Australian Prudential Regulation Authority

APRA Submission to the Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the collapse of Trio Capital

24 August 2011

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Introduction

Following is APRA's submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the collapse of Trio Capital Limited (Trio)1. In this submission APRA addresses the Terms of Reference 5, 6 and 7, which relate to the nature of the regulatory regime and APRA's regulatory relationship with Trio, role in the compensation arrangements for regulated superannuation fund members, and our general approach to the issue of fraud. We also outline some proposed changes to the regulatory framework which will assist future supervision.

Terms of reference 5

The APRA regulatory relationship to Trio and the use of SMSF

Background – Trio as trustee

1. Trio was a trustee holding a registrable superannuation entity (RSE) licence under the *Superannuation Industry (Supervision) Act 1993* (SIS Act).

2. On 17 December 2009, APRA suspended Trio as the trustee of its four superannuation funds and one pooled superannuation trust. APRA appointed ACT Super Management Pty Ltd (ACT Super), a subsidiary of McGrathNicol, as Acting Trustee to manage these five entities. APRA suspended Trio and appointed ACT Super as a result of numerous breaches of Trio's licence conditions: failure to provide the auditors reports for 2009; failure to submit quarterly returns due 5 November 2009; failure to adhere to custodial requirements; failure to exercise care, skill and diligence and failure to act in the best interests of beneficiaries; and failure to demonstrate due diligence on the investment in the Exploration Fund Limited (EFL); and not being unable to satisfy APRA's concerns regarding the valuation of superannuation assets.

3. At the time of suspension Trio was the trustee of the following superannuation entities[2]:

   - Astarra Superannuation Plan;
   - Astarra Personal Pension Plan;
   - Astarra Pooled Superannuation Trust;
   - Employers Federation of NSW Superannuation Plan; and
   - My Retirement Plan (including the sub-plan known as Seagrims Retirement Plan).

1 Trio was known as Astarra Capital Limited from May 2004 until September 2009.

[2] These are referred to below collectively as the Superannuation Entities.

4. In the period from May 2004 to October 2006, the Superannuation Entities made ongoing investments in the EFL. The initial investments took place at a time when the Trio Board of Directors was dominated by the owners of the company and their business associates. The money that was invested in the EFL during this period was ultimately lost.

5. The EFL was a company incorporated in Saint Lucia, West Indies and operated as a hedge fund, although at the time of the initial investment, EFL was newly formed and had no operating history. The EFL appointed a Saint Lucia company, Global Financial Managers Limited (GFML) as investment manager and GFML delegated its duties in relation to Australian investors to Wright Global Investments Pty Limited (WGI). Mr Shawn Richard was a director, secretary and general manager of WGI. Mr Richard was also a director of Trio from 5 November 2003 to 15 November 2005 and a member of Trio's Investment Committee from February 2004 to December 2005 and December 2008 to August 2009. Mr Richard, through various corporate entities, was the ultimate owner of Trio.

6. Largely at APRA's behest, by late 2005 the initial Board of Trio was restructured to comprise a majority of independent directors. During the period subsequent to the board being restructured and the suspension of Trio's Licence, APRA required the board to improve a number of aspects of the operation of the trustee and superannuation entities. At no time did the majority independent board, or the independent external auditors, raise any concerns with APRA about the existence of the assets (including the overseas investments).

7. In the period from October 2005 to October 2009, the Superannuation Entities also made ongoing investments in the Alpha Strategic Fund (later known as the Astarra Strategic Fund (ASF)). The Alpha Strategic Fund had been established by Trio as a managed investment scheme on 28 August 2005. The Alpha Strategic Fund operated as a fund of hedge funds. Astarra Asset Management Pty Limited (formerly Absolute Alpha Pty Limited) (AAM) was appointed by Trio as investment manager of the Alpha Strategic Fund. Mr Shawn Richard was a director of AAM and AAM was an authorised representative of WGI. AAM (as agent for Trio) entered into a Deferred Purchase Agreement (DPA) with EMA International Limited (EMA) when making investments with an investment manager in offshore global markets. The DPA provided that investments would be held offshore until such times as AAM (on behalf of Trio) requested the delivery up of those investments or their equivalent money's worth. EMA was incorporated in the British Virgin Islands and was a sole-purpose vehicle established for the purpose of entering into the DPAs.

8. Effective 30 June 2009, Trio transferred the units in the EFL held by the Superannuation Entities to the ASF with equivalent units in the ASF being issued to the Superannuation Entities.

9. ACT Super, as Acting Trustee for the Superannuation Entities, has been unable to redeem any of the Superannuation Entities' investments in the ASF and has determined that the funds have been lost due to fraud or theft.

10. In the period June 2004 to July 2007, Trio was also the trustee of the Professional Pensions Pooled Superannuation Trust (PPPST). The PPPST was wound up in July 2007. Upon wind-up of the PPPST the members were provided with a new PDS and given the

option to invest the redemption proceeds into the ARP Growth Fund, a managed investment scheme operated by Trio. This fund held substantial monies from self-managed superannuation funds (SMSFs), which were ultimately invested via a British Virgin Islands Segregated Mutual Funds Company in a number of derivative contracts with a US-based investment bank, Bear Sterns. These funds were lost due to the failure of Bear Sterns and the severe market movements during the Global Financial Crisis and not due to fraud.

APRA's supervisory approach

11. APRA's supervisory approach is based on the fundamental premise that the primary responsibility for financial soundness and prudent risk management within a superannuation fund rests with its board of directors and senior management. Our approach, therefore, is to attempt to work with these parties to resolve any issues and ensure that fund member interests are protected. APRA's role is to promote prudent behaviour by superannuation funds through a robust prudential framework of legislation and prudential guidance which aims to ensure that risk-taking is conducted within reasonable bounds and that risks are clearly identified and well managed. Unlike the banking and insurance sector, APRA does not have the power to issue prudential standards for superannuation funds. The Government proposes to give APRA standards-making power for superannuation as part of the Stronger Super reforms (see paragraphs 30-34 of this Submission).

12. APRA fully endorses the Government's view[3] that prudential regulation cannot and should not seek to guarantee absolute protection for fund members. APRA also supports the objective that the prudential regulation regime maintain a low incidence of failure of regulated entities while not impeding continued improvement in efficiency, or hindering competition. APRA aims to achieve this objective through the setting of prudential requirements and its approach to the supervision of individual institutions.

13. In supervising its financial institutions, including superannuation funds, APRA has developed a risk-based approach under which institutions facing greater risks receive closer supervisory attention. This enables APRA to deploy its resources in a targeted and cost-effective manner. The risk-based approach involves:

    - licensing only those institutions that are likely to be able to meet their financial promises under all reasonable circumstances;

    - regularly analysing the financial condition of institutions and reviewing their risk management to assess their relative risk of failure and whether they meet prudential requirements;

    - responding to these assessments by tailoring APRA's supervisory activities to the risk profile of the institutions; and

[3] As outlined in the Government's Statement of Expectations of the Australian Prudential Regulation Authority (2007).

- if necessary, taking enforcement action to protect the interests of beneficiaries or to make it clear that illegal or materially imprudent behaviour will not be tolerated.

14. APRA prefers to work constructively with boards and management of the institutions it supervises to resolve prudential issues that may affect the interests of beneficiaries (depositors, policyholders and superannuation fund members). However, when an institution is unable or unwilling to meet its prudential requirements, APRA engages with these institutions to rectify the outstanding issues and may take enforcement action to protect beneficiaries through a range of remedial actions.

Terms of reference 6

The access to compensation and insurance for Trio Capital investors including in circumstances of fraud

Part 23 - Background

15. The provision for the grant of financial assistance to certain superannuation entities that have suffered loss as a result of fraudulent conduct or theft was an integral part of the design of the SIS legislation. The government of the day recognised the compulsory nature of the superannuation system and the onus on government to provide for security of retirement savings. At the same time, it was recognised that small funds could be exempted from some features of the new prudential framework on the basis that members and trustees were usually related to each other, maintained close contact, and were therefore in a position to communicate quickly and freely about the financial position and management of the fund. Small funds were therefore not covered by the financial assistance arrangements.

16. Since the commencement of the SIS regime, a number of reviews and inquiries have examined Part 23, which covers the financial assistance provisions. While some changes have been made to the scope and processes, it has generally been concluded that the trustees/members of self-managed funds are able to protect their own interests and it is not necessary to extend the Part 23 provisions to these funds.

17. The object of Part 23 is to make provision for the grant of financial assistance to certain superannuation entities that have suffered loss as a result of fraudulent conduct or theft. Recoupment of the cost of providing financial assistance is via a special levy on APRA-regulated superannuation funds and approved deposit funds that have the benefit of the compensation arrangements under Part 23.

18. The conditions that must be met prior to a trustee making an application for financial assistance are:

    - at the time it suffers the loss, the fund is a regulated superannuation fund (other than a self-managed fund) or an approved deposit fund, and

    - the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits.

19. The levy is imposed on APRA-regulated superannuation entities, which collectively hold $740 billion in assets in the $1.32 trillion superannuation industry. In the current case the total cost of the levy is very small relative to total fund assets (less than one hundredth of a basis point).

Process

20. On 2 December 2009, APRA issued a show cause letter on Trio as to why they should not be suspended or removed as trustee. APRA had a number of concerns, the most significant of which that the assets of the Funds under Trio might be at risk. On 16 December 2009, after the completion of a tender process ACT Super was appointed as the acting trustee to take over from the suspended trustee.

21. ACT Super was required by APRA (as APRA would require for any acting trustee) to:

    - determine all contractual arrangements in place and obligations on the Funds;
    - identify all assets of the Funds;
    - ascertain the correct valuation of all assets, including any managed investment scheme (MIS) assets;
    - segregate the assets where an accurate valuation was not available;
    - determine whether in its view any event has occurred that would give rise to an eligible loss under Part 23 of the SIS Act;
    - determine whether there were any breaches of the SIS Act, Regulations, or any other legislation;
    - determine an accurate and reliable price of units held in the Funds to allow for redemptions; and
    - report back to APRA within 14 days on the above dot points or seek additional time to comply.

22. ACT Super determined that there was a likelihood that the Astarra Superannuation Plan, the Astarra Personal Pension Plan, the Employers Federation of NSW Superannuation Plan and My Retirement Plan that invested in ASF had suffered an eligible loss and began an investigation to determine the extent of any losses and whether the losses met the criteria for Part 23 compensation. These criteria included that the loss has caused significant diminution of the fund leading to difficulties in the payment of benefits. The ACT Super investigation concluded that the funds had suffered losses and that those losses met the Part 23 criteria. ACT Super advised APRA that it would be submitting a Part 23 assistance application for funds that had investments in the ASF; however, it had not determined the amount of the eligible loss. The determination of the dollar value of the loss hinged on the ability of the acting trustee to ascertain what exposure the funds had in the ASF at the time the loss crystallised, including an amount of interest allocated up to the crystallisation date.

23. Calculating the value of the investments held by the funds in the ASF presented ACT Super and APRA with a challenge. The fictitious returns allocated to the ASF were not supported from the information gathered by ACT Super and proved unrealistic and inflated. In considering the relevant equity issues surrounding the particular facts of the case, APRA believed that the use of the unrealistic, inflated returns would not only provide an unreasonable and unfair gain for any member who received a payment from a Part 23 grant but, if allowed to stand, would also result in an unfair impost on APRA-regulated superannuation funds.

24. On 13 April 2011, the Minister issued a determination under Part 23 of the SIS Act, for a grant of $54,994,079 to be paid to the ACT Super for payment to the members.

Terms of reference 7

The issue of fraud (in particular international fraud) in the collapse of Trio Capital and regulatory implications

25. APRA recognises that fraud within a superannuation fund can be a significant risk. As a whole we see little evidence of fraudulent activity in the regulated superannuation sector; however we are well aware the incentive for fraud exists and that trustees must be vigilant to prevent fraud from occurring. APRA has issued several publications to assist trustees in meeting their obligations to prevent fraud – 'Superannuation: How to Reduce the Risk of Fraud, A Best Practice Guide for Trustees' and 'Superannuation: Superannuation Fraud, Checklist for Trustees'. These place a significant onus on trustees to ensure that adequate internal controls are established within their funds to safeguard members' assets against fraud. As a prudential regulator, APRA focuses on the high-level risk controls within a superannuation fund.

26. Our review activities highlight the need for trustees to have in place internal control processes, methods and procedures to provide reasonable assurances that the procedures adopted by the trustee to meet the fund's objectives are being properly and appropriately met. The responsibility for the design and effectiveness of internal controls rests firmly with the trustees. Key to this is the attitude of the trustee in demonstrating a commitment to an effective control environment. It is difficult for APRA to identify cases where a trustee wilfully seeks to engage in a fraudulent activity and we generally place a reliance on other control features to ensure that this risk in minimised. Our supervision processes seek to ensure that trustees are aware of their responsibilities and to encourage best practices in fraud management.

27. APRA's guidance to fund trustees suggests that there be adequate verification that all fund assets are recorded and that all recorded assets exist. This Best Practice Guide notes that "consistent with the obligation on trustees to ensure that the assets of the fund are safeguarded, trustees have a responsibility for ensuring the existence of the fund's assets".

28. Cases of fraud in the regulated superannuation sector are rare. There have been nine applications under Part 23, although the vast majority of grant payments made to date

have been to funds which were the victim of fraud while under the trusteeship of Commercial Nominees of Australia, which encompassed 909 of the 924 grants made.

Stronger Super Reforms

29. There are a number of proposals within the Stronger Super reforms that are likely to reduce the likelihood that of similar event occurring.

30. The Stronger Super reforms propose to impose additional duties on the directors of a trustee to personally act honestly, exercise care and diligence and act in the best interests of beneficiaries (in contrast with the current position, s52(8) in the SIS Act, under which directors are merely required to take steps to ensure that the trustee (i.e. the trustee corporation) meets these standards).

31. The Government has announced that APRA is to be given a general prudential standards-making power in relation to superannuation via the SIS Act. One area in which APRA will be issuing a prudential standard is in relation to appropriate processes around investment governance and due diligence. This standard will set a sound foundation requiring trustees to develop strategies, controls and processes in relation to undertaking appropriate due diligence on investments – both at the time they are made and also on an ongoing monitoring basis. That was clearly one of the major weaknesses in how the Trio Board operated.

32. APRA is also proposing to make prudential standards on fitness and propriety and risk management. The former will ensure a greater focus on appropriate skills and conflicts management for trustees and the latter expected to encourage more robust risk management by trustees.

33. As part of the Stronger Super reforms the government has announced that a key feature of APRA's prudential standard should be a mandated conflicts policy, appropriate to the nature, scale and complexity of the trustee's operations, that covers all relevant conflicts issues. The purpose of this policy would be to provide a central and definitive statement around the identification of, and monitoring for, potential conflicts, and identification, avoidance and management of actual conflicts.