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Superannuation fund mergers

Is it time for a merger?

Simon Haddy

On 1 July 2020, First State Super and VicSuper merged to become Australia's second largest superannuation fund, managing \$125 billion in savings on behalf of more than 1.1 million members across the education, health and public service industries. Further, First State Super also announced that it will merge with WA Super later this year, resulting in almost \$130 billion in combined assets under management.

With mounting pressure from the regulator and the burden of administrative costs, superannuation funds are making the decision to merge more often than before; at least 28 have taken the step since 2014.

COVID-19 has placed additional pressure on superannuation funds to merge as a result of poor liquidity and asset prices, increasing unemployment (hence no super contributions) and the fast tracking of super withdrawals on compassionate grounds. Long lasting effects may include declining returns, reduced portfolios and membership bases. As members whose jobs have been affected by the pandemic seek assistance from their super fund, the higher the administration costs associated with this.

To undergo a merger through the common process known as a 'successor fund transfer' (SFT), a super fund trustee must turn its mind to several key considerations.

This paper aims to assist super fund trustees to navigate the pitfalls of a merger under an SFT, with the pressures to merge heightened by COVID-19 being hard to ignore.

Pressure to merge

Since December 2019, APRA has produced a new performance appraisal system—heatmaps—designed to place pressure on those super funds that it has deemed to be underperforming.

APRA has flagged that this mechanism will extend over time to insurance and choice products. Assistant Minister for Superannuation, Jane Hume, said in 2019 that funds with less than \$1 billion should be considering their future. There are approximately 93 or so funds in this category. It is predicted that funds will merge rather than be shamed, and potentially litigated, by APRA.

Key considerations

What is the most suitable type of merger for the super fund?

It has been a fairly standard procedure for super funds to consolidate with other super funds by way of transferring member benefits in a fund either by member consent or, if the transfer is to a 'successor fund', by way of an SFT.¹

However, as Equisuper and Catholic Super demonstrated in 2019, super funds can also consolidate through an 'extended public offer' (EPO) process (which was used to establish a joint ven-

ture between the two separate super funds).

An SFT is the direct transfer of a fund's members (and respective benefits and assets) without member consent to an alternate fund on the basis that the member will have 'equivalent rights' in the successor fund. It typically takes nine to 18 months to complete. APRA must be notified as soon as practicable after the trustee makes the decision to engage in an SFT.

Alternatively, the EPO process is a licence granted by APRA which allows a superannuation trustee to be the trustee of both non-public and public funds (that is, if a superannuation trustee can be the trustee of multiple funds). An EPO can also be used as a preparatory stage, consolidating the trustee and administrative bodies, while keeping the funds separate, until such time as they are able to merge under an SFT. This means that worrisome assets may not mean the death of the joint venture, as they can rectify any issues with assets, while combining administrative forces.

This paper focuses on SFTs, as it is the more common mode of transfer.

Authorisation to undertake an SFT

While the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) allow for SFTs, terms of the super fund's trust deed must be looked at for any relevant power to do so.

This power is not necessarily found in all trust deeds—the Federal Court recently found that a super fund purporting to undertake an SFT did not have the power to undertake this in its trust deed.²

If a super fund does not have the power to undertake an SFT, the trustee may seek an order from the court to amend the trust deed in order to do so.³

Courts have authorised trust deeds being varied to allow for the trustee to have the power to make SFTs in limited circumstances where it is:⁴

- a decision by the trustee to terminate the trust (including on a merger) and transfer to a successor fund which benefits the members of the trust
- a decision by the trustee to terminate a product within the trust and transfer to a successor fund which benefits the members holding that product
- a decision by the trustee to transfer to a successor fund which benefits the members falling within a group for which the trustee determines it is unable to provide competitive benefits at a competitive cost compared to a competitor fund that qualifies as a successor fund; or
- a decision by the trustee to transfer to a successor fund which benefits the employer-sponsored members who are employees of a participating employer which has changed or decided to change the fund to which it makes super contributions from the trust to a competitor fund that qualifies as a successor fund.

Courts have considered that these powers should be conditional on duties consistent with the general superannuation trustee duties; for example, exercising a

trustee power such that one subset of members does not suffer a significant detriment compared to another, and providing notice and an explanation of the transfer.

Due diligence

Like any merger, a transferring super fund will have to undertake thorough due diligence on the receiving fund, and vice versa, prior to signing a deal. If they do not, they risk a failure of post-merger integration. Trustees must ensure that they are realistic about time frames and leave sufficient time to deal with the issues listed below, which may have high stakes consequences if not dealt with appropriately.

Key considerations include:

- the rights of members
- identifying differences between asset allocations in the respective funds' investment options and, more broadly, differences in investment choices which may be indicative of wider cultural and operational inconsistencies
- the transferability of assets between the funds
- valuation of assets
- uncalled capital commitments
- legacy rights or obligations relating to specific assets; for example co-investment or most favoured nation rights
- change of control triggers, transfer restrictions or other asset-level consequences arising from the merger.

Disclosure

Like in any transaction, trustees will provide warranties in respect of the assets being transferred and such SFT agreements may require full disclosure of any underperforming assets.

A super fund trustee has a number of duties, including:

- the duty to exercise the requisite degree of care, skill and diligence
- to act in the best interests of the beneficiaries of the super funds
- to give priority to the interests of the beneficiaries in the event of a conflict of interest.

As part of complying with these duties, a transferring trustee may need to make a receiving trustee aware of any issues to enable them to act in the best interests of members.

Although the trustee does not have an obligation to seek the consent of its members in order to undertake an SFT, APRA has an expectation that both the transferring and receiving fund will disclose their intention to undertake an SFT and keep their members informed about a decision to conduct an SFT.⁵

Further, following the SFT, a super fund will have to provide a significant event notice to each member (see below). Together, the transferor and transferee will have to apply to have the SFT approved by APRA.

'Equivalence of members' rights'

The SIS Regulations do not impose a positive obligation on a trustee to consider an SFT, but instead impose re-



The quote

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strictions or conditions which, unless satisfied, prohibit a trustee from undertaking an SFT.⁶

For a receiving super fund to be considered a successor fund, it must satisfy two requirements under the SIS Regulations: first, the fund must confer equivalent rights to the transferring fund and second, the trustee of the new fund must have agreed that the new fund will confer equivalent rights.⁷ Accordingly, an equivalency of rights analysis is necessary to determine whether a prospective super fund meets the statutory test of a ‘successor fund’ and that, essentially, no member is worse off from the merger.

A trustee owes a fiduciary duty to exercise its transfer power in the interest of the members of the super fund.⁸ A superannuation trustee has a general obligation to act in the best interests of beneficiaries at all times.

APRA’s position is that the equivalency of rights analysis should be undertaken on a ‘bundle of rights’ basis, rather than a line-by-line approach. It considers that equivalent rights means the rights acquired are to be equivalent, not equal. It has stated that:

“... while the SIS Regulations require that equivalent rights be assessed on the basis of the member, APRA considers that it would be open to a [fund] to consider equivalent rights based on groups of members with common rights.”⁹

Post-merger issues

Once a detailed due diligence and equivalency of rights analysis has occurred, key considerations for merging super fund trustees should be:

- a) Who will be on the board of the merged fund and who will be its Chair. This was an issue that unravelled the Catholic Super and Australian Catholic Superannuation’s proposed merger in 2017. Similarly, Energy Super and Equisuper’s proposed merger in 2016 when one trustee refused to have union representatives on the board of the merged fund.
- b) Insurance benefits, and whether the members will receive the same benefits post SFT. In considering this, super fund trustees will have to decide whether insurance policies will be transferred to the receiving fund. Trustees will also have to consider how to deal with:
 - outstanding claims
 - records and data.
- c) All the technical details related to transitioning investment portfolios, adjusting governance processes, outsourcing to third parties and reporting and communication issues should be addressed.
- d) Following the completion of the SFT, a trustee must provide a significant event notice to members that reasonably enables them to understand the nature and effect of the change or event.
- e) Regulatory implications at an asset level. Trustees should ensure that the aggregation of assets complies with Australian competition laws and any requisite regulatory disclosures are filed with the relevant authorities.

When the fund does not merge

If a super fund does not merge, it risks not being able to keep up with the mammoths of the industry that will reach an unprecedented size in the coming years, making them some of the largest funds globally.

Super funds that have merged are achieving greater scale in funds under management; economies of scale across Australia’s superannuation sector have helped create savings of \$4.5 billion over the past 13 years.¹⁰

Both ASIC and APRA have highlighted their intention to use their powers to litigate persistently underperforming funds. APRA has stated that, “in some instances, acting in the best interests of members will require underperforming funds to merge or exit the industry”.

This means that:

- ASIC can apply to the court if a trustee is not acting efficiently, honestly and fairly; a breach of which carries civil penalties. Civil penalties include pecuniary penalties, or a disqualification order.

APRA can:

- issue a direction where it has prudential concerns, including to removing or appointment of a responsible officer
- apply to the court for breach of the ‘best interests’ covenant, which now carries civil and criminal penalties
- apply for the disqualification of underperforming super fund directors, for any such period as the court sees fit.

However, it is yet to be seen whether the courts will agree with APRA, or if APRA’s standards for trustees will be considered too onerous.

While the Australian landscape is home to some megalarge super funds, there are also many funds managing assets below billions of dollars; these funds may soon have trouble competing, leaving them no choice but to be swallowed up by larger funds.

Notes

1. *Superannuation Industry (Supervision) Regulations 1994*, reg 6.29.
2. *APRA v Kelaher* [2019] FCA 1521 at [867].
3. *Trustee Act 1936* (SA) s 59C, *Trustee Act 1958* (Vic) s 63, *Trustee Act 1925* (NSW), s 81(1); *Retail Employees Superannuation Pty Ltd v Pain* [2016] SASC 121.
4. *Retail Employees Superannuation Pty Ltd v Pain* (2016) 115 ACSR 1.
5. APRA SPG 227 Successor Fund Transfers and Wind-ups, 2017.
6. *APRA v Kelaher* [2019] FCA 1521 at [827].
7. SIS Regulations, reg 1.03.
8. SIS Act, s 52(2)(c); *Cowan v Scargill* [1985] 1 Ch 270.
9. APRA SPG 227 Successor Fund Transfers and Wind-ups, 2017.
10. Productivity Commission, 2018.