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Financial System Inquiry

Dear Members

Trusts and superannuation

On page 2-107 of the Interim Report of the Inquiry, the following is stated:

"*Trust law forms the basis for the governance of superannuation. The Inquiry seeks views on whether the trust structure is best placed to meet the needs of all members in a cost-effective manner*."

This submission expresses views as requested.

Review into Australia's Superannuation System (Cooper Review)

A similar question posed by the Inquiry was also posed by the Cooper Review in the early stages of its work. In the Preliminary Report of the Cooper Review dated 14 December 2009, the Review stated:

"*Few submissions seriously questioned the continued relevance of the trust model. That might in part reflect a belief that the costs of changing from such a model would be considerable, but many submissions identified features of the trust model that make it attractive in the superannuation context, including:*

- *the separation of legal and beneficial ownership (which protects both member and government interests);*
- *the substantial body of well-established principles that are inherent in the trust concept; and*
- *the flexibility inherent in the trust model as it can be used in many commercial contexts where it is convenient to separate actual ownership from day-to-day control of the underlying assets*."[1]

The Review's Interim Report then went on to express actual or potential shortcomings in the trust model. Ultimately, the Review's conclusion was that the trust model remains the most appropriate model for superannuation, including from a cost perspective. Even so, the Review made recommendations to address the perceived shortcomings in the trust model, many of which related to the flexibility of the trust model and through the flexibility, the potential for the governance by trustees to be diluted. Many of the recommendations were accepted by the Government and have since been passed into law. Hence, for example, the statutory covenants for trustees and their directors were materially and extensively strengthened and the prudential regulator, APRA, was given the power to make prudential standards (similar to its powers for ADIs, life insurers and general insurers).

[1] At paragraph 6.2

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Submission

In my view, the Cooper Review was correct in its conclusion that the trust model remains the most appropriate vehicle for the provision of superannuation. This view not only applies generally but also specifically in relation to cost (being expressly identified by the Inquiry).

In particular, if the trust model was not to be applied in the future, it seems likely that the alternative model would need to be some form of statutory funding arrangement, with trustees or trustee-like persons charged with the governance and oversight of a relevant fund. This would be similar to many of the old public sector schemes, many of which have since become general law trusts.

At this point, it seems unproductive to speculate what the key features of a new statutory model would look like or whether other recognised structures merit consideration e.g. a corporate based model. If the Inquiry was truly minded to pursue this course, I respectfully submit that the Inquiry should pose a model or models that it genuinely wishes to consider and then seek submissions in relation to those models.

As observed by Cooper, the costs of any transition to a new model would be extensive, if not prohibitive, across Government, the Parliament and the industry. That cost would not only include the cost of unwinding existing arrangements, development of all constituent laws and structures for new arrangements, education of trustees, systems changes and the like, tax and stamp duty would also need to be addressed.

However, even if the transitional cost could somehow be rationalised, it is difficult to perceive how any new statutory regime could be expressed so clearly and be so uncontroversial that it would not involve years of professional and judicial consideration to establish a meaningful and mature understanding of the new regime. Again, that would come at substantial cost.

These costs would ultimately fall (wholly or substantially) to the industry and therefore all superannuation members.

The above comments are directed to reasons why adopting an alternative to the trust model would be extremely costly. That is, the points promote the case against change from the trust model. To this, I submit that one should also look to the case for keeping the trust model and so not ignore the fundamental merits of the trust model, which is a creature of the general law of common law countries and has its centuries old origins in the notion of holding people accountable when they are looking after the property of another. When this is overlaid with the regulatory regime to ensure that the flexibility of trust law is not left unchecked when applied to superannuation, a robust, flexible and accountable regime is the result.

In greater detail, reasons in support of the trust model are, in my view:

(a) in a common law country such as Australia, the trust relationship is the natural home for governing a situation where one person holds assets for the benefit of another person or other persons. Trust law can date back to 1535 with the enactment of the Statute of Uses in England. Accordingly, it has over 470 years of rich history and refinement through the courts;
(b) within that history, the principles of trust law were developed by the courts to overcome or work around the strict rules of contract and property law. Trust law is based on fairness, morality, flexibility and equity. Those principles sit well as foundation principles upon which to maintain the superannuation system;
(c) as speculated earlier, any obvious alternative would likely be a scheme constructed by statute and possibly contractually based. The Life Insurance Act 1995, particularly Part 4 (which in many respects tracks a trust model) is a good example. However, Part 4 is hampered by the lack of case

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law to assist in the interpretation of it and its depth and breadth of legal principle is not as wide ranging as trust law;

(d) the regulatory history of superannuation includes an acknowledged dependence on the trust relationship, particularly the SIS regime;
(e) over the past twenty years or so, many statute based public sector schemes, under which funds were maintained according to statutory provisions, adopted the trust model or trust based principles as a more robust means of imposing duties upon the entities charged with holding and managing the fund assets;
(f) other common law countries have the trust relationship as the base model for their pension/superannuation systems: the United Kingdom, Canada, New Zealand and the United States;
(g) another example of where trust law has been applied in a regulated environment is Chapter 5C of the Corporations Act, which covers managed investment schemes. Managed investment schemes are governed as trusts, a regime settled upon after extensive governmental inquiry in the late 1990s.

The key aspect of my submission is that the trust is the ideal structure upon which to maintain the regulatory regime. Most importantly, the trust structure is highly flexible leaving open the ability for the regulatory regime to be moulded onto the trust structure. The listing of the duties of a trustee in the attachment, together with extracts from selected cases and texts, bear out this point.

I would welcome expanding upon my views if the Inquiry perceived that to be of assistance.

Yours sincerely

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ATTACHMENT

The duties of a trustee

Get in the trust property

> "… Another facet of the duty to get in the trust property requires a trustee to take proceedings against a co-trustee, a former trustee or a stranger who is liable to redress a breach of trust or otherwise owes a present liability to the trust[2], unless to do so would be futile due to the financial position of the person liable, …"

p617, Dal Pont and Chalmers, "*Equity and Trusts in Australia*", third edition.

Know the terms of the trust

> "The first duty of a trustee is to make himself thoroughly acquainted with the terms of the trust which he undertakes to carry out, and all documents, papers and deeds relating to or affecting the trust property as come into his possession and control.[3]
>
> It is necessary that trustees should know precisely the nature and circumstances of the trust property.[4] It would seem the merest truism to set out this as the first duty of a trustee; but the reports show very clearly that people constantly undertake the office of trustee and yet neglect to inform themselves sufficiently as to the duties they are to perform."

p417, Meagher and Gummow, *Jacobs' Law of Trusts in Australia*, sixth edition.

Obey strictly the terms of the trust

> "… As Mr Birrell put it,[5] 'The third duty of a trustee is to adhere to the terms of his trust in all things, great and small, important and seemingly unimportant. This is his very plainest duty; no trustee would ever deny it, or pretend to be ignorant of it, yet it is his hardest unless from the very beginning he makes up his mind to it, and then it is as easy as eating bread and butter.'
>
> The rule that the trustee must strictly conform to and carry out the terms of the trust modifies all other rules because these other rules are applied subject to any provisions contained in the trust instrument itself."

p419, Meagher and Gummow, *Jacobs' Law of Trusts in Australia*, sixth edition.

Standard of care

> "a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and that beyond that there is no liability or obligation on the trustee. In other words, a trustee is not bound because he is a trustee to conduct business in other than the ordinary and usual way in which similar business is conducted by mankind in

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[2] *Longhurst v Waite* [1920] SALR 407 at 428; *Partridge v Equity Trustees Executors and Agency Co Ltd* (1947) 75 CLR 149 at 164; *Re Atkinson* (deceased) [1971] VR 612 at 616.

[3] *Hallows v Lloyd* (1888) 39 Ch D 686 at 691.

[4] *Harvey v Olliver* (1887) 57 LT 239 at 241.

[5] *Birrell, The Duties and Liabilities of Trustees*, 1896, p22.

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transactions of their own. It never could be reasonable to make a trustee adopt further and better precautions than an ordinary prudent man of business would adopt, or to conduct the business in any other way. If it were otherwise, no one would be a trustee at all."

per Jessel MR in *Re Speight.*[6]

p618, Dal Pont and Chalmers, "*Equity and Trusts in Australia*", third edition.

"… Although the rule as stated by Jessel MR in *Re Speight*; *Speight v Gaunt* (1883) 22 Ch D 727 at 739 is that 'a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and that beyond that there is no liability or obligation on the trustee', and, although this may be taken as a precise and accurate statement of the law, it is to be remembered in applying the rule that consideration must be given to the fact that the business of the trustee is investing on behalf of others, some of whom are to enjoy the benefits of the investment at some future time. That is to say, it is not just the ordinary prudence that a man might exercise in investing money for himself, for prudent business men frequently take risks which they consider in the circumstances quite reasonable as regards themselves, but which they might not consider reasonable were they dealing with the investment of savings set apart to provide for wife and children. It would not be prudent in a trustee to take such risks. The trustee must incur no risk of loss that can be avoided by ordinary care. He has to remember not only that he is investing to provide a present income for some of the beneficiaries, but also that he is investing as a means of preserving the capital moneys for the benefit of other beneficiaries who will take in the future. The prudence exercised by him in his investment will be weighed in the light of this fact and not merely by the prudence of a man making an immediate investment for himself. In other words, not only has a trustee to exercise the prudence of an ordinary business man in connection with his own business, but he has to exercise it with special reference to the subject matter. Just as a 'prudent' speculator on the Stock Exchange runs risks that would not be run by a wholesale merchant and the latter runs risks that a small retailer would not be justified in running, so an ordinary prudent business man sometimes runs risks in regard to his own affairs that a trustee must not run in dealing with the funds of the trust. The prudence is to be considered in relation to the special purpose for which the trust funds are entrusted to the trustee."

per Lindley, LJ in *Re Whiteley*; *Whiteley v Learoyd.*[7]

p433-434, Meagher and Gummow, *Jacobs' Law of Trusts in Australia*, sixth edition.

"A trust corporation holds itself out in its advertising literature as being above ordinary mortals. With specialist staff of trained trust officers and managers, with ready access to financial information and professional advice, dealing with and solving trust problems day after day, the trust corporation holds itself out, and rightly, as capable of providing an expertise which it would be unrealistic to expect and unjust to demand from the ordinary prudent man or woman who accepts, probably unpaid and sometimes reluctantly from a sense of family duty, the burdens of trusteeship."

Per Brightman, J in *Bartlett v Barclays Trust Co Ltd (No. 1).*[8]

p618-619, Dal Pont and Chalmers, "*Equity and Trusts in Australia*", third edition.

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6 (1883) 22 Ch D 727 at 739-740.
7 (1886) 33 Ch D 347 at 355.
8 [1980] Ch 515 at 534.

Duty to account

> "[T]he first and primary duty of every … trustee having money in his hands to be received and to be paid is, that an account of his receipts and payments should be kept, to be produced to those interested in the account when it is properly demanded."
>
> Per Windeyer, J *Waterhouse v Waterhouse.*[9]

p619, Dal Pont and Chalmers, "*Equity and Trusts in Australia*", third edition.

Duty not to fetter discretions

> "…. It follows that trustees must not bind themselves contractually to exercise a trust in a prescribed manner, to be decided by considerations other than their own conscientious judgment at the time, in respect of what is in the best interests of the beneficiaries."

per Dal Pont and Chalmers, "*Equity and Trusts in Australia*", third edition, citing appropriate authorities at p626.

Duty to act impartially

> "Properly understood, the so-called duty to act impartially … is no more than the ordinary duty which the law imposes on a person who is entrusted with the exercise of a discretionary power: that he exercises the power for the purpose for which it is given, giving proper consideration to the matters which are relevant and excluding from consideration matters which are irrelevant."
>
> Per Chadwick, LJ in *Thomas Edge & Ors v The Pensions Ombudsman & Anor.*[10]

Duty to pay the correct beneficiaries

> "Prior to the introduction of certain statutory provisions … , it was the absolute duty of the trustee to pay and transfer the trust property to the persons entitled thereto where such persons were the beneficiaries named in the trust instrument. The fact that the trustee made an honest mistake without negligence on his part was no excuse.
>
> …
>
> Now, however, the Trustee Acts of the various States contain provisions which lighten the heavy burden which was thrown on the trustee by the above rules. These provisions give the following forms of relief:
>
> (1) protection when paying under powers of attorney;
>
> (2) protection when paying after advertisement for claims;
>
> (3) protection upon distribution without reserving funds to meet claims for breach of covenants in leases held by the trustee;

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9 (1998) 46 NSWLR 449 at 494.
10 [1999] PLR 216 at p232.

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(4) protection upon distribution without reserving funds to meet possible liability for calls on partly paid up shares;

(5) protection against claims which a trustee has challenged; and

(6) protection to the trustee where, though mistaken, he has acted honestly and reasonably and ought fairly to be excused."

pp448 and 449, Meagher and Gummow, *Jacobs' Law of Trusts in Australia*, sixth edition.

> "… it is suggested that the following principles apply:
>
> (1) Where a trustee has overpaid a beneficiary as a result either of a mistake of law or of a mistake of fact, the trustee is entitled to recoup the payments out of other funds due or to become due to the beneficiary under the same trusts, whether capital or income.
>
> (2) The trustee cannot so recoup, if the income of a beneficiary is subject to a restraint or anticipation.
>
> (3) It makes no difference that the underpaid beneficiary in such circumstances is the trustee itself.
>
> (4) When a trustee has mistakenly paid a beneficiary he may usually recover against that beneficiary by utilising the common law remedy of money had and received.
>
> (5) Overpayments made in respect of one trust cannot be recouped out of payments due to the beneficiary from the same trustee under another trust."

p453, Meagher and Gummow, *Jacobs' Law of Trusts in Australia*, sixth edition.

No conflict rule

> "It is an inflexible rule of the court of equity that a person in a fiduciary position, such as the plaintiff's, is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule."
>
> Per Herschell, LJ in *Bray v Ford.*[11]

Subsequent commentators and courts have suggested that the above might express a counsel of prudence as opposed to principle, not in the principle of needing to address conflicts but in the means by which conflicts can be managed. One means is the avoidance of the conflict. Another means is to acknowledge the role of informed consent such that a conflicted person can continue to discharge their duty if the

11 [1895-99] All ER 1009 at p1011.

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person or persons to whom the duty or duties are owed give their informed consent. See for example, Deane, J sitting on the High Court in *Chan v Zacharia*[12].

In the SIS context since 1 July 2013, the ability to manage conflicts is subject to the further tests of a conflicted person needing to give priority to the beneficiaries and ensuring that the interests of beneficiaries are not adversely affected by the conflict.

History

This history of the regulation of superannuation reflects the use of the trust model as a core feature of regulatory regimes. While I acknowledge that this is not a conclusive reason for maintaining the trust relationship at the centre of any regulatory regime, I submit that the history does add context and weight to the argument.

The history

The history of superannuation in Australia can be marked by many features and events. It is most relevantly tracked from the mid 1980s. The features and events include:

(a) the development of the different sectors: corporate; retail, industry, public sector and small closely held funds;

(b) revenue driven initiatives;

(c) regulatory oversight;

(d) compulsory superannuation;

(e) the growth in value of the overall superannuation savings pool;

(f) the trust as the legal structure/relationship by which superannuation funds are held (apart from some public sector schemes);

(g) the types of benefits provided by superannuation funds being either lump sum or pension and either defined benefit or accumulation style.

In the mid 1980s, the regulatory and tax oversight of superannuation was largely in the hands of the Commissioner of Taxation through the requirements contained in the Income Tax Assessment 1936 ("**ITAA**") for fund income to be tax exempt and for contributions to be deductible. The system was unsatisfactory as the regulatory regime was largely contained in rulings and other published materials from the Commissioner. They lacked legislative precision and could be inconsistently applied throughout the ATO network.

Being a common law country, the vehicle under which private sector superannuation funds were maintained was the trust structure, which continues to be the primary vehicle (with certain public sector funds maintained under statutory schemes which were not trusts).

The shortcomings of the ITAA regime were recognised, culminating in the establishment of a specific regulator for superannuation, the Insurance and Superannuation Commissioner. The regulatory regime was comprised in the Occupational Superannuation Standards Act, 1987 ('**OSSA**'). It was developed

12 (1984) 154 CLR 178

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primarily through work done by Government with relatively little consultation with industry when compared with the industry consultation in the development of the regime under the Superannuation Industry (Supervision) Act, 1993 ("**SIS**"), which commenced in 1994.

Relevantly to this submission, the OSSA regime was built on a trust model. Like the later SIS regime, it had as a foundation (for reasons perceived as necessary to ensure the legislation was within power under the Constitution) the withdrawal of tax concessional status for failure to meet regulatory standards. One of those standards included the requirement to have the other regulatory standards written into the trust deeds of funds, thus building a regulatory regime based on trust law.

A key failing in the OSSA regime was that non compliance could result in loss of concessional tax status for the fund, often punishing members who were innocent of any transgression.

The SIS regime was announced in late 1992. Extensive industry consultation followed the announcement with the legislation commencing in 1994. The SIS regime is also built on the trust model. However, unlike the OSSA regime, it has a system of regulatory enforcement in addition to the use of the taxation system. The preferred view is that the SIS regime is valid under the Constitution.

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