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Practice Group:
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Superannuation Funds - Enhanced Investment Management Governance

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The Australian Government has been rolling out a series of significant regulatory reforms of the superannuation industry, many of which will commence in 2013. These reforms are fundamentally designed to enhance the prudential supervision of the industry and introduce a number of new requirements for superannuation fund trustees.

One of the areas targeted by the reforms is the investment management function of superannuation fund trustees. From 1 July 2013, there are some significant new processes which trustees will need to introduce in relation to the engagement of investment managers and the making of investment decisions. Many of these new processes will require increased input from the investment managers and investment professionals engaged by trustees.

As Australian superannuation funds have significant offshore holdings, these new requirements will change the way superannuation trustees interact with offshore investment managers and investment professionals. These offshore investment counterparties will need to understand the new prudential regime if they are to anticipate and comply with the additional requests for information and assistance from Australian superannuation funds.

K&L Gates has offices across the United States, Europe, Asia Pacific, the Middle East, India and Africa, which can assist superannuation fund trustees deal with offshore investment managers and investment professionals no matter where the manager or transaction is located. We are also well placed to assist investment managers respond to the requests of their Australian superannuation fund clients. Thanks to our global platform, K&L Gates' lawyers all over the world are well versed in the new prudential requirements applicable to Australian funds and, having lawyers across our worldwide network who understand the particular needs of Australian superannuation fund trustees, should be of significant assistance particularly in the hectic early days of the reforms.

Some of the issues on which investment managers and investment professional can expect to be approached about by Australian superannuation trustees in the coming months include:

Prudential Standard SPS 530 Investment Governance

This standard is designed to assist trustees to safely invest members' money and monitor the performance of those investments. SPS 530 represents a significant uplift in the mandatory measures which trustees are expected to meet in connection with the due diligence, monitoring and ongoing management of investment portfolios. As a result, investment managers and other investment service providers may be asked by trustees to provide information and reports on a more comprehensive range of criteria than they have dealt with in the past.

There is no doubt that much of the subject matter dealt with in SPS 530 will be very familiar to investment managers and professionals, but some of the detail may require managers and service providers to revisit their own processes and structures to ensure that they provide superannuation fund trustees with all that is required under the new prudential regime. Some of the specific requirements referred to in SPS 530 which investment managers and service providers may be asked to address include the following:

- assisting the trustee to formulate an investment objective which includes appropriate risk and return objectives for each investment option provided by the manager

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- providing data that enables the trustee to regularly monitor whether investment objectives are being met and the performance of each investment in each option
- identifying risk factors associated with the sources of returns for each investment strategy and the target exposure to these risk factors
- identifying how sources of returns interact in different market conditions and the variability and impact of interactions on the overall diversification of the strategy
- assisting the trustee to determine asset allocation targets and ranges, and the bases on which targets/ranges would be changed
- undertaking stress testing to assist trustees to confirm the investment strategies are appropriate
- adjusting the manager's investment reporting methodology so that it is consistent with the trustee's requirements
- assisting the trustee to identify trigger points for commencement of an internal review of each investment strategy and trigger points for determining that a strategy should be changed
- conducting or assisting the trustee to conduct sufficient due diligence on investments, which may include an assessment of the current relevant market environment, the valuation methodology of the investment and the projected performance of the investment.

Trustees will also be required to implement a process of review of external investment service providers which must include formal periodic reviews (at least annually), and ongoing measurement of performance which includes an escalation process for inadequate performance.

Prudential Standard SPS 231 Outsourcing

SPS 231 will apply to the outsourcing by superannuation fund trustees of "material business activity". A material business activity is one that has the potential, if disrupted, to have a significant impact on a trustee's business operations. Accordingly, it is expected that all investment manager appointments will need to comply with SPS 231.

The standard requires outsourcing agreements to contain provisions which specifically address a range of a number of issues including the following:

- the appointment process and how the renewal will be conducted
- contingency plans that would enable the manager's business activity to be provided by an alternative service provider or taken in-house if required
- service levels and performance requirements
- the form in which the data is to be kept and clear provisions identifying ownership and control of the data
- insurance and appropriate indemnities
- access and cooperation by the manager in relation to requests from the Australian Prudential Regulation Authority (APRA) or the auditor.

Further, where an agreement is an offshoring agreement (such as when an offshore investment manager is engaged), trustees will be required to consult with APRA regarding risk management prior to entering into any new agreements.

All new agreements entered into after 1 July 2013 will need to comply with all the requirements contained in SPS 231. In relation to existing agreements, trustees must make an assessment of the extent of compliance with SPS 231 and seek to put in place appropriate amendments.

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Additionally, any new offshore investment management agreements entered into since 22 November 2012 must comply with a number of the standard's requirements.

Portfolio Holdings Disclosure

In addition to the introduction of a set of new prudential standards applicable to superannuation fund trustees, there are a range of additional regulatory reforms aimed at making the superannuation system more efficient and transparent to consumers. One of the new measures being imposed on trustees is the requirement to publish information regarding each of the financial products or other assets in which the fund's assets are directly or indirectly invested.

Every 6 months trustees must publish on their website information about all financial products and other property in which the assets of the fund are invested (directly or indirectly) at the end of the "reporting day" which is every 30 June and 31 December. The first reporting day for trustees will be 31 December 2013 and the required information must be published by the trustee within 90 days of the reporting day.

These requirements will involve trustees drilling down to all of the underlying assets held on its behalf. Investment managers and other investment service providers will need to engage with trustees to ensure that they are ready to provide the necessary information within the specified timeframes.

Reporting Standards

APRA have also released 35 new reporting standards and forms, most of which will commence on 1 July 2013. These standards specifically set out the requirements for the provision of various information to APRA by a trustee. Some of the reporting standards that may be relevant to the type of information investment managers will be asked to provide to trustees include:

- reporting Standard SRS 530.1 Investment and Investment Flows which requires specific information such as the value of all investments held directly or indirectly by the fund and the portion of those investments which are managed under individual mandates
- reporting Standard SRS 702.0 Investment Performance which requires specific information such as investment fees, costs and taxes
- reporting Standard 533.0 Asset Allocation which requires specific information such as the percentages of asset allocations of the fund and how it compares against the fund's benchmark asset allocation.

Performance-based Fees

The regulatory reforms introduce new restrictions on performance based fees paid to investment managers. Where the arrangement between a fund trustee and an investment manager includes the payment of performance based fees, the trustee is required to ensure that the fees meet certain requirements, including:

- Where a base fee is also payable under the arrangement, the base fee must be adjusted to be lower than it otherwise would be, were no performance based fee also payable.
- The arrangement must include disincentives for the underperformance of investments.
- The period for which a performance based fee is determined must be appropriate to the kinds of investments to which the performance based fee relates.

Conclusion

There is no doubt that Australian superannuation fund trustees are heading into possibly the busiest period they have ever faced in terms of new regulatory reforms. In relation to the investment management function, the reforms are numerous and comprehensive.

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Trustees are going to need considerable assistance from their investment managers and their other investment service providers both within Australia and offshore if they are to have in place the prudential and reporting mechanisms that the Government and the regulator require in the next few months.

At K&L Gates we not only have a global platform with offices in so many important investment markets, but our integrated investment management practice ensures that our practitioners, no matter where they are located, are familiar with the regulatory environment of Australian superannuation funds.

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