapled fund details, especially if this occurs due to manual processes
- Employers should be deemed to have complied with the choice of fund requirements if they contribute to a default fund due to the employee having not chosen a fund and the ATO having not responded to a request for details of the employee's stapled fund
- Employers must be allowed to accept that stapled fund details provided by the Commissioner represents a complying fund for Superannuation Guarantee (SG) and tax deductibility purposes
- The ATO must confirm that all stapled funds are eligible to accept contributions from the new employer
- Consideration be given as to the appropriateness of accepting prohibited products as stapled funds, as well as remaining on the Super Fund Lookup, and
- An appropriate deferral to the commencement date for this measure be communicated to the Minister for immediate amendment to the Bill in Parliament, in the event that an automated solution to the measure is not ready for new employees joining an employer commencing after 30 June 2021.

Exposure Draft Regulations: Addressing Underperformance in Superannuation

The exposure draft regulations, *Treasury Laws Amendment (Your Future, Your Super - Addressing Underperformance in Superannuation) Regulations 2021* provides much needed clarity to the Bill.

CPA Australia and Chartered Accountants ANZ generally support the idea that products issued by superannuation trustees should be held to performance standards. However, this is a requirement which should not have wide areas carved out. While we understand that there are products such as self-managed superannuation funds which are unable to be compared meaningfully to any widely acceptable benchmark, there are a number of products widely available for which benchmarking should be a relatively straightforward exercise. We consider that the variety of reasons that have been offered to reduce the coverage of this measure are not plausible. Our comments follow.

1. Single sector products

CPA Australia and Chartered Accountants ANZ do not believe that the reasons given for the exclusion of single sector investment options or products are justified. The draft explanatory statement states that:

> *The amendments are also designed to exclude products that are single sector investment options, where the member selects a product that mainly has exposure to only one type of asset class. Single sector options are excluded because they are typically used in combination by a beneficiary in order to design their own bespoke diversified investment strategy. The amendments exclude single sector investment options by requiring a trustee-directed product to contain at least two asset classes, where the strategic asset allocation for each of those classes must exceed 10 per cent.*

Single-sector investment options typically contain two asset classes. In addition to the asset class for which the majority of exposure is being sought, the option will typically hold up to 10 per cent in cash. The definition in the final sentence of the text above makes it clear that, unless the strategic asset allocation of both asset classes in the investment option is greater than 10 per cent, the investment option is excluded from performance testing.

We note however, in the Explanatory Memorandum to the Bill, in the "General outline and financial impact" section, that the intention of the performance testing regime is to assess products where the trustee has control of the design and implementation of the investment strategy. Essentially, this means that the performance of proposed Part 6A *Superannuation Industry (Supervision) Act 1993* (the "SIS Act)" products are an assessment of how effectively the trustees have designed and implemented the investment strategy of investment products.

Consequently, the majority of single-sector investment options have been designed by trustees and implemented in accordance with an investment strategy which is subject to no other similar performance mechanism. The corollary of this exclusion is that there would be a mechanism to measure the performance of superannuation fund investment products which would be easily available for use to measure the performance of single-sector investment options, but not actually able to do so.

Furthermore, we note that the reasoning provided in the draft Explanatory Statement (page 5) in relation to the exclusion of single-sector investment options is that "they are typically used in combination by a beneficiary in order to design their own bespoke diversified investment strategy". This is also not strong reasoning, with multisector investment options also used routinely for assisting in creating bespoke investment portfolios by some investors; with other investors often using one single sector investment option to the exclusion of all others.

Finally, we note the comments in the draft explanatory statement that "[p]roducts where the only control the trustee has over the product is to either offer or not offer the product to members are excluded from the definition of a trustee-directed product." This is not a realistic summation of the product-offering process by trustees. Trustees are required to undertake extensive decision-making prior to making such products available, including the design and implementation of an investment strategy, adherence to the design and distribution obligations (including target market determinations) and ongoing compliance with members' best interests requirements.

The decision on whether to offer such a product is therefore never going to be the only control that trustees have over such products.

We believe that it would be wasteful and inefficient to build this infrastructure, leaving Australians who use single-sector options unprotected from underperformance. We strongly urge that single-sector products be subject to performance testing.

2. Income stream products

Income stream products are not covered by the exposure draft. The reasoning given for this in the draft Explanatory Statement is (page 5) is that: "These products have broader aims than accumulation products, which should primarily be focussed on investment performance."

This is not a strong argument, especially for account-based income streams and other similar products, since it is the members of a superannuation fund in these products who bear the investment risk.

Whilst we understand that the focus of the *Your Future Your Super* package of reforms is the accumulation phase of superannuation, it should be highlighted that the retirement phase is a growing part of the $3 trillion in investments currently held within superannuation funds. Similarly to members of defined contribution superannuation products in the accumulation phase, members of account-based income streams are heavily impacted by investment performance, with the greatest impact of sequencing risk likely to occur around retirement.

The impact of sequencing risk is likely to be accentuated by investment into poorly performing superannuation products, which affects longevity risk, as well as quality of life in retirement as retirees compensate for poor investment performance in early retirement by drawing less from income streams.

We also note that certain designs of non-account-based income stream products may be heavily subject to forms of investment risk themselves, either at the point of product commencement or later. These can include variable annuities and collective defined contribution products, and although these products are designed mainly to address longevity risk, such as income volatility risk or income yield risk, ultimately, it is either current or future investors who bear these costs. Although these are not able to be captured within the proposed performance testing regime as readily as account-based income stream products, we do not believe that performance testing of these products is any less important.

The extension of the performance regime into retirement income products would ensure that Australians who are retiring are better protected from poor performing investment options in retirement, particularly at the point of retirement, where amounts being invested are larger, and potential costs of underperformance are greatest. It would also ensure that investment switches into prohibited products are unavailable. Finally, it would ensure that the perverse outcome of a product being prohibited in the accumulation phase but open to members where it is mirrored in the retirement phase, is not able to occur.

We strongly recommend that the definition of Part 6A products include products in the drawdown phase, in addition to the accumulation phase.

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3. Defined benefit products

The proposed performance test does not capture defined benefit products. This is understandable, since the majority of Australians invest in superannuation through defined contribution superannuation products, and it is these for which the test is designed.

Nevertheless, defined benefit superannuation arrangements should be subject to some form of performance testing, since investment underperformance of fully or partially-funded defined benefit arrangements is a cost to members.

In particular, we are aware of non-underwritten, fully funded, defined benefit arrangements where the multiplying factor can potentially be varied depending on the investment performance of the fund, making it conceptually similar to a crediting rate. We fail to understand why the value being obtained by trustees from the implementation of their investment strategy is not being assessed in the same way that a defined contribution product would be.

We also note that in a large number of workplaces, defined benefit products are offered alongside choice of fund. It is also difficult to understand why employees in such workplaces would be forced to choose between products which have been tested, and a defined benefit product which has not.

We note that many defined benefit funds often have a range of investment options for compulsory and voluntary member contributions where the member bears the investment risk.

We believe that consideration must be given to the rating of the performance of defined benefit products, particularly where these products are not underwritten.

4. Lifecycle (glidepath) products

The weighted average approach to lifecycle products and their benchmarks is, in our opinion, flawed. The methodology proposed in the draft regulations suggests that a meaningful return can be calculated by weighting each stage of a glidepath by asset totals, meaning that it does not matter at which age one joins the product, since the product is going to be considered exactly the same way in all instances.

In other words, for an example involving two different investors aged 25 and 55 who may be considering investment in such a product, the performance test will provide precisely the same results, regardless of the fact that the actual investment experience of such investors is necessarily different by design. This means that there is likely to be a high probability of type I and type II errors in respect to the product's underperformance: A product which performs for a specific age cohort may be subject to prohibition, while at the same time another may be underperforming for an age cohort to whom it is open.

CPA Australia and Chartered Accountants ANZ believe that a better method would see tailored 8-year periods across different age cohorts, with prohibitions applying to new members at ages where the products fails testing. We do not believe that this would be onerous to implement.

5. Prohibition notices

CPA Australia and Chartered Accountants ANZ welcome the requirement in proposed new paragraph 2.38(2)(ea) of *the Superannuation Industry (Supervision) Regulations 1993* to make public a notice of where a product has failed the performance test. However, it is not clear why there is no similar requirement for funds to make public the details of any prohibited products. We strongly recommend that, in the interests of transparency, this be made a requirement.

6. Lifting prohibitions

The single proposed criterion which would allow the Australian Prudential Regulation Authority (APRA) to lift a prohibition on a product merely requires the product - where the product is still held by existing members - to pass the annual performance test in a subsequent year.

CPA Australia and Chartered Accountants ANZ believe that this is not a sufficiently robust process and that an affirmation should be sought by APRA from trustees regarding their confidence in the likelihood that the product will not fail the performance test again in the near future. Such an affirmation should be supported by reasonable risk analysis, and the assumptions and methodology used should be made available to APRA, who should have the right to query the analysis.

Ultimately, the provision of a product to the market should be a privilege, rather than a right. It is important that the performance test regime respect this point.

7. Assumed taxation

The regulations clarify at proposed regulation 9AB.17 the assumed rates of tax that are to apply for the underperformance test. However, we are concerned that the rates which are assumed are not realistic. As an example, we note that item 1 in the table at 9AB.17(7) suggests that the assumed rate of tax for the benchmark index proposed to be used for Australian equities is to be zero.

This assumption may be correct if the benchmark to be used is providing a comparison on a pre-tax basis. However, the intention of the performance test is to provide a representative benchmark after fees and taxes. This is recognised where some of the other asset classes assume a 15 per cent, or very close to 15 per cent tax rate, however, the presence of imputation credits does not necessarily mean that 0 per cent tax can be assumed in all instances. That is, it is not necessarily correct to assume that all returns from dividends are fully (or even partially) franked, and returns posted by superannuation funds on their Australian equities portfolio will also include both realised and unrealised capital gains.

Further, franking credits do not alter an investors actual tax rate. They merely change the timing of when that tax is paid.

We would be pleased to liaise with Treasury on this matter to ensure that there is a complete understanding of the issues.

Exposure Draft Regulations: Improving Accountability and Member Outcomes

The exposure draft regulations, *Treasury Laws Amendment (Your Future, Your Super-Improving accountability and member outcomes) Regulations 2021*, implement the much-awaited portfolio holdings disclosure transparency measure, which will enable members of superannuation funds to establish the assets in which their fund invests. This measure is presently subject to regulatory relief until the end of December 2021, and it is these regulations which we believe will provide the certainty to enable portfolio holdings disclosure to finally come into effect.

The draft regulations also support measures, legislated at the same time as the portfolio holdings disclosure requirements, for superannuation funds to hold annual members' meetings, and a prohibition on the use of goods or services by a trustee to influence an employer's decision to nominate a fund as their workplace's default fund.

The mechanism by which the disclosure will look through the structure of the fund ensures that trustees and associated entities of the Registrable Superannuation Entity (RSE) must make available all investments made by or on behalf of RSEs and their associated entities.

We note however, that this measure is flawed in one respect: The enabling legislation does not require look through below the first non-associated entity which is invested in by RSEs or associates. What this means is that where a fund invests in investment entities such as publicly available trusts, exchange traded funds (ETFs), listed investment companies (LICs) or other arrangements where there is no control by the RSE or associated entities, the holdings of these entities will not be available to fund members.

We have concerns that these arrangements could easily be gamed to evade scrutiny. Finally, we welcome the Bill's inclusion of a measure to repeal the 5 per cent minimum holdings exemption from the portfolio holdings but note that until trustees are required to look through non-associated entities, there will continue to be an opaque view of assets held within these vehicles.

Exposure Draft Regulations: Single default account

The exposure draft regulations, *Treasury Laws Amendment (Single Default Account) Regulations 2021* support the measures proposed in the Bill to implement stapled funds. CPA Australia and Chartered Accountants ANZ support this measure, which will remove new employee commencement as a reason for unnecessary account openings. However, we have several minor concerns.

1. Employer penalties

The Bill imposes a superannuation guarantee shortfall charge on employers in the event that a valid contribution is not made to a stapled fund, where one exists. For details of stapled funds, employers are to contact the ATO and seek details for each new employee. We note that where a payment is made in error, the shortfall charge will apply. However, the bill provides grounds for discretion in the instance that a fund which is identified as a stapled fund is unable to accept contributions. The Bill also provides the Commissioner of Taxation grounds to correct errors in notifications to employers about stapled funds. However, it does not expressly provide the ability for employers to rely on representations made by the ATO where these were in error, or to use a default fund in the instance that the ATO does not respond to a request for details about stapled funds.

We note that under the Superannuation Guarantee and tax requirements, the employer must obtain evidence to prove that a fund which is being contributed to is both complying and can accept employer contributions.

In our submission to the Senate Economics Legislation Committee in relation to the Bill, we noted that this could result in employers, who are required to comply with mandatory contribution requirements, being penalised as if they had not complied with the requirements. Furthermore, we noted that there is no discretion in the Bill to ensure that employers are not penalised in the event that they are forced to breach requirements.

Item 2 of Schedule 1 of the draft regulations proposes section 17C, which contains details about how the ATO could correct an error if such an error was identified. However, there is still no express grounds for employers to rely on representations (or no representations) made by the ATO in determining the stapled fund to be used, or in the absence of this information, the need to use a default superannuation fund.

This situation needs to be rectified. CPA Australia and Chartered Accountants ANZ recommend that:

- Employers be deemed to have complied with the choice of fund requirements if they rely on representations made in error by the Commissioner of Taxation in respect to notification of stapled fund details, especially if this occurs due to manual processes
- Employers be deemed to have complied with the choice of fund requirements if they contribute to a default fund due to the employee having not chosen a fund and the ATO having not responded to a request for details of the employee's stapled fund, and
- Employers be allowed to accept that stapled fund details provided by the Commissioner represents a complying fund and can accept employer contributions.

We understand that the Bill accepts that the Commissioner of Taxation can grant discretion in the event that a contribution is made to a stapled fund which cannot accept contributions. However, we do not believe that verification of the ability to accept contributions is an onerous task for the ATO to undertake, prior to notification to employers of stapled fund details. CPA Australia and Chartered Accountants ANZ strongly recommend that this requirement for employees to verify this separately be removed with respect to stapled funds.

2. Prohibited products

Employers are required to consult Super Fund Lookup in the instance that a new employee selects their own fund under the choice of fund requirements. We note that non-complying funds, which in the majority of instances will be SMSFs, will not show up on Super Fund Lookup, however, it is also possible that a non-complying fund is the employee's stapled fund. In the instance the fund will be made non-complying, removed from the Super Fund Lookup, and superannuation fund monies will need to be contributed to the employer's default fund in the absence of another fund being chosen.

In the case of complying funds, CPA Australia and Chartered Accountants ANZ note that superannuation fund products that are subject to an APRA-imposed prohibition under the performance test, can still be both stapled funds, and valid fund selections on the Super Fund Lookup. While we agree that the primary grounds for removal for a fund from the Super Fund Lookup should be a status of non-complying, the policy basis for a prohibition notice is to prevent new members moving into that product.

This issue raises two questions. Firstly, does the commencement of new employment circumstances represent a reasonable opportunity to encourage engagement by the employee with their underperforming stapled fund? And if yes, secondly, is it appropriate for prohibited products to continue to be listed on the Super Fund Lookup or to be allowed to be stapled funds?

While we do not make any recommendations in respect of this matter, we believe that this an important public policy question, particularly if new employment is an ideal time for an employee to move to a new, better performing, product.

3. Implementation

CPA Australia and Chartered Accountants ANZ are concerned about the implementation of this measure.

Presently, the onboarding process of new employees is generally streamlined through an online tool which employers can provide to their employees and which records both tax file number (TFN) and superannuation preferences for a variety of purposes. The proposed implementation date of this measure, presuming that the Bill receives Royal Assent in time, is 1 July 2021. At a little over a month until this date, we are concerned that there still needs to be substantial work to ensure that there is minimal adjustment for business when engaging new employees.

It is expected that the systems to capture TFN and superannuation choices by new employees will be enhanced to capture stapled fund arrangements. However, we are not at this stage aware if business stakeholders have been consulted in relation to the changes needed to make this work.

If processes are not finalised by the implementation date of 1 July, we are concerned that manual workaround processes, such as arranging stapled fund information over the telephone, would not be acceptable for a variety of reasons, including privacy concerns. TFN information is one of the most sensitive items of personal information in Australia, and the risks to employees and employers are great.

We consider that, if there is any suggestion that secure online facilities are not ready to be used by the date by which this measure is meant to be implemented, then it is of the highest urgency that the Minister is advised and that the Bill, presently before Parliament, is amended to defer the measure accordingly.