Merger matters

Superannuation fund mergers are on the rise but there are some roadblocks along the way. JIM BULLING highlights the current challenges facing funds and how to navigate them.

The superannuation industry is experiencing a range of regulatory and commercial pressures resulting in increased merger activity amongst funds. However, there are some issues contributing to the relatively modest number of Successor Fund Transfers (SFT) in recent months.

In the 12 months to June 2016, the total number of super funds declined, but only slightly. Most of the consolidation is occurring in the retail sector where activity was led by NAB which merged five of its funds and signalled the future merger of three more. From what we have observed, there seem to be at least a couple of issues contributing to the relatively modest number of recent SFTs.

Firstly, an SFT has always been technically challenging. However, the process was made even more challenging with the introduction of the comprehensive set of responsibilities imposed on super fund trustees and directors following the release of APRA Prudential Standards for RSE licensees in mid-2013.

Perhaps in response to this, APRA released Draft SPG 227 – Successor Fund Transfers and Wind Ups late last year which was the first piece of guidance from APRA in relation to SFTs since Superannuation Circular No I.C.4 was issued back in 2001. Draft SPG 227 should provide RSE licensees with some confidence on how to tackle the technical issues and should assist licensees to bring more focus to the big picture possibilities of SFTs as a means of protecting the long-term best interests of fund members.

A second issue which may have prevented some SFTs from being successfully prosecuted is the presence of unresolved conflicts of interest. One example of such conflicts is where trustee boards are comprised of directors representing a range of diverse sponsors. In some instances, directors have found it difficult to put the issues and interests of their sponsors to one side when examining the merits of an SFT. Another example of conflicts arises where cash or other consideration is being offered to the target fund as part of an SFT.

PRELIMINARY DUE DILIGENCE

Whether a target fund is actually required to consider an offer from an acquirer fund depends on the circumstances of both funds. A prudent approach would be for the board of the target fund to at least conduct a preliminary due diligence on any proposed SFT. This preliminary investigation should flesh out the critical issues and come to a view as to whether the proposal warrants the investment involved in proceeding further with detailed investigation. The level of preliminary due diligence ought to be modest in the interests of keeping costs down but should cover things such as:

- the existence and profile of respective MySuper and Choice offerings
- the extent of respective outsourcing
- respective scale, market profile and financial circumstances
- legal structure of target and acquirer
- respective board composition
- assessment of what will be required to generate agreement.

HEADS OF AGREEMENT

Assuming an agreement in principle is reached to proceed with the investigation of an SFT at the conclusion of preliminary due diligence, the parties ought to then enter into a Heads of Agreement which documents the understandings around the major issues. The Heads of Agreement commits the parties to the next stage without creating an unconditional obligation to complete the transaction. An appropriate Heads of Agreement would:

- set out the major terms of the transaction
- identify the further steps that need to be taken in order to be able to execute binding transaction documents
- set out the process for the conduct of the equivalent rights analysis and best interests analysis
- set a timetable for the parties to undertake these steps.

At the conclusion of the activity contemplated under the Heads of Agreement, the parties should be in a position to execute documentation which commits them to completing the SFT. While different circumstances will determine the precise approach, the key documents which drive the completion of the transaction are itemised as follows.

EQUIVALENT RIGHTS ANALYSIS (ERA)

An SFT can only proceed if both the transferring fund and the receiving fund confer on the transferring members equivalent rights. The essential components of the conduct of an ERA are examined in the existing and proposed APRA guidelines which include the following:

- the rights to be examined are legally enforceable rights, not features which can be changed at the discretion of the RSE licensee – for example, the list of investment options from time to time are not "rights"
- in making an assessment of equivalent rights the RSE licensee is expected to make the assessment on a bundle of rights basis rather than a line by line comparison of individual 'rights'
- in practice, such an assessment of rights is based on groups of members with common characteristics rather than on an individual basis.

APRA has provided guidance on which features of the transferring and receiving funds should be prioritised for examination and many of these features are shared by conventional accumulation funds. Accordingly, while some bespoke treatment for insurance offerings is usually required, it is likely that in a proposed SFT from a conventional accumulation fund to another conventional accumulation fund, the RSE licensees will find that equivalent rights do exist.

MEMBER BEST INTERESTS

An SFT can only proceed if the transfer is in the best interests of transferring members and the members of the receiving fund. Both boards will need to examine a host of factors should the SFT

proceed. These include:

- access to economies of scale
- fund capabilities and member services
- investment returns and risk profile
- level of reserves
- transaction costs and ongoing fees.

In relation to the assessment of member best interests, RSE licensees as trustees will be expected to have regard to the following legal principles:

- trustees must act in a manner which seeks to maximise the interests of members (not just avoid harm to members)
- trustees should not prefer one class of member over another
- trustees do not have an obligation to guarantee best outcomes
- trustees should not ignore or fail to properly consider a matter which has a material impact on the outcome for members.

Often, the best interests examination is less formulaic than for equivalent rights and RSE licensees are likely to engage in more nuanced assessments of relevant considerations with the outcome less predictable.

SFT DEED AND IMPLEMENTATION DEED

The SFT Deed formally sets out the transfer of assets liabilities and members from the transferring fund to the successor fund. The SFT Deed will also reference that both trustees are satisfied of equivalent rights and best interests and should state that both trustees have agreed to implement the SFT in accordance with the Implementation Deed.

The Implementation Deed covers the detailed terms of the preparation for the transfer including:

- proposed changes necessary for equivalent rights or members' best interests
- any amendments to the successor fund trustee's constitution or to the successor fund's trust deed
- any special arrangements to deal with conflicts of interests
- establishment and rules of an implementation committee
- composition of the successor fund trustee's board
- appropriate governance arrangements and committee structures
- ongoing administration investment and insurance arrangements
- transfer of records held by the transferring fund and its administrator
- transfer of reserves and provisioning for reserves
- cost allocation.

CONSIDERATION OF CONFLICTS AT BOARD LEVEL

Section 52 and 52A of the *Superannuation Industry Supervision Act* provide that when a conflict arises between the duties of the trustee and directors to members, and the duties of the trustee and directors to any other person, the trustee or director must give priority to the duties to, and the interests of, members.

This means in the context of an SFT, the RSE licensee and its directors will need to ensure that any duties to sponsoring entities are not given priority over the duties owed to, and the interests of, members.

For example, where due diligence establishes that the proposed SFT is in the best interests of transferor fund and transferee fund members, a director is not entitled to reject the SFT on the basis that the director will not be a part of the go forward board or the director's sponsoring organisation will no longer be able to nominate directors to the go-forward board.

Another potential conflict may arise where cash or other consideration is being offered to the target fund in order to agree to the SFT. Directors will need to identify how this consideration will be distributed and if any part of it is to go to parties other than members – in which case a conflict with members' best interests arises which will need to be carefully managed. Such management will involve a sophisticated analysis and may involve disclosure to members.

In an environment where economies of scale are challenging the business models of many smaller funds and there is significant likelihood of changes to existing default fund mechanisms, RSE licensees need to better understand the possibilities of SFTs as a means of ensuring the long-term best interests of members.

Such a better understanding needs to involve a structured approach to the legal and regulatory mechanisms for a successful SFT together with a sophisticated appreciation by trustees and directors of their legal obligations in relation to conflicts of interest. SF

Jim Bulling is a partner at K&L Gates.