Research Report

Legal Considerations for Superannuation Investors when Investing in Complex Financial Products

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JULY 2015
WORKING PAPER NO.079/2015 / PROJECT NO.E015

This research was supported by the Centre for International Finance and Regulation, which is a Centre of Excellence for research and education in the financial sector, funded by the Commonwealth and NSW Governments www.cifr.edu.au.
RESEARCH REPORT

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July 2015

ABSTRACT

Institutional investment in Australia is both highly innovative and complex. The regulatory focus – and associated literature – on institutional investment has been on the sell-side. Considerably less attention has been paid to the buy-side, that is to the institutional investors themselves. This research report outlines the structure of Australian superannuation funds and discusses the governance aspects of superannuation fund trustees relevant to investment decision-making. The report also examines the superannuation fund trustee’s investment responsibilities in the context of investment in complex financial products. We have chosen to focus on synthetic CDOs. This research report is the first study in Australia of the governance of institutional investors when investing in synthetic CDOs. We have also created a practical check-list of the key aspects of synthetic CDOs that superannuation fund trustees should understand before investing in synthetic CDOs.

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LEGAL CONSIDERATIONS FOR SUPERANNUATION INVESTORS WHEN INVESTING IN COMPLEX FINANCIAL PRODUCTS

Institutional investment in Australia is both highly innovative and complex. Both aspects are epitomised by the wide range of sophisticated financial products – such as infrastructure-related securities, securities issued in securitisation programmes, and interests in hedge funds and private equity funds – that are available to institutional investors in Australia to choose from. The focus, in terms of understanding these complex financial products and the regulatory response to such products, has largely been on the “sell-side”. This is mirrored in the regulatory framework governing financial products and services in Australia, in relation to both the pre- and post-global financial crisis framework, set out in Chapter 7 of the Corporations Act 2001 (Cth). Chapter 7 is concerned chiefly with the legal obligations of the parties who advise on, promote or deal in financial products: amongst the objectives of Chapter 7 are ensuring “fairness, honesty and professionalism” by parties on the sell-side and that those parties provide sufficient information to ensure that the “consumers” to whom advice on financial products has been given or financial products have been marketed can make “confident and informed” decisions about the advice or financial products.¹

This research report takes a different approach to Chapter 7 and the large body of Australian legal literature on financial product regulation. The report investigates the “buy-side”, that is the consumers of these products. Our focus is on institutional investment in complex financial products and the regulatory context in which these investors make decisions about investments. We have selected superannuation funds to highlight the legal obligations to which institutional investors are subject when investing in complex financial products, for the following reasons: first, superannuation funds display a key characteristic of most institutional investors. Superannuation funds do not invest for their own account but, instead, have been entrusted with the management of assets – in their case, retirement savings – for the benefit of other parties and, therefore, the observations made in this research report can be extended to other institutional investors such as the wide variety of mutual
funds and other collective investment products; secondly, the sheer scale of Australian superannuation funds combined with their “appetite” for complex financial products; and, finally, the recent reforms to the Australian superannuation sector, in the form of the “Stronger Super” reforms, which significantly outweigh recent regulatory interventions in relation to other types of institutional investors. These reforms have had a direct bearing on the discharge by the trustees of superannuation funds of their legal obligations when making investment decisions.

This research report has three sections. The first section outlines the structure of Australian superannuation funds, including the proliferation of the trust in the superannuation sector. The second section discusses the governance aspects of superannuation fund trustees relevant to investment decision-making. This concerns the core legal obligation imposed on these trustees to invest the assets of superannuation funds prudently. Our research report also comments on the extent to which this core obligation has been impacted by the recent Stronger Super reforms. The final section of this report examines the superannuation fund trustee’s duty of prudence in the context of investment in complex financial products as illustrated by synthetic “CDOs” (Collateralised Debt Obligations). We have chosen this particular financial product as it brings into sharp focus the risks associated with investments in complex financial products. CDOs were, moreover, one of the principal mechanisms by which losses stemming from the United States sub-prime mortgage lending market were transmitted worldwide, during the global financial crisis, to institutional investors, including those in Australia. Furthermore, the inner workings of synthetic CDOs have, in one of the rare examples, from a major economy, of judicial scrutiny of complex financial products, recently been laid bare for all to see, including for prospective investors like superannuation funds. This research report is the first study in Australia of the legal obligations of institutional investors when investing in synthetic CDOs – and, as with our examination of the duty of prudence applying to superannuation fund trustees, our comments on investing in synthetic CDOs can be extended to other types of institutional investors and also other types of complex financial products. As part of this study, we have created a practical check-list of the key aspects of synthetic CDOs that superannuation fund trustees should understand before investing in synthetic CDOs.
1. STRUCTURE OF AUSTRALIAN SUPERANNUATION FUNDS

Australian superannuation fund assets totalled $1.93 trillion at the end of 2014. These superannuation funds are, on the whole, less risk averse than their counterparts from other developed countries, bearing out observations as to their “adventurousness” in allocating their assets to complex financial products. Compared to superannuation funds in other OECD countries, Australian superannuation funds tend to invest very heavily in shares and heavily in “other” assets (which include property and infrastructure investments as well as mutual funds, hedge funds, private equity funds and structured products like synthetic CDOs).

Most Australian superannuation funds are organised as trusts, although there is no legal requirement for superannuation funds as a whole to adopt that legal form. Despite that, the overwhelming preference for the trust has been strongly influenced by the Superannuation Industry (Supervision) Act 1993 (Cth) (“SIS Act”), which sets out the regulatory framework for superannuation funds in Australia. The SIS Act imposes certain mandatory covenants on the party responsible for managing a superannuation fund, whether that party is a trustee or not. These covenants – which include the investment duties discussed in the next section of this research report – are informed by Australian trust law and make it very difficult, in practice, for superannuation funds, other than retirement savings accounts, to be structured other than as trusts.

Superannuation funds, particularly larger funds, are characterised by chains of legal relationships arising out of the delegation by the trustee (or manager) of the fund of particular investment-related functions. The trustee of a superannuation fund may directly hold investments in its own name but it is the norm in the case of larger superannuation funds for investments to be held indirectly via intermediaries. Those intermediaries typically comprise, at a minimum, a custodian and a nominee. Investments are registered in the name of the nominee which holds them on a bare trust for the benefit of its client, the custodian. The custodian, in turn, holds its entitlement to the underlying investments on a bare trust for its client, the superannuation fund trustee. While the custodian’s role usually extends beyond the mere safe-keeping of investments and the settlement of transactions to information...
and accounting services (including portfolio valuation and analysis) and securities lending, it is unusual for a custodian (in its capacity as a custodian) to provide a superannuation fund with advice as to the making of investment decisions.\(^{14}\)

The selection of investments (and the subsequent decisions to hold or sell investments) for a superannuation fund are often made on the advice of a third party or made for the fund by a third party. These third parties range from investment advisers and asset consultants (who advise on the selection of individual investments, the composition of the superannuation fund’s portfolio and the appointment of fund managers) to feeder fund managers, fund of funds managers and investment platform managers (who offer a “menu” of specialist fund managers for the superannuation fund trustee to choose from) and, finally, to specialist fund managers (who select investments, including complex financial products, for the superannuation fund).\(^{15}\) This reliance on advice or delegation of selection of investments by a superannuation fund trustee to another party does not absolve the trustee from its own legal obligations in connection with the investment of the superannuation fund’s assets.\(^{16}\)

Thus, Australian superannuation funds, regardless of the legal structure adopted by them, are subject to statutorily-imposed trustee-style covenants, which prescribe duties in relation to the investment of fund assets. In addition, while superannuation investment may involve chains of legal relationships arising from the obtaining of advice from or the delegation of investment-related functions to third parties, these arrangements do not derogate from the trustee’s own legal obligations regarding the making of investments. Superannuation fund trustees cannot contract out of their investment-related duties and remain liable for the discharge of those duties. The next section of this research report examines these investment-related duties.

2. THE INVESTMENT DUTIES OF SUPERANNUATION FUND TRUSTEES

The scope of the investment duties to which a superannuation fund trustee is subject, is established by the interrelationship of the SIS Act, the trust deed or other governing rules of the fund and general law. While the overarching obligation of trustees is to obey the terms of their trust deeds, the SIS Act imports into those trust deeds several covenants that cannot be contracted out of and which determine the minimum
standard of care that trustees must adhere to when making investments. This duty of care is the core investment-related duty owed by trustees of superannuation funds.\textsuperscript{17}

The duty of care exists at general law and “sits alongside” the corresponding statutory duty of care imposed on superannuation fund trustees by the SIS Act.\textsuperscript{18} The current version of this statutory duty, contained in section 52(2)(b) of the SIS Act, is the result of the changes to the SIS Act effected by the \textit{Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012} (Cth) as part of the Australian government’s Stronger Super reforms.

Section 52(2)(b) requires trustees of registrable superannuation entities:\textsuperscript{19}

\begin{quote}
“to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as a \textit{prudent superannuation trustee} would exercise in relation to an entity of which it is trustee and on behalf of the beneficiaries of which it makes investments”\textsuperscript{20} (emphasis added)
\end{quote}

The use of the term “prudent superannuation trustee” and the explanation of that term in the SIS Act as “a person whose profession, business or employment is or includes acting as a trustee of a superannuation entity and investing money on behalf of beneficiaries of the superannuation entity”\textsuperscript{21} constitute a deliberate departure from the “ordinary prudent person” language of the previous version of this trustee covenant.\textsuperscript{22} This new term was explicitly intended to “hold trustees to a higher standard” than that mandated by the earlier wording in relation to the making of investments by a superannuation fund trustee as well as the trustee’s non-investment activities.\textsuperscript{23}

This change to section 52(2)(b) does not, however, impose on the trustees of superannuation funds a higher standard of care than that to which they would have been subject at general law. The standard of the prudent business person has been the widely-accepted benchmark for the duty of care that arises at general law in relation to the making of investments by superannuation fund and other trustees.\textsuperscript{24} The previous version of section 52(2)(b), through its reference to the standard of an \textit{ordinary} prudent person, in contrast to the standard of a prudent \textit{business} person, was considered to impose on the trustees of superannuation funds a lower standard of care.
than that demanded of trustees at general law. Two – alternative – reasons have been mooted for this earlier departure from the general law standard: first, this departure was inadvertent as Parliament’s intention had been, through the reference to the ordinary prudent person, to incorporate in the SIS Act the general law standard of care; and, secondly, this departure from the general law standard was deliberate as Parliament had decided on a lower standard under the SIS Act to facilitate equal representation of employers and employees in respect of employer-sponsored superannuation funds. (It was thought that requiring employee-representatives to meet the standard of a prudent business person would dissuade employees from acting as trustees.)

Whatever the reason for the previous version of section 52(2)(b), the present version of that section makes it clear that the superannuation fund trustee’s duty of care, insofar as investment-related decisions are concerned, now coincides with the general law duty of care. The content of that latter duty, as articulated by Australian and other common law courts, now directly informs the statutory duty.

The boundaries of this duty of care – known as the “prudent investor rule” – have been articulated as follows by the Australian courts:

- The minimum standard required of all trustees is that of a prudent business person. This was the standard established under English law in the 19th Century. At that time, however, trusts were not used for the types of investments that are now commonplace amongst superannuation funds (and other modern investment trusts). Nor then were most trustees professionals. The Australian courts have explicitly left the door open to imposing a higher standard of care on professional trustees who hold themselves out as having special knowledge, skill or experience in investment, invite reliance on their services by virtue of their expertise in investment, and charge significant fees for their services. The current version of section 52(2)(b) is sufficiently broad to cover both the minimum standard and any heightened standard that might be applied by an Australian court in relation to professional trustees.
• The overarching constraint on a superannuation fund trustee’s making of investments is that of “caution”. The primary objectives of a trust are, consequently, the preservation of capital and the procurement of income from that capital. The trustee’s discharge of its duty of care is therefore to be evaluated against this standard. The Australian courts have explained this standard by contrasting the constrained role of the trustee with that of directors. Directors are free to “display entrepreneurial flair and accept commercial risks to produce a sufficient return on the capital invested” whereas trustees must “exercise a degree of constraint and conservatism in investment judgments”.

This theme of caution articulated by the Australian courts – and which informs section 52(2)(b) – raises the issue of the extent to which superannuation fund trustees may avail themselves of contemporary investment theories and practice when investing fund assets. Strict adherence to this need for caution would, in common with the foundational cases on the prudent investor rule from the 19th Century, effectively force superannuation fund trustees to focus on low-risk, low-return investments. In determining whether making a particular investment is consistent with the trustee’s duty of care, the trustee would have to assess that investment on its individual merits, in particular its risk, in isolation from the superannuation fund’s existing investments. The subordination of the trustee’s investment powers to the objective of capital preservation would preclude a trustee from investing in many modern financial products, particularly complex financial products that generally carry a higher risk (and higher return), thus potentially undermining the ability of the trustee to optimise the return on fund assets.

While the preponderance of Australian judicial opinion in relation to the prudent investor rule is on the side of caution, there are a small number of instances in which the Australian and English courts have expressed a clear preference for a different approach. The clearest examples of this are in the English case, Nestle v National Westminster Bank plc and the Australian case, Re Buckland:

“Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk
level of the entire portfolio rather than the risk attaching to each investment taken in isolation.”

“I am satisfied that a prudent investor in Australia would, now, have no hesitation in committing funds to most mining shares, not merely to gather revenue but also to spread portfolio risk in line with the so called modern portfolio theory.”

Modern portfolio theory looks at the relationship between risk and return and considers how different combinations of investments can be used to construct a portfolio that is capable of generating the maximum returns for the particular level of risk assumed. This approach to investing is predicated upon portfolio diversification and the focus is not so much on the riskiness of individual investments (which might, under a strict adherence to the requirement for caution, have rendered those investments ineligible for inclusion in the superannuation fund trustee’s portfolio) but on how each investment in the portfolio performs in relation to, or is correlated with, other investments. Modern portfolio theory posits that it is possible to construct portfolios that generate higher rates of return with a lower overall risk than might be suggested by the riskiness of each investment contained in the portfolio. Investors should, on that basis, be able to reduce the overall riskiness of their portfolios by diversifying those portfolios across investments that are weakly or not correlated with each other.

The difference between an approach to investments predicated upon modern portfolio theory and one based on a strict reading of the requirement for caution can be explained in the following terms:

“The central principle of portfolio theory ... is that the risk of a portfolio is wholly distinct from the risk of any particular investment contained in the portfolio. The risk of a portfolio is a function of the interaction of its component investments. Thus, a trustee can use securities and instruments that are highly risky viewed in isolation to assemble a portfolio that is safe ... Portfolio theory justifies the inclusion, in appropriate amounts, of stocks thought to be risky. It also justifies the use of financial instruments, highly
volatile in themselves, that may be deployed so as to lower portfolio risk or to attain a portfolio of a given risk at a lower cost.  

The SIS Act also goes some way to resolving the concerns created by this overarching requirement for caution. Section 52(6) of the SIS Act requires trustees of registrable superannuation entities to give regard to certain prescribed circumstances when formulating an investment strategy. These include:

- The risk and likely return of individual investments;
- The composition of the investments including the extent to which the investments are diverse or involve the superannuation fund being exposed to risks from inadequate diversification;
- The liquidity of the investments;
- The ability of the trustee to discharge its liabilities;
- The tax consequences of the investments; and
- The costs that may be incurred in relation to the investments.

The above concepts mentioned in section 52(6) are all consistent with modern portfolio theory but whether they signify the importation of modern portfolio theory into the trustee covenants of the SIS Act remains open to debate. Donald aptly notes that these concepts are not unique to modern portfolio theory and, indeed, have long pre-dated that theory. What can, however, be said is that, at a minimum, there is nothing in section 52(6) that would bar a superannuation fund trustee from making use of contemporary investment theories – including modern portfolio theory – when formulating investment strategies or otherwise making investment decisions for its fund. The trustee’s freedom of action in relation to investment decisions thus remains bounded by the requirement for caution due to the nature of the trustee’s office (trustees are, consequently, denied the freedom enjoyed by a director of a company that invests for its own account) but the rigours of that requirement have
been mitigated by section 52(6) of the SIS Act. Complex financial products which might have been barred by a strict adherence to the need for caution in investment are potentially available for inclusion in the portfolios of superannuation funds due to section 52(6).

The SIS Act also introduces three major refinements to the superannuation fund trustee’s duty of care that have no counterpart at general law:

- The directors of a registrable superannuation entity must, in the case of their statutory duty of care, discharge that duty to the same standard of prudence as applies to the trustee itself;\textsuperscript{44}

- Section 52(6) prescribes the matters trustees must take into account in relation to both the whole of the superannuation fund and each individual investment option offered by the trustee to the beneficiaries of the fund.\textsuperscript{45} This recognises the reality that superannuation funds are not managed as a single portfolio in accordance with a monolithic investment strategy. The majority of the larger superannuation funds, particularly industry funds and public sector funds, offer their beneficiaries a choice of investment strategy.\textsuperscript{46} Accordingly, the assets subject to each strategy are to be managed as individual sub-portfolios within a larger portfolio; and

- Superannuation fund trustees are subject to enhanced duties in relation to MySuper. MySuper was introduced as a low cost, simple, default superannuation product for fund beneficiaries who had chosen the default investment strategy offered to them or who, as is the case with the vast majority of beneficiaries, had not made a choice of investment strategy at all.\textsuperscript{47} These duties are in addition to the trustee covenants in section 52 that apply to the entire fund and all of the investment strategies, including MySuper, offered by the superannuation fund trustee.\textsuperscript{48} A trustee must promote the financial interests of MySuper beneficiaries and also consider whether those beneficiaries are disadvantaged compared to MySuper beneficiaries under other superannuation funds.\textsuperscript{49} These additional duties are explicitly intended to subject trustees to a higher standard of care in relation to their MySuper
beneficiaries, in recognition of the fact that these beneficiaries have “effectively delegated the responsibility for making decisions regarding their superannuation to the trustee”. It is not immediately clear how the position of MySuper beneficiaries differs from that of the other beneficiaries of the fund who have also effectively delegated the responsibility for managing their portion of the superannuation fund to the trustee. It is presumably the case that the former are considered deserving of a higher degree of protection since, in contrast to the latter, they have not selected an investment strategy and thus bargained for the level of risk inherent in that strategy.

The web of investment duties imposed by the SIS Act is depicted in the following figure.

*Figure 1. Trustee’s core investment duties*
Superannuation fund trustees are subject to a duty of care, at both general law and under section 52(2)(b) of the SIS Act, when deciding to make investments. The discharge of the statutory duty involves trustees taking into account a non-exclusive list of prescribed matters which are consistent with, and flexible enough to permit the trustee to take account of, modern portfolio theory. This means that complex financial products are not rendered ineligible as investments for superannuation funds simply because of the higher risks that may be associated with them. Nonetheless, a trustee who invests in complex financial instruments, such as synthetic CDOs, will need to be able to justify that investment for the entire superannuation fund as well as in terms of the individual strategy under which that investment is being made.  

3. INVESTING IN SYNTHETIC CDOs

Synthetic CDOs usefully illustrate the challenges for superannuation fund trustees when contemplating investments in complex financial products. One of the main challenges to trustees concerns the transparency of these products and the trustee’s ability to obtain information about them. The placing of details about synthetic CDOs on the public record, following submissions to the court by expert witnesses, in *Wingecarribee Shire Council v Lehman Brothers Australia Ltd*, not only educates prospective investors about synthetic CDOs but also informs such investors, by way of analogy, of the matters that they need to understand in relation to similar complex financial products. That case involved a successful claim by three local councils against an investment bank for mis-selling synthetic CDO securities to them. This section explains the structure of a generic synthetic CDO corresponding to the CDOs that were the subject of *Wingecarribee Shire Council v Lehman Brothers Australia Ltd* and considers the matters that superannuation fund trustees should have regard to, in the discharge of their investment duties, when considering the securities issued in synthetic CDOs for inclusion in their fund portfolios.

The synthetic CDOs in *Wingecarribee Shire Council v Lehman Brothers Australia Ltd* exposed its investors to the risks of United States sub-prime mortgage loans. This was by no means unusual. It has been estimated that, in the lead-up to the global financial crisis, over a third of the synthetic CDOs that had been sold to investors worldwide, including investors in Australia, carried some form of exposure to US
sub-prime mortgage loans. However, for many of these investors, the link between the risks associated with those mortgages and the securities that they had purchased was not obvious. This is largely due to the structure of synthetic CDOs and the manner in which risks are transferred to the investors in the securities issued in a synthetic CDO.

The securities held by investors in a synthetic CDO differ from conventional debt securities in that they are backed neither by the assets of a corporation (in the case of corporate bills and bonds) nor by assets purchased by the issuer using the proceeds of the securities (in the case of a conventional or asset-backed securitisation). The assumption of risks by the investors is more transparent in these instances compared to a synthetic CDO – here the investors are directly exposed to the risks of the purchased assets since the performance of their securities depends upon the assets generating sufficient cash-flows.

In contrast, a synthetic CDO comprises one or more securitised credit derivatives. The investors, by purchasing the securities, are collectively assuming the risks that have been transferred to the issuer of the securities under a credit derivative that it has entered into with a third party such as an investment bank (as was the case in Wingecarribee Shire Council v Lehman Brothers Australia Ltd) or a hedge fund. The investors are thus collectively betting that the risks transferred will not eventuate or, at least, will not eventuate with sufficient severity to impact adversely the particular securities held by them.

This transfer of risk is effected using a credit derivative known as a “credit default swap”. A credit default swap is a privately negotiated contract between a “protection buyer” (the third party referred to above), who agrees to transfer the credit risk in relation to specified financial assets (the “reference obligations”), and a “protection seller” (the issuer of the securities in a synthetic CDO) who, in exchange for the payment to it of fees by the protection buyer, agrees to assume that risk. If a stipulated “credit event” occurs, the credit default swap will normally terminate and the protection seller will be obligated to settle the credit default swap with the protection buyer. The credit events most commonly encountered in the credit default swaps used in synthetic securitisations are the bankruptcy of the underlying obligor or
obligors in relation to the reference obligations (for example, the borrower under a sub-prime mortgage or the corporation that is the borrower under a corporate loan or is the issuer of debt securities) and a payment default in relation to the reference obligations.\textsuperscript{58}

Credit default swaps can be structured to transfer the credit risk relating to selected reference obligations of a single entity or the credit risk of a portfolio of the reference obligations of multiple entities. It is also possible for these swaps to be structured so that they do not terminate until a designated number of credit events have occurred in relation to the reference obligations but the vast majority of credit default swaps are designed to terminate on the first occurrence of a credit event.\textsuperscript{59}

Notwithstanding the basis for termination used in a particular credit default swap, all credit default swaps provide for two mutually exclusive scenarios. Either the termination of the credit default swap is not triggered, in which case the swap continues in force until its maturity date, or termination of the swap is triggered by a credit event occurring, in which case the protection seller must physically settle or cash settle the swap. In the case of a physically-settled swap, the protection seller must pay the protection buyer the aggregate face value of the reference obligations against the delivery to the protection seller of the reference obligations or eligible substitute obligations.\textsuperscript{60} In contrast, there is no delivery of obligations in the case of a cash-settled credit default swap; instead, the protection seller must pay the protection buyer an amount calculated by reference to the fall in the value of the reference obligations or a previously agreed percentage of the aggregate face value of the reference obligations.\textsuperscript{61} The credit default swaps that underpin synthetic securitisations are usually cash-settled.\textsuperscript{62}

In a synthetic CDO, the credit risk assumed by the protection seller or issuer is passed on to the investors as a whole by making the issuer’s obligation to pay principal and interest on their securities subordinate to the issuer’s obligation to make a payment under the credit default swap during the term of the securities.\textsuperscript{63} If no credit event occurs, meaning that the reference obligations have performed according to their terms, the investors will receive principal and interest payments on the scheduled payment dates. On the other hand, if a credit event occurs leading to the termination
of the credit default swap (or swaps) between the issuer and the protection buyer or third party, the amount paid by the issuer under that swap will deplete – or even exhaust – the assets that it has available to meet the investors’ claims for principal and interest.

The issuer, in a synthetic CDO, sits between the third party that has transferred credit risk under the credit default swap and the investors who hold securities issued by the issuer. The proceeds from the issue of the securities are invested by the issuer, typically in highly liquid, highly rated debt securities (such as government bonds). That investment supports, in order of descending priority, the issuer’s obligations under the credit default swap and services the issuer’s principal and interest obligations under the securities held by the investors.

The investors are compensated for this collective assumption of credit risk, with interest payments on their securities comprising a combination of the income from the issuer’s investment of the proceeds of the securities and a portion of the fee paid to the issuer by the third party under the credit default swap. The securities held by the investors are also usually tranched, with the senior tranches of securities having priority over the junior tranches.64 On both the maturity of the securities (where the credit default swap has not been terminated by a credit event) or on the earlier termination of the credit default swap, the investors receive their payments in order of descending seniority. The senior-most tranche of securities is paid first and the junior-most tranche last; only after the issuer’s principal and interest obligations to the senior-most tranche have been fully discharged will the next senior-ranking tranche receive any payments. The credit risk of the reference obligations are therefore concentrated in the junior-most tranche and that tranche will be the first to be adversely impacted by the issuer’s application of the invested proceeds in payment of its obligations under the credit default swap.

The legal structure of a synthetic CDO can be depicted as follows.
For many institutional investors, including superannuation funds, the attraction of synthetic CDOs lies in the enhanced interest rates carried by the various tranches of securities (as these securities receive the benefit of the income from the highly rated debt securities that the issuer has invested in, supplemented by a portion of the fee paid to the issuer under the credit default swap). Behavioral institutional investors may also be attracted by the capacity of synthetic CDOs to deliver to them a highly customised exposure to the credit risk of, for example, selected companies, groups of companies or even companies that are operating in a selected industry or are based in a selected geographic location. A superannuation fund trustee contemplating an investment in a synthetic CDO must understand the structure of the CDO and the risks associated with the securities issued to investors and be able to assess the risk and return profile of the CDO securities and the impact of investing in them on not only the superannuation fund as a whole but also on the particular investment strategy under which the CDO securities will be acquired.
In the absence of explicit legislative, regulatory or case-law guidance, we have created a practical check-list of the key aspects of synthetic CDOs. This is intended as “best practices” check-list for superannuation fund trustees and is consistent with the standard of prudence analysed in this research report. A superannuation fund trustee therefore should, in terms of meeting the standard of prudence that applies to it, be in a position to understand or obtain advice on:

- The legal structure of the synthetic CDO, in particular:

  (i) the nature of the reference obligations. These can range from highly risky unsecured loans to individuals, to less risky corporate bonds and relatively low risk residential home mortgage loans. In addition, the trustee should be aware that the reference obligations can encompass securities issued in other securitisations, including synthetic CDO securities and it may be difficult to obtain clear information on the reference obligations underlying those securities. The nature of the reference obligations also has implications for any diversification benefits that the trustee is expecting to gain by investing in the securities. Those benefits may be eroded where the reference obligations are similar to other investments that the trustee already holds;

  (ii) the credit events stipulated in the credit default swap or swaps through which investors in the securities are being exposed to the credit risk of the reference obligations. While these credit events are usually confined to the bankruptcy of the underlying obligors or a payment default (“failure to pay”) on the reference obligations, that will not necessarily always be the case. The credit events may encompass the rescheduling or other restructuring of the reference obligations and thus the issuer’s obligations under the credit default swap may be triggered by steps taken in relation to an underlying corporate or government obligor to address a deterioration in its creditworthiness even though bankruptcy or a failure to pay has not yet occurred;

  (iii) the settlement terms for the credit default swap or swaps. If it is difficult to value the reference obligations (particularly where the
reference obligations are illiquid) following the occurrence of a credit event, cash settlement may not be practicable. In this situation, the terms of the credit default swap may make provision for alternatives to cash settlement and the trustee needs to understand the implications of these often very complex alternatives for the issuer’s payment obligations under the credit default swap. These alternatives impact the payments that the issuer is required to make under the credit default swap and will, as a consequence, impact the issuer’s payments to the investors under the securities; and

(iv) the priority-ranking of the securities that the trustee proposes to invest in.

These four structural features of synthetic CDOs have a direct bearing on the risk of the securities and thus on the superannuation fund as a whole and the relevant investment strategy;

- Whether the interest rate payable on the securities that the trustee proposes to invest in is sufficient compensation for assuming the credit risk of the reference obligations. The trustee should be aware that, depending on the severity of a credit event and the priority-ranking of the tranche of securities, the principal amount of those securities may be substantially depleted or even entirely exhausted by the discharge of the issuer’s obligations to the third party under the credit default swap;

- The liquidity of the securities that the trustee proposes to invest in. The more complex the structure of the synthetic CDO and the less liquid and transparent the underlying reference obligations, the more difficult it may be for the trustee to exit its investment position by selling the securities, even before a credit event has occurred; and

- The regulatory status of the synthetic CDO. The court in Wingecarribee Shire Council v Lehman Brothers Australia Ltd held that the securities issued in a synthetic CDO satisfied the definition of “derivative” in Chapter 7 of the Corporations Act (section 761D). While this is testament to the very broad
terms in which that statutory definition is expressed, the result is that securities, whose payment obligations are uncertain (that is, contingent on a credit event happening or not happening) and where the amount to be paid to the investors is ultimately calculated by reference to the value of something else (namely, the reference obligations), will be treated as derivatives. Accordingly, the trustee must ensure that not only do the securities satisfy the matters prescribed in section 52(6) but that the securities – as derivatives – do not breach any of the guidelines that the superannuation fund has in place for the trading of derivatives.

4. CONCLUSION

The regulatory focus – and associated literature – on institutional investment as well as complex financial products, such as the synthetic CDOs discussed in this research report, has been on the sell-side. This is unsurprising given that one of the best ways of protecting the consumers of financial products is to restrict the parties who can advise on, promote or deal in those products. This, however, leaves us with an incomplete picture of the regulatory framework for institutional investment and, consequently, with an incomplete picture of the regulatory protections available to consumers. The focus on the sell-side tends to overshadow the fact that many of the largest “consumers” of financial products, especially complex financial products, are investing in those products not for their own account but on behalf of and for the benefit of their own investors, the ultimate consumers of the financial products. An understanding of the legal duties that intrude when, for instance, a superannuation fund trustee invests in financial products is necessary for assessing the efficacy of the protections available to Australian consumers whose retirement savings are held in superannuation funds. This, in turn, has a direct bearing on consumer confidence in, and, consequently, the integrity of, Australia’s superannuation sector and, ultimately, Australia’s institutional investment sector and the Australian financial markets.

The recent changes to the regulation of Australian superannuation funds effected by the Stronger Super reforms, make it clear that the trustees of superannuation funds (excluding self-managed superannuation funds) must, when making investment-related decisions, meet the benchmark of a prudent business person. This is a
deliberate heightening of the standard – of an ordinary prudent person – that previously applied to superannuation fund trustees under the SIS Act. The SIS Act also prescribes certain matters, including the risk and return profile of investments, that must be taken into account in the discharge of a trustee’s investment responsibilities. These matters apply not just to the fund as a whole but also, as a result of the Stronger Super reforms, to each individual investment strategy that the trustee has offered to the beneficiaries of the fund.

The synthetic CDOs that we have selected for discussion in this research report provide a useful illustration of the issues confronting superannuation fund trustees intending to invest in complex financial products. Trustees must, in order to discharge their investment duties, have sufficient understanding of such products to assess the likely impact of those products on their superannuation fund as a whole and also on the particular investment strategy under which the investment in the product has taken place. A trustee must, first, obtain reliable information about the risk and return profile of the financial product and, secondly, be in a position to evaluate that information. We have created a check-list of the most important facets of a synthetic CDO that a trustee should understand when deciding whether to invest in synthetic CDO securities. Beyond the practical guidance that this check-list may provide, the check-list is intended to give an example of the informational hurdles confronting a trustee intending to invest in a complex financial product.

Finally, the ramifications of Wingecarribee Shire Council v Lehman Brothers Australia Ltd for superannuation fund trustees (and other institutional investors, such as mutual funds, that invest fund assets on behalf of others) have yet to be fully explored. The judicial confirmation of the status of synthetic CDO securities as “derivatives” has implications beyond those securities for all complex financial products where the securities or other instruments held by investors are substantially underpinned by derivatives or other risk-transfer mechanisms. This also warrants superannuation fund trustees re-examining their guidelines for transacting derivatives, particularly where those guidelines largely restrict dealings in derivatives to hedging against risks like adverse interest rate and foreign exchange movements.
Corporations Act 2001 (Cth), s 760A.


Synthetic CDOs have been comprehensively examined by the Australian courts in Wingecarribee Shire Council v Lehman Brothers Australis Ltd (2012) 301 ALR 1 and ABN AMRO Bank NV v Bathurst Regional Council (2014) 309 ALR 445. The information contained in these two decisions strips away much of the mystique associated with these complex financial products and also constitutes a valuable advance in understanding such products.


Donald, above n 2, 64.

OECD, ‘Pension Markets in Focus’ (2014), 21; APRA, ibid, 8. See also J. Getzler, ‘Fiduciary Investment in the Shadow of Financial Crisis: Was Lord Eldon Right?’ (2009) 3 Journal of Equity 219, 224. The investment strategy and asset allocation of a particular superannuation fund will be affected by factors such as its benefit structure, its liabilities, its membership profile, the level of member contributions and whether the fund is predominantly in an accumulation phase or a withdrawal phase. Despite this, the country-level data published by the OECD shows that Australian superannuation funds have, on the whole, a relatively high proportion of their funds under management allocated to “other” assets compared to superannuation funds from other developed countries.

The Superannuation Industry (Supervision) Act 1993 (Cth) requires all APRA-regulated superannuation funds (s 19(2)) and all ATO-regulated self-managed superannuation funds (s 17A(1) and (2)) to have a “trustee”. However, paragraph (b) of the definition of “trustee” (in s 10(1)) explicitly contemplates that a superannuation fund may take forms other than that of a trust. Notwithstanding this, superannuation funds which are “public offer entities” (that is, public offer superannuation funds (which include most industry funds), approved deposit funds and pooled superannuation trusts) must be organised as trusts proper (s 152(2A)(b)). The trust is also the preferred form for superannuation funds in other major common law jurisdictions, for example, England (G. Moffat, ‘Pension Funds: A Fragmentation of Trust Law?’ (1993) 56 Modern Law Review 471, 471) and the United States (J. H. Langbein, ‘The Secret Life of the Trust: The Trust as an Instrument of Commerce’ (1997) 107 Yale Law Journal 165, 168-170).

E.g. SIS Act, s 52(1).


Australian Superannuation Commentary (online version, CCH, Sydney, 2015), [17-110].

14 Benjamin and Yates, ibid, 3-5.
15 Ali, Stapledon and Gold, above n 12, 5-9; P. F. Hanrahan, Funds Management in Australia: Officers’ Duties and Liabilities (LexisNexis Butterworths, Sydney, 2007), 9-12.
16 Australian Superannuation Commentary, above n 11, [33-190]. Superannuation fund trustees can appoint agents such as fund managers and custodians to act on behalf of the trustee (SIS Act, s 52(5)). The SIS Act imposes minimum qualifications for both fund managers (ss 125 and 126K) and custodians (ss 123 and 126K). In addition, just as a superannuation fund trustee is subject to a duty of care in connection with its investment-related decisions so too will a fund manager owe the trustee (but not the beneficiaries of the fund) a duty of care in relation to the investments it selects for the fund: Hanrahan, ibid, 60-61; T. Spangler, The Law of Private Investment Funds (Oxford University Press, Oxford, 2008), 82-84. Further, in the case of APRA-regulated superannuation funds, approved deposit funds and pooled superannuation trusts, the SIS Act renders void attempts by fund managers to exclude or limit their liability for negligence (s 116). See also Hanrahan, ibid, 54-56; D. Loxton and N. D’Angelo, ‘Trustee’s Limitation of Liability: Myths, Mysteries and a Model Clause’ (2013) 41 Australian Business Law Review 142.
18 Hanrahan, ibid, 57.
19 Registrable superannuation entities are APRA-regulated superannuation funds, approved deposit funds and pooled superannuation trusts (s 10(1)).
20 SIS Act, s 52(2)(b).
21 SIS Act, s 52(3).
22 The original “ordinary prudent person” wording has been retained in relation to self-managed superannuation funds: SIS Act, ss 52B(2)(b). This further bears out the
argument that the “prudent superannuation trustee” standard represents a heightening of the original “ordinary prudent person” standard: see further House of Representatives, Explanatory Memorandum: Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, [1.65].


26 Donald suggests that the SIS Act simply adopted the Australian Law Reform Commission’s view that the benchmark at general law was that of an ordinary prudent person. The Law Reform Commission, as Donald notes, cited Re Whiteley (1886) 33 Chancery Division 347 in support of this view but only one of the three judges in that case articulated the duty of care by reference to an ordinary prudent person; the other two judges, in contrast, used the prudent business person standard. See Donald, above n 25, 52.

27 Butler, above n 10, 236; Donald, ibid, 52. The requirement for equal representation is set out in the SIS Act, s 89(1).

28 The current version of section 52(2)(b), like its predecessor, imposes on trustees a higher standard of care than that required by general law in relation to the trustee’s non-investment-related activities: see Hanrahan, above n 15, 65.


31 Australian Securities Commission v AS Nominees Ltd (1995) 18 ACSR 459, 470-471. See also Hanrahan, above n 15, 60; Collins, above n 17, 645-646.


33 Ibid, 469 citing, with approval, Daniels v Anderson (1995) 16 ACSR 607, 658. See also Hanrahan, above n 15, 62; Collins, above n 17, 645.

34 Ali, Stapledon and Gold, above n 12, 78-79.


37 Re Buckland (unreported, VSC, 11 August 1993).
38 Ali, Stapledon and Gold, above n 12, 82-84 and 87-89.
40 SIS Act, s 52(6). These requirements are elaborated upon in APRA, ‘Prudential Standard SPS 530 – Investment Governance’ (July 2013) (“SPS 530”), paras 11, 16-18 and 23 and in APRA, ‘Prudential Practice Guide: SPG 530 – Investment Governance’ (November 2013) (“SPG 530”), paras 4, 6, 20, 21, 23, 24, 37, 38 and 66. The terms of these two APRA documents are consistent with the views expressed in the body of this research report on s 52(6) and modern portfolio theory.
42 Donald, above n 2, 62-63.
43 Donald, ibid, 63.
48 See also SPS 530, para 21 and SPG 530, para 27.
49 SIS Act, s 29VN. The directors of the trustee must also exercise reasonable care in ensuring that the trustee discharges its MySuper duties under section 29VN: s 29VO.
50 House of Representatives, Explanatory Memorandum: Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012, [1.16].
51 Complying with section 52(6) is necessary if the trustee is to avail itself of the statutory defence – in section 52(5) – to claims for losses arising out of the trustee’s exercise of its investment powers.
52 See Donald, above n 2, 65-66.
53 The synthetic CDOs in Wingecarribee Shire Council v Lehman Brothers Australia Ltd display the key structural features common to all synthetic CDOs and also share those features with the entire class of complex financial products involving the repackageing of derivatives and other risk-transfer instruments as securities: e.g. M. J. Logie and J-P. Castagnino, ‘Equity Default Swaps and the Securitisation of Risk’ in J. J. de Vries Robbe and P. Ali (eds), Innovations in Securitisation (Kluwer Law International, The Hague, 2006).
55 Australian banks – and, to a lesser extent, Australian corporations – have regularly made use of conventional securitisation to raise funds in the domestic and off-shore capital markets on the security of cash-flows generated by designated pools of financial assets, including home mortgage loans, credit card debts, corporate loans
and trade receivables. The securitisation programmes established to accomplish this are relatively transparent as regards the risks being assumed by the investors in the securities backed by these assets. Debt securities are issued to investors, mainly institutional investors including Australian superannuation funds, and the issuer uses the proceeds from the securities to purchase the assets. The cash-flows generated from the collection or amortisation of the purchased assets are, in turn, used by the issuer to service principal and interest payments on the securities. See J. C. Lipson, ‘Re: Defining Securitization’ (2012) 85 Southern California Law Review 1229, 1239-1242.


Ibid, 32-33. Where the credit default swap covers a portfolio of reference obligations, the issuer (or a manager appointed by the issuer) can actively manage the portfolio so that it can pre-empt a credit event occurring by replacing reference obligations that are considered to be more at risk of such an event with reference obligations where that risk is less. This was the case in Wingecarribee Shire Council v Lehman Brothers Australia Ltd (2012) 301 ALR 1, 21. See also J. J. de Vries Robbe, Securitization Law and Practice (Wolters Kluwer, The Hague, 2008), 74-77, 253-254 and 257-258.


Das, ibid, 87-89; de Vries Robbe and Ali, ibid, 22-23 and 55-56; R. Bruyere, Credit Derivatives and Structured Credit (John Wiley & Sons, Chichester, 2006), 41. The fact that the payment by the protection seller to the protection buyer may have the effect of making the latter whole in respect of any losses that it has incurred in relation to the reference obligations does not make credit default swaps contracts of insurance. Unlike a contract of insurance, the protection seller’s payment obligation is contingent upon a credit event occurring and not upon the protection buyer suffering actual losses. A credit default swap can be triggered by credit events that do not involve the bankruptcy or an actual default by the underlying obligors. Nor, unlike a contract of insurance, is there any requirement under a credit default swap for the protection buyer to hold the reference obligations or to be otherwise exposed to the risk of the reference obligations. See further de Vries Robbe, above n 59, 130-134.

This was also the case in Wingecarribee Shire Council v Lehman Brothers Australia Ltd (2012) 301 ALR 1. See also de Vries Robbe and Ali, ibid, 21 and 53.


See L. S. Goodman, S. Li, D. J. Lucas, T. A. Zimmerman and F. J. Fabozzi, Subprime Mortgage Credit Derivatives (John Wiley & Sons, Hoboken, 2008), 132-133 and 178-180; de Vries Robbe, above n 59, 182-185. For example, the credit default swaps that underpinned the synthetic CDO that was the subject of ABN AMRO Bank NV v Bathurst Regional Council (2014) 309 ALR 445 referenced two indexes each representing a basket of 125 obligors (ABN AMRO Bank NV v Bathurst Regional Council, ibid, 472-473).


See Parker, ibid, 322-326; de Vries Robbe, ibid, 209-213.


See Parker, ibid, 462-463.

Wingecarribee Shire Council v Lehman Brothers Australia Ltd (2012) 301 ALR 1, 307, 313-314 and 318. In addition, the court opined that neither of two potentially available exceptions to the definition of “derivative” applied. First, the issuer in a synthetic CDO lacks the breadth of business to satisfy the definition of “debenture” (in paragraph (a)(ii) of the Corporations Act, s 9 definition of that term), since the ordinary business of the issuer does not involve borrowing money and providing finance: ibid, 316. Secondly, the investors in a synthetic CDO are not parties to a managed investment scheme as there is no scheme or plan of action for them to pool or use the proceeds from the issue of the securities in a common enterprise: ibid, 317.

SPG 530, para 28 requires superannuation fund trustees to have in place formal guidelines for their fund’s use of derivatives. Also, if synthetic CDOs are treated as derivatives, superannuation funds which invest in them will have to comply with the guidelines published by APRA dealing specifically with the use of derivatives by superannuation funds: SPG 530, paras 28-30 and 87-91. This is in addition to the guidelines published by APRA that apply generally to investment by superannuation funds: see above n 40.