Australian Prudential Regulation Authority

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TO: All RSE licensees

Important lessons for trustees arising from APRA's Trio Capital Ltd investigation

On 8 April 2016 the Australian Prudential Regulation Authority (APRA) released the report on its investigation into the failure of Trio Capital Limited. The outcomes of the Trio investigation provide important lessons for superannuation trustees.

APRA considers the significant investment losses sustained by Trio in the six related-party investments that were the focus of the investigation can be attributed to a number of key factors:

- inadequate investment governance processes;
- failure to adequately manage conflicts of interest from dealings with related parties; and
- failure to have adequate controls to mitigate fraud-related investment risk.

As a result of APRA's concerns that Trio and its former directors had failed to act in members' best interests, APRA accepted enforceable undertakings from 13 individuals who were Trio directors between 2003 and 2009 that effectively removed these individuals from holding senior roles in the APRA-regulated superannuation industry for periods ranging between 3 years 6 months and 15 years (with one having no expiry date).

Further detail on these important areas is provided below.

<u>Investment governance</u>

Trio made the related party investments through a series of unlisted assets such as hedge funds, private equity trusts and residential property funds. These investments had a number of common features which heightened the associated investment risk. This included the use of small proprietary corporate vehicles, opaque or complex investment structures, investment vehicles that had no prior operating history, investments in offshore locations not subject to enhanced regulatory oversight, inadequate security and uncommercial terms. The investigation report identified APRA's concerns that insufficient due diligence had been undertaken by Trio given these heightened risks.

It is essential that trustees have rigorous due diligence processes and criteria for the selection of investments, ensure that sufficient due diligence is undertaken prior to the selection of investments and that trustees have appropriate measures in place to monitor an investment's performance. These expectations in relation to effective investment governance are now clearly articulated in *Prudential Standard SPS 530 Investment Governance* and the accompanying prudential practice guide that were released in July 2013.

Conflicts of interest

The investigation report refers to the complex series of related party relationships in these investments that gave rise to material conflicts of interest.

The identification, avoidance and management of conflicts of interest are critical components of a trustee's obligations in ensuring it acts in members' best interests.

Since Trio's collapse, a trustee's duties under the *Superannuation Industry (Supervision) Act 1993* have been expanded to give priority to the interests of members over the interests of the trustee or other persons.

From 1 July 2013, *Prudential Standard SPS 521 Conflicts of Interest*, applies and requires trustees to develop and maintain a conflicts management framework, containing a comprehensive system of internal controls and reporting under which conflicts are identified, avoided or managed and reported. Additional guidance is provided in *Prudential Practice Guide SPG 521 Conflicts of Interest*.

In March 2015 APRA also published the outcomes of a thematic review of conflicts of interest in the superannuation industry. APRA's review focused on identification of conflicts, governance structures, policies and procedures, and related party dealings. APRA highlighted issues that can arise in related party dealings and noted that robust management of related party arrangements is a critical element of a sound conflicts management framework. While the review indicated there are some examples of sound conflicts management practices in the industry, APRA's view is that there remains significant room for improvement.

Fraud-related investment risk management

A significant proportion of Trio's investments losses were due to fraudulent conduct in relation to the Astarra Strategic Fund.

The loss of members' entitlements is one of the most critical risks for a superannuation fund. An effective risk management framework should ensure all material sources of risk are identified, and appropriate procedures implemented to control or mitigate each risk. A robust and effective due diligence process for the selection of investments and investment managers is fundamental to mitigating fraud related investment risk. Unmitigated conflicts of interest can also contribute to the risk of fraud events occurring, reinforcing the need for a comprehensive conflicts management framework.

In June 2015, APRA released *Prudential Practice Guide SPG 223 Fraud Risk Management* which outlines prudent practices in the management of fraud risk and includes a specific section on fraud related investment risks. The most significant fraud related investment risks include the misappropriation of investment assets, material overstatement of investment asset value or material misrepresentations on the nature of the investment asset's risk and return profile.