Protecting Superannuation

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Adam Graycar

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Introduction

ADAM GRAYCAR

These papers comprise the formal presentations at a conference entitled *Superannuation Crime*, which was held in Melbourne on 21 June 1996.

The knowledge of the existence of vast financial holdings provides temptation for those who may wish to use unlawful means to lay their hands on money that is not theirs.

Australian superannuation funds and approved deposit funds have approximately A$240 billion invested. (As at June 1995, Superannuation funds had A$188.7 billion, and ADFs A$9.2 billion (*Year Book Australia 1996,* p.611), and more recent estimates foreshadow the beginnings of an exponential growth spurt which will take the investment from the present A$¼ trillion to approximately A$2 trillion over the next 25 years).

Protecting the investment of the depositor, and ensuring a base for economic growth form the basis of regulatory activities. The challenge facing regulators is to determine whether any real or potential shortfall is due to criminal activity or poor practice. The dividing line between these two activities is not always as clear as might be imagined.

The conference, organised jointly by the Australian Institute of Criminology and the Department of Criminology, University of Melbourne, explored these issues, and examined a range of countermeasures.

The development and growth of superannuation has been a key part of public policy for almost a decade. Following the 1986 deferral through superannuation of a 3 per cent productivity linked pay rise, the number of employees covered by superannuation increased dramatically. Until then superannuation as an employment benefit was available only to a select group of (mostly white collar) industries and occupations. Even in more recent years the growth in superannuation coverage has been phenomenal. From 1989-90 to 1993-94 the proportion of employees covered rose from 66.9 per cent to 91.5 per cent (*Year Book Australia 1996*, p. 159), with the Superannuation Guarantee legislation of June 1992 making compulsory superannuation coverage for all employees who earned more than the tax free threshold.

There are more than 125 000 superannuation funds in Australia, with the bulk of the money (and members) concentrated in a small number of large funds. There are, however, around 120 000 funds with fewer than five members, and it is here, in particular, that the line between criminality and poor practice needs to be scrutinised.

The estimate, given by Roger Brown of the Insurance and Superannuation Commission (ISC), of fraud in the order of A$17 million over the past eight years, highlights the potential for criminal activity on a large scale. While A$17 million is a sizeable amount for any criminal activity, it must be pointed out that this is less than one one-hundredth of one per cent of the current total assets. (We have all read about scams which cream off fractions of cents and build these into sizeable fortunes!)

Given the very great importance, in public policy and macroeconomic terms of having a safe, secure, and growing superannuation pot, this conference brought together a number of industry experts and law enforcement practitioners to explore issues in preventing superannuation crime, to describe best practice, and identify a way forward.

Professor Freiberg's opening paper lays a rigorous base for the analysis of the issues under discussion. There is no suggestion that there is any crisis in Australian superannuation, but as Chair of the Senate Select Committee on superannuation, Senator John Watson points out, fraud = opportunity + motivation, and while corporate cowboys had caused some grief, our regulatory system, the *Superannuation Industry (Supervision) Act [SIS Act] 1993*, provides confident prudential measures. The real dangers, Senator Watson argues, are the incompetent and bad managers.

Incompetence and bad management recurred throughout the conference, and Roger Brown of the ISC outlined the process by which the ISC has been holding fraud detection seminars and educating trustees. It is the trustees who are most at risk because they can be deceived by dishonest professionals, and they may not always feel sufficiently knowledgeable, nor comfortable in tackling things they may not understand — and often they simply cannot wade through the voluminous paperwork that usually accompanies each trustees' meeting.

Materials distributed at the conference (prepared by the ISC and Deloitte Touche Tohmatsu) provided a best practice guide to the detection of superannuation fraud.

Defining fraud as *"an intentional misstatement of information to obtain financial benefits through improper, unauthorised or illegal actions"* (ISC / Deloitte Touche Tohmatsu booklet, p. 4), the most common types of fraud in the superannuation industry include:

- diversion of funds;
- conflicts of interest between trustees, administrators and investment managers;
- misappropriation of assets;
- improper registration and use of the fund's assets.

Most of the fraud is committed by those close to the operation of the fund, and fraud can be countered by Preventive controls and Detective controls (ISC / Deloitte Touche Tohmatsu booklet, p. 4).

As the first line of defence, preventive controls include:

- accountability;
- safeguarding;
- recording;
- authorisation.

As a second line of defence, detective controls include:

- reconciliation;
- verification;
- review and monitoring.

Some of the main signals which should alert trustees to the possibility of fraud include:

- domineering trustees / senior management;
- deterioration of earnings;
- dispersed business — inadequate reporting;
- long staff hours;
- high staff turnover in key positions;
- frequent changes of solicitors / auditors;
- uncorrected control weaknesses;
- conflicts of interest;
- premature reporting;
- analytical review variances;
- large year end transactions;
- unusual payments;
- difficulty in obtaining audit evidence;
- unexpected audit difficulties;
- poor staff morale;
- large commissions;
- defensive responses to queries;
- member complaints;
- unnecessary complexity.

(ISC / Deloitte Touche Tohmatsu booklet, p. 7).

Papers at the conference (and reproduced here) cover a range of preventive and detective approaches to superannuation crime. Ranging from broad overviews to specifics such as the perspectives of the police, the National Crime Authority, the regulator, and views from a big fund, an auditor and a practitioner, this volume is a starting point for better understanding countermeasures to superannuation crime.

Reference

Insurance and Superannuation Commission / Deloitte Touche Tohmatsu (unpub.), *Best Practice Guide to the Detection of Superannuation Fraud*, booklet.

1

Superannuation Crime in the 1990s[1]

ARIE FREIBERG

In its 1995 Budget, the Australian federal government announced that increasing levels of compulsory and other forms of superannuation contributions would, by the year 2020, see the nation's superannuation savings pool rise from its level of approximately A$183 billion to some A$2000 billion. However, the government's understandable desire to encourage private savings in order to ease the growing strain on the public pension system carries with it the potential that this large savings pool will become prey to fraud, corruption, theft or incompetent management.

The sheer size of the asset pool, its rapid growth and events elsewhere in the world have sounded alarm bells. Before his mysterious demise, British media tycoon, Robert Maxwell, allegedly stole over A$A900 million from the pension funds of two of his public companies, in relation to which his two sons recently stood trial in England and were acquitted (*see* Klumpes 1993, p. 194, 1992, p. 31; Fairley 1992; Ellison 1993, p. 19). In Australia, examples of theft and fraud in relation to superannuation funds are slowly emerging and experts have warned the industry of its vulnerability to criminal activity. This article examines the structure of the superannuation industry in Australia, the nature and extent of the vulnerability of superannuation funds to crime and the regulatory scheme in place to prevent such crime and enforce the law should breaches occur.

The Structure of the Industry

In June 1995, assets held by superannuation funds amounted to A$187 billion (ISC 1995). A decade earlier they were A$32.6 billion, and by the year 2000, they are predicted to reach A$600 billion. The federal government's 1995 Budget announcement that the level of compulsory superannuation contributions would increase further in the late 1990s has seen the projected superannuation pool rise to approximately A$2000 billion by the year 2020.

Though startling in size at first sight, the A$187 billion superannuation "honey pot" is in fact, a series of pots, some more accessible and vulnerable than others. The superannuation industry is immensely complex and its susceptibility to fraud can only be understood in the context of its structure, which requires examination of the number, type and size of funds (*see also* Brown et al. 1995, p. 5102; ANAO 1995, pp. 188-96). There are at least seven types of funds available under the present law, including employer-sponsored

1. This article originally appeared in *Australian Business Law Review* 1996, vol. 24, no. 3, pp. 217-35. Reproduced by permission of the Law Book Company.

funds (to

which employers make contributions on behalf of their employees); industry funds (to which employees of particular industries may belong); public offer funds (superannuation products open to members of the public at large); public sector schemes established under state and federal law (open to public servants or members of government authorities); approved deposit funds accepting superannuation rollover payments, master trusts which combine a number of sub-plans run by employers or individuals, and personal superannuation products offered by insurance companies. Funds may also be categorised according to their tax status as complying or non-complying, or regulated or non-regulated,[1] or by their size, whether they are excluded or non-excluded.[2]

According to the Insurance and Superannuation Commission (ISC), there were 78 456 complying superannuation funds in June 1993, increasing to approximately 107 000 in June 1995. A large part of this growth can be attributed to the growth of small funds (*see* ISC 1995, p. 77), so called "do-it-yourself" funds, and predictions have been made that there may be some 200 000 funds in existence by the turn of the century.

The distribution of assets within superannuation funds is markedly skewed. Of the A$187 billion of fund assets held as at June 1995, over 76 per cent have less than A$250 000 in assets. Fewer than 4.2 per cent of funds have assets over A$1m and the largest 1000 funds (that is, 0.93 per cent of funds) cover approximately 85 per cent of the industry by assets (ISC 1995, p. 76). Approximately 44 per cent of total superannuation assets, or A$83 billion, was held by life insurance companies through the sale of personal superannuation policies to self-employed persons or through their management and administration of corporate and industry funds[3].

Although it is possible to assume that the large insurance and investment companies have been, and will continue to be, relatively safe depositories for public moneys, and therefore that the large proportion of superannuation funds are relatively safe, the recent Barings Bank disaster and significant losses by banks, insurance companies and municipal authorities through theft and fraud which have come to light mean that all funds must be considered as vulnerable to crime. Even a minimal 1 per cent defalcation rate in the year 2000 would result in losses of A$60 million per year. Close observers of the superannuation industry have already warned of the dangers (*see* Maher 1992; Ferrers 1992; *The Age* 31 October 1994, 6 June 1994) and examples of such conduct are beginning to emerge (*see Sunday Herald Sun* 1 May 1994; *Australian Financial Review* 25 October 1994; *see also* Renton 1991).

Nature and Extent of Deviance

No data are currently available which indicate the extent of fraud in the superannuation industry. The ISC estimates that over the last few years, losses in the industry have been minuscule (ISC 1995 p. 4).

> *...there have been no large-scale or widespread losses due to fraud or mismanagement in the superannuation system: over the past seven or eight years, there is only evidence of members losing entitlements in a handful of cases, with losses amounting to less than $10m, in total, compared with industry assets in the order of $190b.*

Police data do not distinguish finely enough between types of fraud and the annual reports of the various supervisory agencies produce little information of value in this area. Law enforcement and regulatory authorities remain close-lipped and defensive over the operation of superannuation funds, possibly

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1 A "regulated" fund is one in which either the trustee is a constitutional corporation or whose sole or primary purpose is the provision of an old age pension and therefore subject to the Commonwealth's control.

2 Funds with fewer than five members are subject to a less stringent regulatory regime.

3 According to a more recent survey carried out by the ISC in cooperation with the Australian Bureau of Statistics, the total asset value of the industry was in fact A$230 billion at the end of September 1995. Retail funds held 43%, public sector funds 26%, corporate funds 18%, excluded funds 8% and industry funds 5%. 34% of superannuation assets were placed with an external investment manager, 38% were used to purchase life insurance policies and 28% were directly invested: see "Super Industry Continues Boom" *The Age*, 21 December 1995.

fearing a loss of confidence in the investment industry generally. Extensive bibliographic searches of a number of the major reference sources failed to disclose any articles in any major jurisdiction relating to the general issue of pension or superannuation fraud, although there are a number of references relating to specific instances of fraud. These omissions may be symptomatic. Either fraud or malfeasance are so minuscule as to be criminologically insignificant, or they may be activities which have been insufficiently recognised by regulators or enforcement agencies. The following survey is the result of an examination of official reports, newspapers, journal articles and interviews. It reveals a small, but growing problem.

United Kingdom

When British media tycoon Robert Maxwell disappeared from his yacht in November of 1990, his fall generated a wave of financial devastation which left shareholders in his companies languishing and some 30 000 members of his pension funds between £400 million and £450 million (over A$900 million) poorer. Subsequent investigations revealed that this amount had been misappropriated from the pension funds of two of his public companies, Mirror Group Newspapers (MGN) and Maxwell Communications Corporation (MCC).

Stripped to their bare essentials, the alleged thefts were simple (*see* generally Superfunds (1992), *The Economist* 7 December 1995, p. 15, 14 December 1995, p. 16, 14 November p. 15). As well as the two public companies, Maxwell also owned or controlled over 400 private companies, many of which were controlled in tax havens such as Liechtenstein. The pension funds, many of which were held in a common investment fund, were managed by Bishopsgate Investment Management, a subsidiary of the Maxwell Charitable Trust which was controlled through Liechtenstein. Maxwell himself was chairman of the board of trustees of the pension funds and the assets were managed by a company which was ultimately owned by his family. He was, effectively, employer, trustee and investment manager.

In the six months before his death, the pension funds of MGN and MCC lent to Maxwell's private companies shares owned by them to the total value of £415 million (*see Financial Times*, 10 July 1992). Collateral to support these loans was provided by MGN and MCC, but were, in essence, held by Maxwell interests and sold. However, the proceeds were not paid to the pension funds. In addition, the borrowed shares were also used to borrow further moneys from the banks in order to buy shares illegally in MCC to support their price. (The shares were themselves collateral for other loans and if they dropped below a certain price, the bank and other lenders would call in their loans, probably leading to the collapse of his financial empire). This was done indirectly and in secret through trusts in Switzerland and Liechtenstein. Maxwell's death precipitated the collapse of this structure and the theft was discovered soon after.

The case was investigated by the Serious Fraud Office in 1991 and theft charges were laid against his sons. These were subsequently dropped in 1993 and replaced with charges of conspiracy to defraud pensioners by using pension fund assets to raise money for Robert Maxwell's private companies.[4] A number of other people affiliated with Maxwell-owned companies have also been charged with conspiring dishonestly to deliver pension fund assets to a bank as collateral for loans (*see The Age* 27 May 1995). The trial commenced in June 1995 and was completed in January 1996. After eleven days of deliberation, the jury acquitted the defendants.

The Maxwell fiasco exposed a range of weaknesses in the system of regulating pension funds in the United Kingdom. All the lines of defence failed. Although the trustees of the funds are there to protect the assets of the fund, Maxwell was both the employer and trustee and was inevitably faced with a hopeless conflict of interests. In his capacity as trustee, he took control of the pension funds and dealt with them in fundamental breach of his duties (Maher 1992, n. 14 p. 14). The investment of so much of the funds in the employer company was imprudent, but not, at the time, illegal.[5] By

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4 The reasons for these changes are not known. The alleged conspiracies were between the sons and the father and between the parties themselves.

5 The Social Security Act 1990 (UK) places a limit of 5% of a funds assets which can be invested in

all accounts, he was a ruthless and dominating person who overbore the other trustees and his employees (*see The Financial Times* 10 July 1992). The need for a board of trustees which is independent of the employer is manifest.

The auditors denied responsibility. Although they were auditors to all his companies, they did not detect the fraud because Maxwell had extended the audit period for the funds and the funds were stolen after the last audit date. The auditors could not insist on interim accounts. The merchant bankers, the banks and stockbrokers failed to require adequate security for loans, made loans imprudently and were aware that some of the security they received did not belong to Maxwell (*see The Economist* 14 December 1991, pp. 81-2). The regulatory agency, the Investment Management Regulatory Organisation (IMRO), took the Maxwell companies on faith and failed to establish systems for identifying funds in need of closer supervision. (The pension system was governed by the *Financial Services Act* 1986 (UK) which created the framework of self-regulation largely based upon trust and the belief that excessive regulation was undesirable. Therefore, the self-regulation system depended upon the honesty of its members.) A review by the Securities and Investment Board, which supervises IMRO, concluded that no financial services regulator should be "unduly ready to rely on the good faith and professionalism of those with whom it deals."(*see Financial Times* 10 July 1992). It observed that the task of regulation requires a critical attitude, a high alertness to any indicators which cast doubt upon the fitness and propriety of the firms they regulate and a willingness to probe, to go beyond any assurances or information given.

Two major government inquiries followed the collapse (House of Commons 1992; Department of Social Security 1993; *see also The Economist* 1993, pp. 84 & 97) and concluded that the laws and regulations of the United Kingdom governing pension funds were inadequate and in need of a fundamental overhaul. In the meantime government funds were made available to meet payments to fund beneficiaries (*The Economist* 14 November 1993, p. 97). The recommendations of the second Committee (the Goode Committee) were wide-ranging, including the introduction of a single pension regulator, the bolstering of trust law; limits to trustee's discretion; minimum solvency standards; a compensation scheme funded by a levy on all occupational schemes; the right of employees to appoint up to one-third of trustees and a requirement that actuaries and auditors report directly to the trustees. They have yet to be adopted by the Major government and will probably still leave English law in a less satisfactory state than the current Australian scheme (*see* Goode 1993; Ellison 1993).

One other superannuation-related malfeasance has come to light. In 1993, IMRO investigated Pyrford International PLC (formerly Elders Investment Management UK), which was the manager of A$2 billion in pension funds including A$600 million in the Courage Breweries and Foster's Pension Fund (Burns 1994; *see also The Bulletin* December 1993, p. 77). IMRO identified breaches of a number of pension fund rules including investment in associated companies, failure to disclose such investments, failing to disclose to the trustees that investments were not readily realisable, defective quarterly reports and failure to maintain proper systems. The company was fined £30 000 and it lost the management of a number of other funds as a result of the inquiry.

United States

Pension plans in the United States are a very big business. There are approximately 200 million pension plan participants in some 731 000 pension plans with assets, in private pension funds and welfare plans, totalling US$2.5 trillion (GAO 1994). Pensions are regulated by the *Employment Retirement Income Security Act* of 1974 (ERISA) which is enforced by the Department of Labor's Pension and Welfare Benefits Administration (PWBA). The PWBA is, in turn, subject to oversight by the General Accounting Office (GAO), the American equivalent of the Auditor-General. As in Australia, the regulatory regime is based upon the granting or withdrawal of tax concessional status, civil penalties imposed by the regulatory

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the sponsoring company. However, this limit was not in place at the time of the Maxwell theft.

agency and the use of the criminal law. However, its orientation is toward securing compliance to the law, rather than upon prudential supervision. The range of ERISA and Internal Revenue Service violations is wide and relate to minimum funding requirements, prohibited transactions, coverage and participation, prudential investments and discharge of duties, diversification, conformity with plan documents, vesting, reporting and disclosure, discrimination, deductibility, actuarial issues and a range of fiduciary obligations.

Both the PWBA and the IRS investigate and review pension funds for conformity with the law as a result of complaints from participants, referrals from other agencies, or as a result of reviewing annual returns. According to the GAO, in 1994, 72 199 plans were affected by investigations, involving 21 million participants. As a result of these investigations, forty-one individuals were indicted (GAO 1994, p. 6). Many of these investigations were minor and were the result of mandatory IRS referrals involving small plans or plans in relation to which corrective action had already been taken. An earlier GAO report revealed that from 1985 to 1987, 1323 individual pension plans had been investigated by the Department of Labor, with about 25 per cent of these being cited for ERISA violations (GAO 1989). The most common types of violations were prohibited transactions and prudence violations. The GAO also reported that IRS investigations found a 20 - 30 per cent violation rate, the most-cited violations being prohibited transactions, minimum funding, participation and coverage requirements. In its report to Congress in 1992 on ERISA, the Department of Labor reported some 2725 civil investigations into prohibited transactions covering overpayment of management fees, improper loans, improper purchases of assets at inflated prices, improper selection of annuity providers and improper failure to distribute surplus assets following the termination of a plan. It also reported 23 criminal convictions in 1992, 16 in 1991, seven in 1990 and seven in 1989.

Pension funds in the United States are underwritten by the Pension Benefit Guarantee Corporation which, in 1988, paid out US$324 milion in insured benefits to 113 000 retirees who had participated in 1400 terminated pension plans. Although this amount represents unfunded liabilities, rather than fraud, there has been speculation that pension insurance has encouraged sloppy pension practices and parallels have been drawn with the savings and loan crisis. This has been described as the "moral hazard" problem (*see* Chapman 1994, p. 4). A numerically small but significant problem in the United States is the influence of organised crime in the labor unions and its access to affiliated employee benefit plans. In New York the government has used both ERISA and the Racketeer Influenced and Corrupt Organizations Act against persons associated with a union, alleging that it was infiltrated by corrupt officials who used the trust funds for their own personal gain by way of embezzlement of funds, kickbacks in connection with expenditures from the funds to service providers. Stories of pension frauds periodically surface in the press (*see The Washington Post*, 12 September 1993) and elsewhere (*see Report of the Office of Inspector General of Labor* 1994, p. 59) but this anecdotal evidence fails to provide a clear picture of the overall extent of pension fraud in the United States.

Australia

There are few documented cases of fraud in the superannuation industry in this country and most commentators agree that no Maxwell-type fraud has yet occurred (Klumpes 1993, p. 197). The National Crime Authority, in its report on money laundering, *Taken to the Cleaners,* (1991) found little evidence of that activity in the life insurance industry, but a later review of law enforcement arrangements (Australia 1994, p. 359) stated that superannuation funds "have been vulnerable to trustees, without adequate checks, acting at the direction of the employer, or to publicly criticised practices such as employers refunding surplus superannuation funds to their own balance sheets." Neither of these are necessarily criminal activities. (Note that the SIS legislation now specifically prohibits the direction of trustees by another party, although there are exemptions: s.58. There are also strict rules concerning payments from a superannuation fund to an employer sponsor: s.117.)

Direct evidence of malfeasance in the superannuation industry is scant. However, some cases have come to light:

- in ABC Engineering (Senate Select Committee 1992) the director of the firm, who was also a trustee of the superannuation fund with sole responsibility for the investment of the fund's assets, embezzled some A$975 000 from the firm and the fund;
- the Byrnewood Superannuation scheme (Senate Select Committee 1992), the inexperienced trustees of an industry fund appointed a company to manage and administer the fund. The administrator improperly charged fees and received kickbacks from the insurance company. Subsequently the administering company went into liquidation and its directors disappeared;
- the case of McDonnell & East superannuation fund (*see Financial Review* January 1994, p. 27) is subject to conflicting interpretations. According to one report (Dowling 1994, p. 7) 33 member employees of the retailer McDonnell & East had lost some A$500 000 when the retailer's parent company was placed in the hands of a liquidator and a shortfall in funds was discovered. The loss was attributed to a great number of early retirements, redundancies, a poor investment performance and the purchase of shares in companies related to the employer which realised a very poor price. However, a later report (Galllery & Sharples 1994, p. 8) argues that the fund was in breach of both the Corporations Law and the trust deed by illegally and inappropriately overinvesting in related companies;
- the Queensland Professional Officers Association Superannuation Fund was the subject of an inquiry by the Senate Select Committee, which heard allegations of mismanagement of the fund which amounted to a breach of trust and possibly criminal conduct (Senate Select Comittee 1993b; *see also* Gilbert 1993, p. 33). The evidence was to the effect that four of the beneficiaries had been singled out for special treatment in the disposition of their superannuation entitlement, contrary to the trust deed. The employer was required to top up the fund by A$34 000 and, although the amount was small, one senator, Senator Ferguson, stated his concern that the superannuation system was vulnerable to fraud, malpractice and maladministration;
- in 1993 the Beneflex Retirement Plan, which operated in the Queensland hospitality industry, was the subject of action by the ISC for not appointing employee representatives to the trustee board and for multiple serious breaches of the superannuation standards (ISC 1994 p. 60; *Superfunds* May 1994, p. 5). The fund, with a membership of 9000 and total assets of A$1.4 million (see *The Age* 2 July 1995), was deemed as "non-complying" thereby losing its concessional tax status and a receiver was appointed to the corporate trustees in May 1994. In July 1995, the former managing director of the corporate trustee was banned by the Federal Court from managing a corporation for ten years and a number of companies associated with him had judgment entered against them for a total of A$643 000 (see *The Age* 2 July 1995). The fund's auditor has been disqualified from auditing regulated funds. Criminal charges are still being considered by the Australian Securities Commission;
- the State Superannuation Board of Western Australia was the subject of an alleged theft of A$75 000 by Mr Kevin Parry, who was committed for trial in August 1994. It was alleged that Mr Parry made a donation of the money to the ALP and that the Board had not consented to the donation. The money was held in a land development account jointly held by a Parry subsidiary and the Board;
- in the Australian Capital Territory, a fraud by a superannuation broker is being investigated by the Fraud Branch of the Australian Federal Police. It is alleged that the broker used forged documentation to misappropriate A$820 600 of clients' funds. As the money had not reached the insurance companies, they do not consider that the theft has occurred from them and

this case may not strictly be classified as a "superannuation fraud";

- In Queensland, funds totalling approximately A$1.2 million handled by a company called the Professional Excellence Group are alleged to have been embezzled and the company is the subject of police investigations in Brisbane (*see The Age* 2 July 1995);
- in December 1995, it was reported that three superannuation funds with total assets of A$250 million had been frozen by the ISC due to the alleged incompetence of the trustees and new management put into place. No money has been lost to date (ABC Radio 1995).

The Major Fraud Group of the Victoria Police has successfully completed and prosecuted one fraud and have a number of ongoing investigations in relation to superannuation fraud. The completed case involved eight thefts totalling approximately A$600 000 from superannuation funds by an accountant who was acting as trustee for the funds. The thefts occurred between 1981 and 1992 and took place when the clients of the accountant were persuaded to invest their superannuation funds through his trustee company. He then diverted the funds to a range of companies controlled by him which were involved in poor investments, failed business ventures and the repayment of debts incurred by him (*see* R *v* Jacobs, Unreported, County Court of Victoria, 20 October 1993).

Tangential evidence of malfeasance in an industry fund, albeit not strictly a superannuation fund, was found by the New South Wales Royal Commission into the building industry (*see* Dixon 1991, p. 8). The fund in question was a charitable trust, the Construction Employees Redundancy Fund, established to manage employers' contributions to fund redundancy and other benefits for building workers. The Commission found a variety of problems, including high levels of fees and commissions, high administrative costs charged by certain funds, uncertain security of funds, lost or untraceable members, uncontrolled disposition of investment income and the distribution of funds nominally owned by persons missing from the industry. Dixon (1991) has argued that similar problems may have occurred in some industry superannuation funds, in particular the diversion of funds for purposes other than investment for employees, hidden and disguised commissions to agents and potential conflicts of interest between the managers of funds as trustees and managers.

The Problems

That superannuation funds are generally vulnerable has been frequently commented upon, with the following problems being identified (*see* Fairley 1992; *see also* Chapman 1994).

- improper registration and use of fund assets;
- collusion between trustees and fund managers improperly to divert assets;
- collusion between trustees and managers in overcharging fees or paying unauthorised expenses;
- falsification of records;
- misappropriation of assets;
- improper or bogus loans to interested parties;
- failure to pay benefits.

However, the vulnerability of the superannuation industry to criminal activity, and the extent of that activity, can be better understood by examining the flow and control of money and the nature of the various superannuation obligations and fund structures. Some of the examples below are composites drawn from case studies, the sources of which must remain confidential.

The superannuation guarantee

The superannuation guarantee, introduced in 1992, (*see Superannuation Guarantee Charge Act* 1992 [Cth] and *Superannuation Guarantee (Administration) Act* 1992 [Cth]; *see also* Senate Select Committee 1995) is a scheme whereby employers are required to make payment to superannuation funds on behalf of their employees. Although employers are not compelled to make such payments, failure to do so within the specified time renders the employer liable for the Superannuation Guarantee Charge, which is a non-tax deductible charge collectable by the Australian Taxation

Office (ATO). The ATO has a major responsibility to ensure that employers are paying the charge and that the workers' entitlements are paid on their behalf into a complying, regulated fund.

In a recent review of the operation of the ISC (ANAO 1995) the Australian National Audit Office (ANAO) has identified the possibility that superannuation guarantee payments are not being paid into regulated funds. It notes that some 2000 funds are not supervised by the ISC (that is, those funds not wishing to claim tax concessional status) and that, because of this, "it is feasible that some moneys which purport to satisfy the employer's SG obligations, could be placed in non-regulated funds without the knowledge of the ISC or the ATO" (ANAO 1995, p. 9).

There is some evidence that some companies have failed to transmit the current 5 - 6 per cent superannuation guarantee on behalf of their employees (*The Bulletin*, 27 July 1993, p. 65; Harris 1995), although overall, the level of compliance is said to be very high, comparing favourably with other tax legislation (*see* Senate Select Commitee 1995, p. 135). The reasons for failure to remit vary, but a major problem is likely to occur where an employer may experience cash flow difficulties and use the member contributions to support the business (Senate Select Committee 1995, p. 136). As members only receive a report on their scheme annually, the employer's failure to remit the charge may remain undetected for some time. However, the Australian Taxation Office may detect such failures through its own audit program. Section 64 of the SIS requires employers to remit employee contributions to a superannuation fund within 28 days of the month in which the deduction was made. The failure to remit employees' contributions can detrimentally affect the rights of employees in the event of an employer's insolvency for, whilst no claims can be made against the superannuation fund assets by a member creditor, the superannuation fund may claim for deductions not remitted to the superannuation fund and in many cases becomes a preferential creditor (*see The New York Times*, 26 November 1995).

Taxation fraud or losses

Superannuation funds which attain complying status are eligible for taxation concessions, but the differences between the tax regimes of complying and non-complying funds leave the way open for abuse of the revenue. Both the ATO and the ISC operate on a self-assessment basis, subject to appropriate verification, such as an audit. A complying fund is eligible to be taxed at the concessional rate of 15 per cent. However, this regime has its weaknesses as the Australian National Audit Office (ANAO) audit revealed. It found that superannuation funds were claiming the concessional tax rate without first having obtained compliance status by the ISC. It also identified some 7817 funds, with assets totalling A$33.5 billion, which had lodged returns with the ISC but not income tax returns, creating the potential for possible serious losses to the revenue (ANAO 1995, p. ix). How many non-complying funds were paying the full taxation rate was also unknown.

The interface between the ISC and the ATO was of particular concern to the ANAO. Its audit of the ISC found that a comprehensive compatibility check of ISC and ATO records had never been undertaken and a pilot attempt to do so was thwarted by program errors in the ATO's data base. It also identified numerous errors in the ISC's data, attributed to data transfer problems in 1991 as well as problems in the tax file numbering system and its relationship to the ISC's record system. The ANAO concluded (ANAO 1995, p. 22):

> *Based on the results of the ANAO compatibility check there appears to be the potential for a significant loss of ISC revenue with the potential for a far greater loss to ATO revenue.... The results of this check highlight the need for the ISC and the ATO to develop a more effective system of control to safeguard their respective revenue base derived under SIS.*

Employer-sponsored funds

Many employer-sponsored funds tend to be administered "in-house" and are particularly vulnerable to fraud, especially where the trustees are inexperienced or have been selected to favour the employer's interests. (The requirement for equal employer sponsor and member representation on trustee boards may be an impediment to fraud, although it is unlikely to eliminate it.)

Where employer-sponsored funds are administered in-house, the superannuation fund may be persuaded to make poor investment decisions at the behest of the employer to the latter's advantage. For example, an employer-sponsor in need of cash flow may influence the trustees to purchase from it an asset at an inflated value which, in the long term, may result in losses to the fund. Although such a ploy should be detected by an audit, asset values can readily be manipulated to make detection difficult. Another problem in relation to these and all other funds arises from the "sole purpose" test. The superannuation legislation requires that funds be invested for the sole purpose of providing benefits to members of the fund upon retirement or death. A recent decision by the Administrative Appeals Tribunal in relation to an employer-sponsored fund operated by a fast food outlet highlighted the possible conflict between the personal interest of the employer and the purposes of the superannuation fund. In that case, the Tribunal, upholding a ruling by the ISC, held that the superannuation fund was used to support the employer's family trust interest in the assets rather than the beneficiaries'' interests. The fund forfeited its tax concessional status (*see The Australian*, 22-23 July and 2 August 1995).

Internally administered funds are also vulnerable through weaknesses in their information systems. Many of the administration problems encountered may be attributable to computer or administration failures due to rapid growth in fund membership. These "growing pains" can be criminally exploited. The expense of running small to medium-size superannuation schemes, (for example, one with 30-100 members and A$10 million in funds) often means that funds are supported by a small infrastructure whose responsibilities overlap with those of the employer-sponsor. Those responsible for maintenance of the accounting records may be nominated and elected as employee representatives on the trustee board because of their expertise. With the growth in the number of members and the size of the fund, the fund's data are often transferred from the employer-sponsor's computer system to stand-alone, off-the-shelf software packages which the administrators may be poorly equipped to handle. In the process of conversion it is not very difficult for the account-keeper to alter benefits in their favour, a fraud which is extremely difficult to detect (ISC 1995, p. 59).

In-house information systems can also be the vehicle for fraud if a fund's disaster recovery plan is inadequate. In this case, the account-keeper may enter invalid data (in his or her favour) into the computer, back up these data on disks which he or she has in their safekeeping and then cause the primary system to fail, thus obliterating the original files. On the restoration of the system, the invalid transactions are processed in that person's favour without fear of detection.

The interweaving of employer-sponsor and fund information systems is common in small, community organisations such as hospital or religious groups. Although SIS requires the assets to be kept separate, separate bank accounts were, until very recently, not mandatory for in-house funds. In these situations the manipulation of journal entries by a company accountant was not difficult.

Opportunities for theft or fraud arise whenever assets or funds are transferred between one entity and another. Thus an employer-sponsor fund may appoint an investment manager to manage a fund's assets or a custodian in whose name the assets of the funds are invested. On the termination or cancellation of the contract, the funds can be returned to the trustees, not the fund, leaving open the possibility that the funds may be used by the trustee in its own right or, in some cases, stolen from the fund. Although there is a requirement that trustees have equal employer/employee representation, their composition may be open to manipulation in favour of the employer and ultimately to the detriment of the fund.

Excluded funds

Excluded funds are funds that have fewer than five members and are usually set up for small family businesses. Although they account for about 3 per cent of all members, they are a fast growing segment of the market, with "self-managed" funds becoming more and more popular as disillusionment grows with professionally-managed funds (Kavanagh 1995). Their obligations under the SIS legislation are less onerous in that they do not require equal representation of members and management and have less strict reporting requirements. (They are also, for example, exempted from having a complaints procedure and do not need to inform members of changes to trust deeds. Trustees also have a greater discretion in relation to investments.)

Because of the closed nature of these funds, internal fraud is less likely and, because they deal mostly with the investors' own money, they are subject to fewer audits (*see The Age*, 11 September 1995). However, the ANAO has identified problems where non-related employees also participate in the fund and has recommended that these excluded funds should be targeted for audit purposes[6] (ANAO 1995, p. 10). However, the ANAO has identified problems in some of the funds which could work against the interests of the beneficiaries. One such scheme identified by the ATO[7] (ANAO 1995, p. 30):

> *involved trust deeds which limited the rights of members in their eligibility for superannuation benefits. For example, the trust deed may restrict the payment of benefits to those who retire only, thereby excluding payments to persons leaving before age retirement or retiring early due to disability or death. In those cases, workers may have been purposely terminated before becoming eligible to receive benefits in terms of the trust deed, thereby ultimately making the management of the business the sole beneficiary of the superannuation benefits (see The Australian, 2* August 1995*).*

Industry funds

Some industry funds are characterised by a high level of worker mobility between employers and funds. Itinerant workers frequently have small superannuation balances in relation to which they may be unaware or simply careless—it is not unknown for up to one-third of fund members to be "lost". The number and size of these balances and the difficulties of tracing the members leaves the system open to fraud in the following manner. An employee of a company acting as an administrator for several industry funds, with a high level of authority and access to the information system, can identify fund members who frequently move between employers, or those who cannot be located, and whose balances are below A$500. (The superannuation legislation permits preserved amounts of less than A$500 to be withdrawn prior to retirement upon resignation from an employer.) By falsifying requests to the trustees to withdraw funds, the person may divert each of these small benefits to their account. Because relatively small amounts are involved, the fund member is unlikely to be aware of the loss or, if aware, unwilling, incapable or uninterested in taking action. The large number of apparently trivial transactions is also likely to ensure that the trustees' interest or scrutiny is minimal.[8]

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6 These audits should examine such areas as member reporting requirements, the level and nature of in-house assets, investment decisions and loans to members. The ISC audit program now gives more emphasis to funds with arms' length members.

7 It should be noted that under the SIS legislation, the superannuation guarantee component, and member contributions must vest immediately in the member, as must the allocated earnings. However, a scaled vesting regime may still apply to benefits financed by non-compulsory employer contributions. The problems outlined by the ANAO are therefore unlikely to re-occur under the new SIS scheme.

8 The "small amounts" problem may become less problematic following recent changes to the superannuation legislation which will permit persons with minimal contributions to put their money into a fund set up through the Australian Taxation Office. From 1 July 1995, employers who pay less than A$1200 for their employees may pay them into the

Public offer funds

In this type of fund, generally equal representation on trustee boards is not required, but the trustee must meet minimum capital requirements and must be approved by the ISC (*see also* ISC 1995, p. 6). Public offer funds are also vulnerable to fraud. For example, a public offer fund may be established by an accounting firm for its clients. The partners of the firm will make up the trustee, which will be responsible for the operation of the fund including accounting, record-keeping and investments. Under this scenario, one partner of the firm will be delegated the primary responsibility for the fund, although the partners will meet periodically to discuss investment options. The concentration of powers in the hands of one person, the position of trust that that person holds, and the lack of scrutiny of his or her actions by the trustees or policy committees render this type of fund particularly vulnerable to fraud.

Public Sector Funds

As at the date of this article, Public Sector funds do not have the requirement to be regulated under SIS. Under s.45(6) of the *Superannuation Industry (Supervision) Act* 1993, if, at all times during the year of income, the fund was an "exempt public sector superannuation scheme", the fund was deemed to be a complying superannuation fund for tax purposes. Consequently, the controls around which the system of compliance is built, are not universally applied. Thus the ISC is unable to conduct its audit reviews and apply the annual return provisions of the Act. The supervision of these funds is only as good as the regulatory provisions contained within the special statutory provisions applicable to the individual funds.

Pooled and master funds

Most superannuation funds in Australia are managed or administered by life insurance companies or professional fund managers. Although their record to date has been creditable (although not completely unblemished: *see* Klumpes 1993, p. 197) it is in this area that the greatest potential for large scale losses exists. Though not related to superannuation funds, the recent conviction in Melbourne of a bank officer in relation to a theft of A$93 million from the ANZ bank indicates just how vulnerable the practices and procedures of well-established and trusted institutions are to internal crime. Whether it be through the use of risky and/or fraudulent investment practices such as has occurred in the United States (in Orange County, California, the Treasurer of the county bankrupted the county's investment pool by losing US$1.3 billion in derivative trading; he pleaded guilty to fraud by lying to investors and agencies,) and elsewhere by the use of derivatives, of which the Barings bank disaster is but one example, or the rapid growth of managed funds in the hands of inexperienced operators, the rapid accumulation of sums, which now exceed total bank deposits, carries the danger that major losses can create a crisis of confidence in the superannuation system. As the Barings experience has revealed, the age and reputation of a company is no guarantee of the safety of one's investments. For example, the ISC recognises that derivatives pose a major danger to an investment strategy if used carelessly or unwisely, but accept that they have a legitimate role to play in the financial system (*see* ISC 1995 p. 4; *see also* Superannuation Circular II.D.7.).

Regulation

The superannuation regime is primarily regulated by the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS), although superannuation itself is embedded in a complex of laws relating to taxation, corporations, compulsory payments and the like (*see Income Tax Assessment Act* (Cth) 1936 [dealing with tax concessional status of contributions and payments]; the *Superannuation Guarantee [Administration] Act* 1992 (Cth) (regulating the system by which employers are required to make contributions to funds]; the *Corporations Law*

Superannuation Holding Account Reserve. This also avoids some of the high entry and maintenance fees charged by the funds which have eroded superannuation returns. The Liberal Party is supporting proposals to introduce bank-based superannuation by way of special retirement accounts: *see* "Libs Back Banks on Super Bid", *The Australian*, 1 November 1995.

[which regulates trustee corporations] as well as the general criminal law relating to offences against property, industrial law, bankruptcy law, family law, social security law and trust law). This regime is the product of many years of endeavour. The regulation of superannuation has been the subject of reports by the Australian Law Reform Commission and the Companies and Securities Advisory Committee (1992), the Senate Select Comittee (1992) and ad hoc committees (Australia 1994). It combines the specification of minimum rules to which funds must adhere to qualify for concessional income tax treatment, the codification of prudential standards and a range of civil and criminal sanctions for breaches of the statute. It utilises a number of control mechanisms including general and specific disclosure requirements, whistleblowing provisions, record keeping and wide powers of investigation.

However, problems remain. The industry is made up of a complex web of relationships between numerous participants each of which has a role to play in the prevention of fraud. Amongst the most important of these participants are the contributors and beneficiaries, employer/sponsors, trustees, custodians, investment managers and advisers, administrators, auditors, actuaries, the ISC, the ATO and law enforcement agencies. Some of these parties, such as the contributors and beneficiaries, can do little to detect fraud other than to maintain a state of alertness in relation to the general state of the fund and the timeliness and comprehensiveness of the information that is provided to them[9]. Others such as the trustees and auditors play a central role in the process.

Trustees

Trustees play a pivotal role in the operation of the superannuation funds. The trustee is the person or entity responsible for the operation of the trust. It has the responsibility for controlling the fund's investment strategy, meeting their fiduciary obligations to members and ensuring compliance with the regulatory regime (Australia 1994, p. 357). Trustees are at once the major weakness of the superannuation system and the first line of defence. However, trust law alone proved inadequate in the Maxwell case for the trust instrument gave him the casting vote, the right to amend the scheme and the right to appoint and remove the trustees. It also does not ensure that the trust operates solely in the interests of the beneficiaries.

The SIS establishes a prudential framework within which superannuation funds must operate and which is designed to minimise fraud, malfeasance or misadventure. Amongst the most important provisions are those which require equal member and employer representation on trustee boards for funds with more than five members, prohibit lending money to members, restrict loans or investments in employer sponsors to 5 - 10 per cent, protect the trustee from direction from any other person, including the employer, prohibit borrowing of funds other than for short-term cash flow purposes and payment of benefits, require investments to be at arm's length, prohibit certain convicted persons and bankrupts from holding office, require annual audits and the provision of a range of relevant information relating to the fund (*see generally* Chapman 1994).

There are two outstanding problems in relation to the role of trustees. One relates to the relative experience, knowledge and skill of trustees. No formal qualifications are required to become a trustee, and many trustees, especially employee members who are now statutorily required to make up half the board, may lack experience and skill to be able to supervise the activities of the fund and perhaps to stand up against a strong employer. The second relates to how the assets of the fund are held. Klumpes argues (1993) that under SIS, funds will remain exposed to Maxwell type problems so long as an independent custodian trustee does not hold all of the investment assets (*compare* Lockery 1993).

It is pleasing to note that the SIS provides for a higher level of personal responsibility by Trustees. The added responsibility includes their being subject to the imposition of severe civil and criminal penalties where the trustee has been found to be fraudulent or dishonest.

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9 According to the ISC, one member complaint resulted in a major investigation by the ISC, leading to the discovery of two frauds by an employee of the employer sponsor. A fraud on the superannuation fund involved A$800 000, and one on the employer resulted in a loss of A$4.2 million.

These penalties, together with an intensive ISC sponsored education program, should assist in the achievement of a higher level of professionalism and vigilance in the discharge of trustees' obligations to their members.

Auditors and actuaries

Accounting firms provide a range of services to the superannuation industry: administration, auditing, investment services, tax and legal consulting and general superannuation consulting (McDonald 1994). Auditors play a central role in the regulation of superannuation, as all complying funds are required to submit an annual independent audit to the ISC. It is upon this report, together with the trustees' annual return, ISC audit reviews and the submission of quarterly surveys for large funds, that the ISC's system of compliance is built.

The spate of corporate collapses in Australia over the past decade has focussed attention upon the role of auditors who have been the subject of numerous law suits by disgruntled shareholders, creditors and the corporations which themselves have been the victims of fraud (*see* Tomasic 1992a; 1992b). The Maxwell case itself raised issues relating to the roles and responsibilities of its internal auditors, in particular, their possible conflicting roles as auditors and employees, and the relationship between internal and external audit (*see* Vinten 1992, p. 3). Its external auditors, Coopers and Lybrand, had discovered some problems relating to the share certificates and had reported them to the management company, which failed to respond. However, in relation to the accounts as a whole, its last audited accounts were submitted before the thefts occurred and, apparently, its suspicions were not aroused. As is often the case in such circumstances, a system of mutual trust operated.

With effect from the 1995-96 year of income, fund auditors under SIS are expected to provide more than a mere review of a fund's financial statements. In addition, the ISC is encouraging fund trustees to arrange prudential reviews[10] (ANAO 1995, p. 33). In its audit of the ISC, the ANAO detected significant differences in the quality of audits between the large and small funds. Whereas the very large funds tended to be audited by the large accounting firms with specialised staff whose work was of very high quality, small and medium sized funds were less well-served by their auditors, although details of these shortcomings were not provided (ANAO 1995, p. 34).

A central issue in the debate surrounding auditors' responsibilities has been that of their obligation to report financial fraud or illegality. (Cases of audit failure include Rothwells, Tricontinental Bank and the National Safety Council (Victorian Branch). The traditional view of the auditing profession in Australia has been that their primary duty is to report on whether the accounts are true and fair, and that it is management's task to detect fraud (Tomasic 1992a, p. 45). This is a rather paradoxical view in cases where it is management itself which is fraudulent. Public expectations of auditors have certainly been at variance with the auditing profession's view of itself, encapsulated in the watchdog rather than bloodhound epithet of Lopes LJ in 1896 (*In re Kingston Cotton Mill Co*. (No 2) [1896] 2 Ch 279). The Australian Law Reform Commission and the Companies and Securities Advisory Committee in their joint report in 1992 recommended that auditors should become more proactive in the supervision of compliance by superannuation funds, as did the Senate Select Committee. The latter committee recommended that a superannuation fund's auditors should be independent of sponsoring employer, union or promoter. In its review of the ISC, the ANAO reported the concerns of ISC auditors that audits of small funds often involved the accountants who maintained the books of the fund and who also conducted their own audits and completed the annual returns. The ANAO concluded that the question of auditor independence required further clarification although the ISC itself seemed less

10 A compliance review relates to the trustee's obligation to lodge the annual return, the nature of the fund's governing rules, compliance with those rules, including lending, borrowing and acquisition of asset practices, in-house asset rules, member reporting requirements, trustee's reporting to the ISC etc. Prudential views relate to the security, effectiveness and productivity of the fund's investment and administrative practices.

concerned about the problem (ANAO 1995, p. 38; *see also* Inspector General of Labor 1994, p. iii; and McDonald 1994, p. 101). The ANAO also echoed the concern of the Senate Select Committee that auditors who exercised their whistleblowing functions might be liable to unjust or unreasonable termination (ANAO 1995, p. 40). The Senate Committee recommended that the ISC monitor the appointment and termination of auditors in the superannuation industry. The ISC has taken the view its primary concern is the safety of funds for fund members and that an auditor should be dismissed if it is not safe for fund members to allow the auditor to continue auditing the superannuation fund.

The Senate Committee recommended that only auditors registered with a Board of Superannuation Auditors should be able to sign the audit certificate on a fund's return (supported by the ANAO — *see* ANAO 1995, p. 36), that registered auditors should be required to audit anti-fraud internal controls within the fund and to report to members on fund's procedures for such matters as the regular reconciliation of accounts, the regular supply of statements from investment managers, checks on benefit entitlements, authorisation of payments to members, custody procedures for valuable documents and signatory procedures. It also recommended that auditors be required to report any concerns to the trustee or the ISC.

Section 129 of SIS requires an auditor or actuary who forms an opinion that a contravention of the Act may have occurred, may be occurring or may occur, to report in writing to the trustee. The trustee has an opportunity to rectify the problem, but if the auditor is not satisfied that appropriate action has been taken, the auditor is required to inform the ISC, by which time, of course, it may be too late to prevent further harm (*see* Lockery 1993, p. 66; *see also* Inspector General of Labor 1994, p. 66). Failure to do so exposes it to a maximum fine of A$5000. The auditor or actuary also has a duty to report its opinion as to the solvency of the fund (section 30, *see* Davis 1994, p. 497). An auditor who fails to carry out its duties may be prohibited from being an approved auditor (*see also* ANAO 1995, p. 38).

It is the view of the ISC that the auditor has no discretion but to report a breach, although the ISC itself retains a discretion as to how to respond to such breaches (Harris 1994). To date, the ISC has been unimpressed by the performance of auditors of superannuation funds and its own audits have found a significant level of non-compliance, generally for minor technical breaches (*see* Harris 1994), which had either not been found, or had been ignored, by the auditors. Standards had been breached in 80 per cent of the cases (Tomasic 1992a, p. 57).

Clearly, further training of superannuation fund auditors is needed; however, the change from watchdog to bloodhound will require both a high degree of cultural change in the auditing profession and a significant increase in its specialised technical knowledge (McDonald 1994). The former may be more difficult than the latter, given the historical traditions of the profession, but in any case there may well be limits upon the extent to which auditors can be relied upon to detect fraud or illegality (Tomasic 1992a, p. 57).

The Insurance and Superannuation Commission

The industry regulator, the Insurance and Superannuation Commission, was established in 1987, when the offices of Insurance Commissioner and Life Insurance Commissioner, the Australian Government Actuary and the Occupational Superannuation Interim Group were integrated. Until 1994, the Australian Securities Commission was directly involved in supervision of superannuation through its control of corporate trustees, of prospectuses for public offer funds and of the investment industry generally, but it has now ceded the first role to the ISC. The ANAO audit recommended that accounting bodies should receive feedback from the ISC on the performance of their members in the conduct of audits (ANAO 1995, p. 35). The ISC has three primary responsibilities in relation to superannuation (ANAO 1995, p. 2): (1) to promote the sound growth and prudential management of retirement savings through superannuation; (2) to provide protection for fund members' superannuation benefits;[11] and (3) to help ensure that taxation concessions provided to encourage superannuation are used for that purpose.

Although the Commissioner and his inspectors have been armed with a formidable array of investigatory powers (*see* SIS part 25: including powers of access to premises, inspection of production of books, search warrants, examination of persons under oath and the power to freeze assets.). The Commission does not see itself as a police agency. Its supervisory framework is "premised upon the principle that primary responsibility for superannuation rests with trustees and fund managers"(Chapman 1994; p. 4). This is in accord with the government's policy that its role is to provide a prudential framework designed to encourage trustees and managers to exercise integrity and professional skills in fulfilling their functions and to hold them fully responsible for their actions to their members and to the regulatory authorities (Dawkins 1997, p. 22). Its supervisory role includes (ANAO 1995, p. 4).

> *monitoring performance of trustees, fund managers, custodians, actuaries and auditors, test checking compliance through a program of relevant audits, taking appropriate enforcement action, improving public awareness and liaising with interested parties concerning prudential requirements, including the conduct of periodic compatibility checks with ATO superannuation records.*

The Commission's overall strategy is to build upon a devolved system of surveillance and disclosure, building upon the role of the auditors and actuaries. The Commission sees disclosure as a powerful tool of deregulation and seeks to review the systems and controls put in place by funds, rather than itself reviewing their technical compliance with the rules (Association of Superannuation Funds of Aust Ltd 1994), through its own powers of audit (Australian Accountant 1994, p. 26). In other words, it will audit the auditors. Its ethos, however, is one of providing support for the industry, rather than requiring strict adherence to the letter of the law, and has been criticised for "focusing on actuarial issues and for being too close to the industry it is supposed to regulate."(Westfield 1995). In Grabosky and Braithwaite's (1986) terms, it is a "benign big gun" rather than an "enforcer". It has stated (Association of Superannuation Funds of Australia Ltd 1994; *see also* ISC 1995 p. 59) that its objective is not to try to catch trustees out in order to penalise them, but to prevent undesirable conduct occurring in a fund, to educate trustees to carry out their duties rather than enforce. Penalties will be a last resort.

Despite its relatively benign and compassionate approach to regulation, the Commission is aware of the industry's vulnerability to malfeasance and is developing a regime of fraud control which includes the identification of the kinds of fraudulent activity which may occur (*see* Chaman 1994, p. 10), assessing the risk of them occurring, ensuring that information from funds is adequately reported, undertaking random audits, following up complaints made about funds and responding to whistleblowing by auditors and actuaries (Chapman 1994; but *see* Westfield 1995). In 1995 it was awarded A$200 000 from the federal government's Confiscated Assets Trust Fund for training in fraud detection (*see Canberra Times* 1995).

In 1994-95, the ISC was the subject of an efficiency audit by the ANAO, whose task was to assess the ISC's work practices under the previously existing regulatory regime and to form an opinion as to whether its preparations for meeting its increased responsibilities under SIS were adequate (ANAO 1995, p. xi). In general, it found that the ISC's planning had been soundly based, but found deficiencies in its management and administration, particularly in relation to its relationship with the ATO. Many of these had been, or were being rectified, during the audit process.

The ISC's audit function was subject to particular scrutiny. In 1993-94 it audited 1238 funds (or 1.66 per cent of all funds) of which 16 per cent did not measure up to one or more of the operational standards (ISC 1995, p. 5a). Forty-six of the larger funds were scrutinised and a number of breaches were detected, the majority of which related to information

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11 "Protection" in this context does not mean a guarantee of member benefits; rather it refers to the establishment of a regime of supervision and control in which benefits will grow and be relatively safe.

disclosure and member reporting standards. 1059 of the smaller (less than A$1 million) funds were audited and breaches were detected across the full range of requirements. A key area of concern in relation to these funds was the "in-house" asset rule. In 1992-93 year, the auditors visited 500 funds and completed 462 audits. Although no major prudential problems or frauds were detected, they found that a substantial number of funds had failed to comply with standards. Sixty per cent related to disclosure and member reporting practices. Twenty-four of the 462 funds lost their tax concessional status. The audit program revealed that the risk of non-compliance was greater where the employer was the sole trustee of the fund and where the principal contact point named in the fund's annual return was also its auditor. However, under the new SIS legislation, an employer cannot be the sole trustee.

The ANAO noted that the ISC's limited resources prior to 1993-94 had limited its abilities to carry out a sufficient number of effective audits. It had not been able to cover adequately the full range of funds, by type, location or assets. However, the audits which were undertaken achieved good results (ANAO 1995, p. 15). The transition to the new legislation will see changes to the number and kinds of audits, with a greater number of auditors being employed by the office. However, as the ANAO notes, it will take some time for the ISC to gain the necessary information and experience to create a profile for high risk funds which will assist it to select audit cases.

The ISC's lack of experience in fraud control and investigation has led it to develop closer contacts with the Australian Federal Police and the Commonwealth Director of Public Prosecutions, with neither of whom it has had experience working (Chapman 1994). Commonwealth concern over the possibilities of fraud in the superannuation industry has been reflected in the preparation of reports by both the National Crime Authority and the Australian Federal Police (AFP, 1992 unpub.), both of which remain unpublished, as well as by the recent Review of Commonwealth Law Enforcement Agencies. In 1994, it was in the process of developing its own prosecution policy and was deciding whether or not to develop its own investigatory capacity. Much of the ISC's success will depend upon its level of funding. In the light of the criticisms made by the ANAO of the liaison between the ISC and the ATO, and the possible large losses to the revenue, there is considerable scope for greater cooperation and liaison between the two agencies.

Law enforcement

As noted earlier, superannuation regulation is comprised of a host of interlocking and overlapping laws and responsibilities. The Australian Securities Commission remains responsible for the policing of the corporate status of trustees whilst the Australian Taxation Office is responsible for ensuring that the tax concessional status of a fund is maintained. However, this is a very limited safeguard as the Australian Taxation Office relies on the ISC's reports as to a fund's compliance. Both these agencies have extensive powers of investigation. Also at the federal level, the Australian Federal Police will be called upon in cases of major fraud and has prepared a paper in anticipation of growth in this area (AFP 1992, unpub.). The National Crime Authority, whose charter is confined to the investigation of "relevant criminal activity" (*see* Brown et al. 1995, pp. 7053 ff) has considered the issue of superannuation fraud so serious as to require a commitment of its resources to determine the extent of the risk.

The SIS contains a variety of civil and criminal offences relating to dishonest conduct, conduct which fails to conform to prudential standards of operating or reporting requirements (*see* Brown et al.). However, state police forces will remain involved as many of the offences which may be committed in relation to superannuation funds fall within state jurisdiction. As is so often the case when complex commercial fraud is concerned, coordination between state and federal agencies, and between federal agencies is crucial (*see* Australia 1994, p. 359).

Whilst the penalties for white-collar crime may appear heavy, it is unwise to rely upon the criminal law to ensure compliance with the regulatory regime. Because of the complexity of the cases and the difficulties of proof, convictions are rare and the maximum penalties are rarely imposed upon first time, middle-class and middle-aged offenders. And from the victim's point of view, what may be more important is not the prosecution of the offender, but the re-instatement of his or her loss.

There is no doubt that at some time in the future, whether through fraud or incompetence, a superannuation scheme will fail, leaving members without a retirement income other than the age pension. As the ISC itself observed (ISC 1994, p. 6):

> *Despite the existence of sound and well-developed supervisory frameworks, the Government cannot realistically prevent a determined act of theft or fraud, or predict the economic future or prevent poor commercial judgment or pure bad luck.*

The new regulatory scheme provides that if a fund has suffered a loss through fraud or theft, the trustee may apply to government for financial assistance under Part 23 of the *SIS* Act (*see Superannuation (Financial Assistance) Funding Levy Act (Cth)* 1993). The Treasurer will be required to determine, on public interest grounds, whether any assistance should be given. If assistance is to be given, a levy, not exceeding 0.05 per cent of a fund's assets, may be imposed on all regulated superannuation funds. Despite the arguments that increasing the moral hazard of funds will increase their chance of failure, some form of support for victims of crime, short of a guarantee, is a welcome recognition that the satisfaction to be obtained from obtaining a conviction against a fraudster does not compensate for the loss of a lifetime's savings and the possibility of a penurious retirement. Similar schemes have been recommended in England (*see The Economist*, 2 October 1993) and exist in the form of mandatory pension insurance under ERISA in the United States.

Conclusion

It is a sad indictment of modern corporate life that the control of organisation behaviour must be built upon a base of mutual mistrust and rely upon multiple levels of surveillance and supervision. The Maxwell debacle revealed that massive frauds can occur when information is not exchanged between professions and agencies (but *see* Chapman 1994, p. 13), when each agency relies too heavily on the work of others and fails to independently investigate suspicious activities, when professional advisers are willing to accept large fees but little responsibility, and when one person can dominate an organisation by a combination of force of personality, secrecy and deceit.

Crime against superannuation funds is always a possibility. The pillage of companies in the 1980s was not a unique event in history and will re-occur, given the right conditions. Most at risk are those funds where the control of assets remains closest to employers and trustees.

When introducing the new superannuation scheme in 1992 which made superannuation mandatory for almost all workers, the then Treasurer Mr Dawkins refused to guarantee superannuation benefits to members. The prudential system that the government has put in place, relies upon devolved supervision and enforcement, but emphasises cost efficiency over security. It provides a useful framework for fraud control. However, it will fail, if the ISC remains a benign regulator, relying upon the honesty of companies reporting to it, if auditors fail to adopt an attitude of constant vigilance and eternal suspicion and remain watchdogs rather than bloodhounds, if fund members are not vigilant, if trustees are not fully educated and empowered to exercise their prudential rights and duties and if law enforcement agencies lack the expertise and skill to understand and investigate this arcane area of law.

The recent review of the ISC by the ANAO shows that although it has managed the transition to the new regulatory scheme relatively well, there is still much to be done. Whilst the superannuation and taxation systems remain uncoupled and unco-ordinated, the revenue remains at risk. Though the larger funds appear to be safe from the minor frauds, they may be subject to cataclysmic losses through rogue or imprudent investment practices which can lead to a loss of public confidence in the financial system and ultimately de-stabilise it (ISC 1995, p. 2). On the other hand, the numerically greater small funds are more likely to be the targets of fraud and, although these frauds will be more frequent, they will be relatively small. Regulation and enforcement are ongoing and evolving processes. As each weakness or loophole is uncovered, as it inevitably will be, the government's response must be quick and sure and in the interests of the beneficiaries of the funds, not of the insurance companies, the professional advisers or its own agencies. The pensioners, annuitants and lump sum recipients of the future deserve nothing less. Failure to maintain the system's integrity will undermine the superannuation system and cast more people onto a social security system supported by fewer and fewer workers. That will be a heavy price to pay for not heeding the sounds of Maxwell's hammer.

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2

Corporate Cowboys and Superannuation

JOHN WATSON

The issues of superannuation and its prudential safeguards, including the questions being discussed in this volume, are among the most important economic and social issues presently facing the nation. In common with other developed nations in this era of increasing longevity, we have an ageing population. Interestingly, however, Mr Ian Macfarlane, then deputy governor of the Reserve Bank of Australia, pointed out that Australia's dependency ratio is not rising as rapidly as other similar countries, mainly because of our immigration levels. On present indications, though, it will rise more rapidly in the future.

With our rising standard of living, there has dawned on us a realisation that a publicly funded age pension, on its own, may not deliver the secure and prosperous retirement to which we would all aspire. The superannuation arrangements that successive governments have put in place attempt to address this problem. According to a survey by Perpetual Funds Management reported on 16 May 1996 in *The Australian Financial Review*, however, while most Australians now believe superannuation will be their *main* source of income in retirement, few expect to accumulate sufficient funds to live comfortably. This reflects the increasing awareness of the responsibility we all must take for providing for our retirements, although it also indicates that there is a lot of work yet to be done to perfect our system and to ensure that adequate provision is made.

Superannuation excites interest across a broad spectrum. Parliamentarians and public servants have tended to concentrate on the fiscal and social equity ramifications of policy options. Employers have been concerned with the industrial relations and profitability implications of retirement incomes policy. Trade unions have seen superannuation as an industrial issue, and more recently have expressed views about the nature of the investment of those funds. And the superannuation industry itself—trustees, fund administrators, fund managers, actuaries, accountants and lawyers—has been active in the development of the field.

At the political level, there has generally been a bi-partisan approach to the broad issue of superannuation. It is this bi-partisan approach which has contributed to Australia's capacity for change and capacity to adapt quickly and efficiently to the contemporary global environment. For example, we now have in place the Superannuation Industry (Supervision) regime, with Australia being recognised as a world leader in the field. The main purpose of the prudential SIS regime is not to prosecute but to ensure appropriate action is taken before a breach has occurred.

Some statistics help paint the picture. Over the last decade, the percentage of Australian workers covered by superannuation has grown from 39 per cent to 87 per cent, and superannuation savings represent 25 per cent of the financial system assets compared with 18 per cent in 1984. At the end of 1995, six and a half million people owned a total of A$239.8 billion in superannuation assets. We therefore have a vast, and growing, pool of accumulated savings. This growth in assets actually presents the opportunity for fraud. Establishing sound prudential standards, good accounting systems, understanding personal responsibility and internal controls and audits will be essential.

Superannuation funds represent probably the largest single pool of investment in Australia, and certainly are the fastest growing sector: in fact, only last year it was estimated that the assets of superannuation funds in this country would increase to around A$2 000 billion by 2020. This growth in assets will present an opportunity for fraud.

For many (if too few) Australians, superannuation is their only significant savings activity. For all Australians, superannuation is their future. Their savings must be adequately protected.

Regulation of the Industry

An increasing regulatory sophistication has accompanied the recent period of unparalleled growth in superannuation assets in Australia. We are fortunate in Australia that our superannuation regulatory system has, by and large, kept apace of the change. When Robert Maxwell went down, taking his pension funds with him, he left 30 000 Maxwell employees wondering just what the future held for them and, at the end of the day, a government to pick up the pieces. His demise also provided, in the most dramatic way, the impetus for a major review of the UK system of providing for retirement income and of the manner in which that system should be regulated.

In many ways, the UK system reflected an older Australian system, where the common law of trusts had formed the legal underpinning and there was little else to support it. From its origin as a system of providing benefits according to a pre-determined arrangement for mistresses, illegitimate children, wastrel sons and other family members, it became the basis of a multi-million dollar investment enterprise, involving many investors, a range of investments and spawning an entirely new superannuation industry.

Clearly contemporary requirements were more than this legal basis could sustain. As a consequence, we have moved on, to a situation where the role of trust law is modified by legislation which sets out the duties of trustees and investment managers and defines some of the rights of beneficiaries.

The Goode Report

Indeed, members of the United Kingdom's Goode inquiry, including Professor Goode himself, were impressed by much of what they saw on their fact-finding visit to Australia. Their recommendations for change in the UK reflect much of what we have in place with the *Superannuation Industry (Supervision) Act 1993,* the SIS Act, notwithstanding their recommendation that trust law continue to form the basis of their retirement funds system. For example, they recommended the replacement of statutory investment criteria with a general prudent person standard and emphasised the importance of monitoring by auditors and actuaries, in addition to a strong industry regulator.

The latest gloss on the Maxwell case came only recently with the news that Mr Maxwell's two sons had been found not guilty of conspiring to defraud the pension funds. This is akin to a public relations disaster for the UK's Serious Fraud Office. It is likely that this result will give rise to a round of calls for the Serious Fraud Office to change its tack and get tougher on prosecutions. Already the Institute of Chartered Accountants has called for a "more active stance" in combating fraud, but obviously the major difficulty in this particular case was the absence of Mr Maxwell himself!

While there is no system of regulation in the world that can be entirely foolproof, it is unlikely that a fraud on the scale of the Maxwell affair could happen again in the UK. Much of their regulatory system has now changed. Custodianship of pension shares has been tightened and pension supervision has been shaken up, and the financial community is ever more aware of the need for prudence and honest dealing. as a consequence of this timely reminder of just what can happen in the case of regulatory failure.

Nor are we likely to see a "Maxwell" in Australia.

The Australian Experience

Australia now has in place a well-developed system of prudential regulation, embodied in the SIS Act and related legislation. The Senate Superannuation Committee has been able to play an active role in that process, and played a particular role in the development of the SIS Act.

In the lead up to its enactment, the Committee held public hearings all over the country, each one attended by a representative of the Insurance and Superannuation Commissioner. Following each hearing there would be very extensive discussion amongst committee members and the ISC about the evidence that was emerging. As a result, the Committee drew up an extensive list of issues which were subsequently adopted by the Government. This indicates the unique role the Committee is able to play during the legislative process, at the very interface of community interests and the government of the day.

The SIS Act showed a new awareness on the part of the parliament. By its enactment, the parliament showed it had an interest in protective measures, not adequately addressed in the past, and despite what might have seemed up until that time to have been a preoccupation with revenue issues.

The prudential approach of the SIS Act also provided a refreshing contrast with the view of some previous corporate regulators. A conversation I had with one such person, with a reasonably high profile in the community, is illustrative. I was concerned at the apparent lack of commitment during the late 1980s to prosecution in the area of corporate crime generally. His response was that many of the corporate high fliers that I was referring to were heroes. Certainly the financial press at the time regarded them in that way, on account of the very large amounts of money with which they dealt — and that no court in the land would convict them.

Fortunately, this has changed, but we cannot now become complacent. Our vigilance should not just be in terms of the cowboys of the title of this session. This suggests that it is only a Maxwell-type event that need concern us. In fact, the Maxwell incident should really be considered atypical by virtue of the scale of the loss and the very concentrated control that Mr Maxwell had in his domination of the employer company, the trustee board and management of the funds. Maxwell is not the only example of loss and there is much more to preventing superannuation fraud, mismanagement or incompetence than just looking out for the big ones.

Fraud and Superannuation in Australia

Australia has not had a "Maxwell"—fortunately, the gross excesses of the corporate cowboys have not extended to superannuation assets. Although a "Maxwell" is unlikely here, we should not forget its lessons. A strong regulator is essential to the viability of a prudential system. It is also of significance when we have a privatised pension system, as we do in Australia.

The *Excelsior* case in Western Australia highlights the need for a quick and effective regulator. Excelsior was set up in the late 1980s by a large Perth accounting firm and quickly grew to about A$400 million, helped by some aggressive marketing. It seems that some serious computer and management bungles which surfaced in 1993 led to the situation where fund members were unable to get an account of the state of their nest eggs.

Excelsior shows it is not just the cowboys who are the greatest danger. In hindsight, it seems the problems with Excelsior were of incompetence or mismanagement, rather than of design. The problems included long delays in finalising accounts, wrong financial statements about investments and balances being sent to investors, and wrong payments being made on termination.

In a situation like this, the regulator must step in quickly and decisively. It is a matter for debate whether the ISC was quick enough off the mark in this particular situation, and we must ensure that it is properly equipped to deal decisively and effectively with such defaults in the future. It is not just a matter of consumer protection but also of maintaining the integrity of our financial institutions. While legal action remains a possibility, Excelsior fund members voted in April to keep the plan going 'under new management', at least for the moment. And it is not to legal action after the event that we should be looking in a prudential model.

Although outside the superannuation system, I am cognisant of the fact that Australia has also produced a *Pyramid*. The Habersberger report on the Pyramid collapse, tabled in the Victorian Parliament in December 1994, provided a catalogue of fault that gave us no excuse for remaining sanguine when it comes to loss through either fraud or mismanagement.

The report found that Pyramid's managing director, with an 80 per cent interest, dominated the affairs of the group and at times quite deliberately breached provisions of the relevant legislation. The other majority partner appeared to have done nothing to restrain the excesses. The report was critical of the Victorian government's regulation and of its provision of resources to regulatory bodies. It found that the Registrar of Building Societies did not seem to have taken steps to force the transgressing building society into line, and found that he had had a “fundamental misapprehension of his role” of ensuring prudential regulation rather than defending societies not known to be sound. It found that legislative provisions had been inadequate. It found that Pyramid had issued misleading prospectuses and literature and had engaged in aggressive marketing. And it found that the auditors had failed to identify numerous breaches of the legislation which had affected the quality of the relevant loans and a report in the compliance area had been “quite deficient”.

It is a masterful under-statement to say that this report did not reflect well on either our financial sector or our regulatory system, although we have progressed substantially since then. The report is a useful illustration of how fraud prevention techniques must be broad in their application and the prudential model that the SIS Act puts in place achieves this breadth and means that we are well placed to deal with any potential defaults in the future.

Following an investigation of the *Beneflex Retirement Plan*, the Insurance and Superannuation Commission in July 1995 for the first time disqualified a superannuation fund auditor under section 131 of the SIS Act. In March 1994, Beneflex had been declared a non-complying fund for previous income years because of persistent breaches of the *Occupational Superannuation Standards Act 1987*. This meant that it was denied a concessional tax regime and was ineligible to receive contributions under the Superannuation Guarantee Charge.

Beneflex had approximately 9000 members through 400 employers in the hospitality industry in Queensland. Alleged breaches by the trustee included the sole purpose test, for example, it was alleged that an expensive computer had been purchased with members' funds.

The trustee company, Corplan Nominees, was investigated by the Australian Securities Commission following allegations of unauthorised payments from the retirement fund to companies associated with Corplan. The investigation showed the fund had received contributions totalling A$2.9 million but had assets available for distribution of just A$314 000. Liquidators of the trustee were expecting to be able to distribute a dividend of just 6c in the dollar to fund members.

Unfortunately for Beneflex members, their loss occurred before the prudential provisions took effect, at a time when the ISC's powers for dealing with such problems were inadequate. Prior to 1 July 1994, members were limited to claiming damages from the trustees through the courts. Since that date, however, under Part 23 of the SIS Act, the Treasurer has been able to levy other funds "in the public interest" if a fund suffers loss as a result of fraudulent conduct or theft which causes a substantial diminution of the fund and leads to difficulties in the payment of benefits.

The ISC also has powers under the superannuation law to remove a trustee and appoint a replacement. It did this for the first time in November last year. It removed the trustee of the NSW-based CASS Superannuation Fund, which had about 5000 members and assets of A$9 million. The ISC is required to act in the interests of the members. It directed the acting trustee to assess the ongoing viability of the fund and make recommendations on a process of sustainable trusteeship.

Level of Fraud in Australia

Despite our Pyramids and like failures, it is of some comfort to know that the level of corporate fraud in Australia is well below international averages, despite a rise worldwide. A KPMG International Fraud survey, released in April 1996, showed that South Africa and the United States had close to the highest rates of fraud, with 80 per cent of the companies surveyed - 4000 companies in 18 countries experiencing fraud in the previous 12 months. Malawi was at the top of the scale with 83 per cent; the Netherlands and Bahrain were at the bottom with 20 per cent. Australia was in the bottom half of the domestic fraud league table with 43 per cent of respondents saying they had experienced some type of fraud.

Although not in the international league, the incidence of fraud in Australian corporate history is still disturbingly high. A survey of the major and most publicised corporate collapses in this country, dating from 1817 when Australia's first company (the then Bank of New South Wales) was formed, indicates that while bad management was the largest single cause of corporate failure, fraud is at the very least a contributing factor in 50 of the 85 cases studied. It is the prime cause in about 30 of the 85 cases. Note that these cases do not include small and medium-size companies, which tend to have a higher mortality rate than large companies.

Derivatives

Before the Barings fiasco, I went very close to suggesting that derivatives were inconsistent with the very concept of superannuation. While I acknowledge the difference between the hedging and speculative functions, the dividing line is nevertheless indistinct, especially for uninformed trustees.

At the time, I suggested an internal risk assessment process and protective legislative measures. I am pleased the ISC has now come out with guidelines for superannuation funds using derivative instruments, and risk management strategies are to be filed by trustees by 1 July 1966. In the wrong hands, derivatives could quickly wipe out an entire superannuation fund. I remain concerned that too many trustees remain ignorant when it comes to derivatives. This is a potential time bomb.

Both the House of Representatives Committee on Banking, Finance and Public Administration and the Parliamentary Joint Committee on Corporations and Securities have examined the use of derivatives over the last year, each expressing some concern that the area be monitored closely. This is a role for which the Senate Select Committee on Superannuation is well suited. I've also been discussing the issue of external audit reporting on the use of derivatives by superannuation funds with the ISC.

The Role of Auditors

Too often, auditors have been able to rely on the narrowness of their "true and fair account" role. In the United States, of the hundreds of savings and loans institutions which failed during the 1980s, many had received clean audit opinions only shortly before being identified by the regulatory authorities as insolvent! But we need not look so far afield. Corporate empires in Australia, outside the superannuation sphere, have collapsed within months of auditors signing off the accounts with few qualifications. In hindsight, frequently glaring and critical oversights have been obvious, although invariably by that time it is too late.

The SIS legislation gives auditors a key role in maintaining the integrity of our superannuation industry and requires high professional standards and experience of them. Auditors of superannuation funds must be "approved auditors". This means that they must be a registered company auditor or a member of a relevant professional association. The ISC has been explicit that it expects audits of superannuation funds to be carried out in accordance with Australian Accounting Standards, and that auditors must be independent, in keeping with the Statement of Auditing Standards and Codes of Professional and Ethical Conduct. The ISC itself, of course, maintains oversight.

Three distinct types of audit are available to trustees. Recent amendments require a compliance audit in addition to a financial one. Prudent trustees from time to time will also invite a prudential audit from an experienced auditor.

The Compliance Audit

The absence of a requirement for a compliance audit has been cited as the key reason for the Maxwell fraud. In keeping with the SIS legislation's focus on prudential standards, section 113 of the SIS Act now requires an auditor to make such an assessment.

The auditor's role in relation to prudential matters is primarily one of exception reporting. The SIS legislation provides that where an auditor or actuary has reason to believe that the fund is at risk or believes a breach of the law has occurred, is occurring or may occur, he or she is obliged to inform trustees in writing. Nevertheless, it is my view that auditors should not resile from making comment just because they have been charged primarily with conducting a financial statement audit.

Fraud is often the result of weak internal controls. Compliance audits should assist in limiting that possibility, but obviously we should monitor the effect of our provisions and make an assessment further down the track as to whether they are strong enough.

Fraud is often the result of weak internal controls. Compliance audits should assist in limiting that possibility, but obviously we should monitor the effect of such provisions and make our own assessment further down the track as to whether they are strong enough.

It is to be hoped that the increasing use of the compliance audit will also assist in limiting the audit failure which has arisen in the past out of sheer commercial pressure. In a competitive environment, where there is pressure on auditing firms to bid aggressively for work, fees may be negotiated which really are inadequate. This may mean that only so much involvement of senior staff or partners can be afforded before the firm begins to lose money. It may mean also that a firm tailors its audit work to the fee it has negotiated.

A requirement for an audit compliance, such as we now have in the SIS Act, goes some way towards indicating that we now have to focus on the quality of audit. It echoes the prevailing community view that professional lack of diligence will not be tolerated.

Trustees

Under the SIS legislation, ultimate responsibility for prudential management of a superannuation fund remains with the trustees, whatever the responsibility and obligation placed on auditors. It codifies their basic duties, which exist in addition to any imposed at common law. They are required to act always in the best interests of the beneficiaries and to develop a sound and balanced investment strategy. They are also required to ensure there are effective internal complaint-handling procedures for beneficiaries. The ISC maintains an active role in advising how such requirements can be satisfactorily met by trustees.

Conclusion

Superannuation funds are nothing short of a national asset, and they must be protected from both the unscrupulous and the careless. It is for this reason that the SIS legislation is so important. It is important also that the prudential controls that it established are not used as the lowest common denominator but as an indication of the very high standards that are expected of all professionals in the superannuation field.

Access to superannuation as the mechanism for providing appropriate retirement incomes largely depends on community confidence in the system. There is, therefore, a need for the government to provide the confidence, stability, simplicity and flexibility necessary for Australians to plan for their retirement with certainty.

The Wallis, or "Daughter of Campbell", inquiry is currently underway. No doubt there will be a great deal of pressure to wind back some of what I have characterised, and indeed, championed, as prudential regulatory measures, although it is now a much more tightly limited and controlled inquiry than many had hoped.

The inquiry must be careful not to lose sight of the purpose of the prudential measures that have been put in place to maintain the integrity of every aspect of the financial system.

From time to time, suggestions have been put to me and the Senate Superannuation Committee that aspects of the SIS legislation are too tight. This is something that we should continue to monitor. Given the acceptance of the Committee's role in oversighting developments in this arena, and its track record in working with industry groups, government and consumers, it is well placed to exercise this function and will continue to do so.

We are all aware of the formula: fraud = opportunity + motivation. With the sheer volume of money invested in superannuation, fraud prevention must be an ongoing concern. It is not only the cowboys but also the incompetent and bad managers who must be caught by our regulatory system. The cowboys are the worst case scenario. With good management, we need never encounter one of their ilk.

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3

Assessment of Potential for Fraud[1]

DAVID HELLINGS

The National Crime Authority (NCA) first took an interest in the superannuation industry after being asked by the Attorney General's Senior Advisory Committee, which comprised of the Chairperson of the NCA, Comptroller-General of Customs, Commissioner of Australian Federal Police and Secretary of the Attorney-General's Department, in mid 1992 to prepare a preliminary strategic assessment of the vulnerability of superannuation funds to criminal attack.

The scope of the preliminary assessment was limited by the requirement not to undertake overt inquiries in the superannuation industry. The assessment found that fraudulent conduct (albeit mostly small scale) has been detected by law enforcement agencies, as has extensive but minor non-compliance with the *Occupational Superannuation Standards Act 1987*. In conclusion it stated that given the changes taking place in the superannuation industry's regulatory framework at that time, particularly with the major changes envisaged in the Treasurer's Statement of 21 October 1992, it was not then possible to determine with any certainty whether and how the proposed changes would impact on the potential vulnerability of superannuation funds to criminal attack. It was therefore recommended that a further assessment be commenced in January 1994 when the strengthened regulatory framework will be in place and additional information available to assist such an assessment.

Formation of Working Party

On 22 December 1993 the Chairperson of the National Crime Authority (NCA) met with representatives of the ISC and agreement was reached on participation in a joint working party to carry out a comprehensive evaluation of the vulnerability of superannuation funds to criminal attack, highlighting any areas in the superannuation industry where there are high levels of fraud or opportunities for fraud to occur, and to determine whether there are any indicators that such opportunities are being exploited.

The Australian Taxation Office (ATO) and the Australian Securities Commission (ASC) agreed to participate in the working party.

The Industry

The superannuation industry can be divided into three distinct segments or fund types each

1 Paper based on a report prepared by the National Crime Authority in conjunction with the Insurance and Superannuation Commission, Australian Taxation Office and Australian Securities Commission.

subject to different prudential management controls and fraud prevention mechanisms.

Type of Fund	Systemic Controls
Excluded funds (less than 5 members)	general coincidence of ownership and control of assets
Non-excluded funds, generally employer sponsored	equal employer and beneficiary/trustee representation in conjunction with the SIS Act disclosure and anti fraud measures
Public offer funds	ISC approved corporate trustees. ISC controls entry, operations and can force exit

Each of these types of funds have different risk profiles. The excluded funds, which are the bulk of funds in numeric terms, are not expected to have many problems with fraud given the fact that the control of the fund is generally in the hands of those who are the beneficiaries. The bulk of the money placed with public offer funds is controlled by life assurance companies which generally have substantial financial strength and strong fraud prevention systems. Even so, fraud can and does occur in large and small companies, whether their financial position is strong or weak. Nevertheless it is in the area of employer sponsored funds where problems with fraud and potential criminal attacks are most likely to occur.

Trustees

Trustees can invest the contributions, authorize others to hold and invest contributions, take advice from appropriate experts, pay benefits, allocate forfeited benefits, distribute funds on winding up and generally exercise any discretion set out in the trust deed.

A survey of 247 superannuation funds conducted by the Association of Superannuation Funds of Australia, Research and Statistics Committee, (*Superfunds* June 1993) found that, where the trustee is a natural person, the typical trustee is

- a male aged between 35 and 55,
- an employer representative appointed by the sponsoring employer, and
- has only a 50 per cent chance of having had some form of training in his duties and responsibilities.

Being a trustee is an increasingly onerous responsibility due to changes in the law, greater beneficiary awareness and the pressure to maintain a good rate of return on investments. Today there is reduced tolerance towards short term below average performance along with insufficient consideration being given to long term strategies.

Trustees are in a very powerful position as they control the money and, in situations where no fund manager is employed, they are in direct control. A prudential balance to this situation is that funds wanting concessional income tax treatment must be regulated under the SIS Act, which, inter alia, requires that as from 1 July 1995 funds with between 5 and 50 members will have a choice of appointing an independent trustee or employees will be entitled to have equal representation on the board of trustees with the sponsoring employer. For public offer funds the trustee must be approved by the ISC.

Employers and Employees

With the introduction of occupational superannuation and the superannuation guarantee charge, more and more employers are setting up superannuation funds for their employees. Unless the fund is administered by an independent trustee both the employer and employee may appoint an equal number of representatives to the board of trustees.

Traditionally the relationship between employers and employees is that of master and servant; when they come together as trustees of a superannuation fund with equal powers and rights the situation changes and problems can and do occur. As a safeguard to trustees Section 68 of the SIS Act protects the impartial status of trustees in fulfilling or exercising their powers by prohibiting intentional or reckless acts of victimisation. In the past employers were often able to exert pressure and penalise employee trustees (see paragraph 14). Employee trustees may be concerned that if they oppose the views of their employer promotional prospects may disappear, postings to unattractive or out of the way positions may occur, or even threats of dismissal be received. Even if the threat is perceived rather than real, the effect can be the same.

During the course of Robert Maxwell's fraudulent activities in the United Kingdom he was only on one occasion significantly opposed in anything he proposed. Interestingly the co trustee who opposed him was a union trustee from Scotland who ended up losing his position as trustee and his employment position as well.

The difficulty with indirect forms of discrimination is that it is hard for an employee trustee to prove dismissal was connected with trustee related actions. Superannuation lawyer, Noel Davis, was quoted as saying there have been few instances in Australia where a trustee had refused to yield to the employer's will and later was considered no longer necessary as an employee of that company. But each of these cases was eventually settled out of court. "The action for wrongful dismissal was withdrawn because the employer had been able to provide alternative justification for the termination of employment," said Davis (1993, p. 36).

Employee representative trustees can also be subjected to pressure from union groups in the area of disability claims. Payments of spurious claims are not in the best interests of all fund members and could have the effect of raising contributions or premiums in the future. If the trustees do not follow the union line they could find that they have no support when their terms expire and they are seeking re-election.

Asset Consultants

The role of the asset consultant is to advise trustees on which fund manager, or managers, to employ and how much should be invested in different types of assets and particular funds.

There is some potential conflict between fund managers and asset consultants as fund managers often see asset consultants as encroaching on their turf. For many years and still now in many cases, trustees rely on the fund manager to make asset allocation decisions. Another area of conflict is that asset consultants monitor the performance of fund managers and publish regular performance surveys of investment results while fund managers assert that asset consultants operate without scrutiny and are not subject to prudential controls.

Asset consultants are beginning to move beyond their traditional role of providing independent investment advice for a fee. Some are now managing their own pooled investment funds because they say more money can be made by charging an asset based management fee rather than intermittent fees for services. This new trend presents a potential conflict of interest for those asset consultants who provide both services. The issue is whether consultants advise clients to invest in the fund they are running or is their advice impartial and they advise clients to place money elsewhere.

Consultants are in a strategically powerful position so far as fund managers are concerned. In a survey conducted by the Association of Superannuation Funds of Australia, reported on in the September 1993 issue of the magazine Superfunds, it was stated that fund managers were concerned about asset consultants showing bias as they tended to steer superannuation funds towards their favourite managers, overlooking smaller fund managers in favour of larger, better known ones. This is leading to a high concentration of a large pool of funds controlled by a small number of large fund managers.

While this concentration may limit the ability of small efficient competitors to compete in an open market, no evidence has been received to suggest that the recommending of a particular fund against another is anything but totally above-board.

From a fraud point of view asset consultants could be in a position to take advantage of clients by directing money to their own funds where this may not be the best course of action; or persuade fund managers to pay them some form of commission or kick-back for directing money into their funds. Conversely fund managers could offer inducements to consultants for them to direct business their way.

Trustees need to consider whether they have a genuine need for an asset consultant, and if so, are they going to receive independent advice? There have many been cases in the USA where ostensibly independent consultants have been found to be receiving commissions from life insurance companies for any business they placed with them (*Washington Post* 12 September 1993).

Investment Managers

Investment Managers play a vital role in the superannuation industry because they have the responsibility of earning an investment return on the members funds. Trustees of a fund may delegate the responsibility of day to day investment decisions to an investment manager who has fiduciary responsibilities including the duty to act in the best interests of the fund or trust.

Under the SIS Act a number of prudential controls have been put into place to control and regulate the actions of Investment Managers.

Investment Managers can be involved in unlawful behaviour by offering incentives to Asset Consultants etc to steer business their way. At a conference of the Investment Funds Association , held in Sydney during October 1994, it was said that sales incentives such as holidays, given by investment managers to financial planners was harmful (*Business Review Weekly*, 31 October 1994, p. 95).

This shows that these sorts of practices can occur in Australia. While no evidence showing that the adoption of such practices has led to losses being incurred by funds, such practices may however amount to the granting of secret commissions, contrary to law.

Accountants

The role of an accountant is to maintain or examine the accounts of a superannuation fund to ensure that they reflect the true and fair position of the fund and to prepare the annual returns for the ATO and the ISC.

For funds with arms length members which are audited by a member of a professional accounting body the accounts should be drawn up in accordance with Australian Accounting Standard 25 (AAS 25) entitled "Financial Reporting By Superannuation Plans". Each superannuation fund is required to prepare a general purpose financial report at least annually and to make that report available to members. This report should include a statement of net assets, an income and expenditure statement, and in the case of a defined benefit superannuation plan, a copy or summary of the latest actuarial report for the plan.

The purpose of accounting standards is to provide an industry with a consistent framework within which it can present its accounts. Standardisation enables contributors to compare the performance of their funds with others and generally be in a position to ask questions of the trustees.

While accounting standards do not directly impact on fraud, however, in general terms they assist in investigations. Without standards, it is difficult for an investigator to determine what practices deviate from the norm and warrant closer inspection.

Accountants are often called upon to provide advice, or they themselves, as a service to their clients, offer advice on superannuation matters. Often the accountant will assist clients in setting up superannuation funds and place themselves in control of it via a trustee company or by acting as the fund manager. Often because of their long association with each other, clients implicitly trust their accountant with all their financial advising, tax, superannuation and auditing work. This reliance on one person to provide all or most of these services can lead to problems particularly with small family funds where by using a number of corporate entities the Accountant can provide trustee and fund manager services.

Auditors

The functions of auditors are to audit the annual accounts of a fund and to give their opinion as to whether or not the accounts represent a true and fair picture of the entities financial status. In the Annual Return each superannuation fund is required to lodge with the ISC, the auditor is required to sign a certificate expressing the auditor's opinion, that the information provided by the trustee in the return is consistent with that contained in the audited accounts in respect of which the auditor has carried out an audit.

As auditors report after the event they obviously do not prevent frauds that have happened but they may discover on-going frauds and the knowledge of the audit function may have a deterrent effect on potential fraudsters.

Accounting firms traditionally provide a wide range of services beside the auditing of superannuation funds. It could be possible for entities within the same firm to be a funds administrator, its auditor as well as being the auditor of the parent company that has set up the superannuation fund These sorts of situations, Maxwell for example, could affect an auditor's independence. Is an auditor of a superannuation fund going to vigorously pursue a trustee and report the matter to the ISC if an implied threat or other discrete signal is given that such a course of action could result in the accounting firm losing the parent company as a client? This type of problem could be overcome by legislating that the auditor of the superannuation funds' accounts cannot also be the auditor of the parent companys' accounts. The USA experience is also noteworthy in this regard. The difficult issue of conflicts of interest is not confined to the superannuation industry. The resolution of this type of problem will have to be addressed by the accounting profession and other interested parties.

Professor Jack Shaw, one of the United Kingdom's foremost accountants and the deputy Governor of the Bank of Scotland, in an address to a gathering of accountants in Melbourne referred to the relationship between auditors and corporate managers as being conspiratorial. He stated some auditors put their imprimatur on practices they know to be dishonest (*Business Review Weekly,* 31 October, p. 89).

Vendors of Superannuation Products

Due to their size and standing the life insurance companies are seen as safe repositories for superannuation funds. They are financially stable and not likely to disappear overnight with the money.

From a fraud perspective they are not as high a risk as trustees and fund managers but they or their employees can engage in unlawful behaviour by offering inducements to gain business in a lucrative growth industry. In Australia a provider of workers compensation insurance paid inducements to obtain and retain lucrative contracts (*Royal Commission into Productivity in the Building Industry in NSW*, vol. 3, p. 54).

Consumers of superannuation products can be induced by fraud or misrepresentation into purchasing superannuation products by sales agents of life insurance companies who unconscionably misrepresent product terms, conditions and benefits. There was the example a few years ago in Australia where agents of some of the life insurance companies used these sorts of tactics to effect sales amongst the aboriginal communities of northern Australia.

In the United Kingdom consumer confidence in the industry as a whole has been dented by many recent scandals, such as the revelation that many consumers had been sold inappropriate and expensive personal superannuation products and the dubious sales tactics of life assurance companies (*Business Review Weekly*, 8 August 1994, p . 100).

Regulation of the Australian Industry

Insurance and Superannuation Commission

The ISC seeks to promote public confidence in the insurance and superannuation industry by protecting the interests of insurance policy holders and superannuation fund members. The Commissioner sets and monitors standards for the solvency of life and general insurance companies and the management of superannuation funds. Accordingly, the supervisory framework is based on the fundamental principle that trustees are primarily responsible for the viability and prudent operation of funds and for ensuring compliance with the operational standards.

Fund members, auditors and actuaries also have important roles in monitoring the operation and performance of funds.

As trusts, superannuation funds provide members the protection afforded by the fiduciary obligations which trustees owe them under the trust deed and trust law. However, the new superannuation supervisory regime provided for under SIS supplements this by codifying the main fiduciary duties of trustees and requiring them to formulate and give effect to an investment strategy. Other checks and balances in the legislation include extensive disclosure requirements, internal complaints handling arrangements, equal employee representation on trustee boards of employer-sponsored superannuation funds and minimum capital requirements for trustees of public offer funds.

The ISC also has a revenue protection as well as a prudential supervision role in respect of superannuation; various standards (including the sole purpose test, preservation, vesting, and restrictions on acquiring assets from or giving financial assistance to members) are designed to ensure that tax assisted superannuation is used for genuine retirement income purposes and not for tax minimisation purposes or to prop up an employer's business. The superannuation supervisory regime provides for a system of annual reporting by trustees, supplemented by an extensive audit program conducted by the ISC, and whistle-blower obligations on external auditors and actuaries (ISC 1994).

Funds assess their own compliance with the superannuation standards in their annual returns, with the ISC checking compliance through its audit program. During the 1992-93 year the ISC expanded its audit program. It completed 462 audits that involved checking compliance with the superannuation standards and monitoring prudential matters such as the quality of investments, management controls and systems. No major prudential problems or frauds were detected . However it was found that a substantial number of funds had failed to comply with the superannuation standards mostly for minor or technical reasons. Also identified was a need for greater compliance with in-house asset requirements. In 1994-95, 751 funds were audited by the ISC with the focus predominantly on issues of prudential management rather than technical compliance with the former *Occupational Superannuation Standards Act 1987* and Regulations (OSSA). In the course of this work, a number of instances of considerable prudential concern have been identified, leading to extensive rectification programs being developed by the trustees and monitored by the ISC. Instances of possible fraud have been detected in New South Wales and Queensland, with these matters being referred to the state police.

Problems With Self-Regulation

The SIS Act vests the primary responsibility for the viability and prudential operations of the superannuation industry with trustees and fund managers. This is because there is no other efficient and economical way for prudentially supervising 80 to 90 thousand superannuation funds.

Prudential supervision of 150 general insurance and 50 life companies is based on ISC staff having knowledge of the management of each such company, based on visits, statistical returns, audit and actuarial reports. But for the 90 000 superannuation funds checks and balances and prudential rules have to be set out in law, because it is not possible to know the management and trustees of each fund. Trustees and fund managers can be the very people who are in the best position to carry-out a fraud against a superannuation fund. Self regulation can be cost effective from an administrative point of view but to become effective in discouraging or preventing fraud it needs to be supplemented by an aggressive auditing program that has a high probability of detecting infringements. If the industry forms the view that the chances of detection are minimal then the incidence of abuse may increase.

In July 1987 ATO stopped manually checking every income tax return lodged and moved towards a system of partial self-assessment. In 1989 full self-assessment came to companies and superannuation funds. Full self-assessment that was to have been extended to individuals and non-corporate business taxpayers from July 1994 has been deferred on the recommendation of the Joint Parliamentary Public Accounts Committee. The committee's report on its review of the ATO stated there should be no further extension of self-assessment until the present arrangements are bedded down and properly evaluated. The committee was uncertain if self-assessment creates a potential for understated income, overstated expenses and increased public perception of tax evasion opportunities.

It also said that if self-assessment is to be a valid system, taxpayers should be able to broadly understand their obligations by referring to tax rules and regulations without an excessive need for professional advice. The ATO shares the same opinion as the Parliamentary Joint Committee (*Taxation in Australia*, vol. 29, no. 2, August 1994).

If the ISC thought it was necessary to get a definitive assessment as to the level of compliance and the effectiveness of self-regulation it could select an Australia-wide stratified sample of funds and audit each one of them.

Fraud Auditing versus Financial Auditing

Currently just over 1 per cent of returns lodged with the ISC are being audited annually. In 1994-95 this gave coverage of approximately 4 per cent of members and 9.9 per cent of assets in the superannuation industry. A new computer based case selection system is currently being developed to refine the selection process. Total reliance on the Audit Certificate to promote compliance is not in itself a reliable fraud deterrent. On the surface everything may look correct but further checking may show otherwise. There is a big difference between financial or compliance auditing and auditing to detect fraud.

The ISC is a prudential supervisor and is not specifically responsible for fraud detection. ISC audits are not directed at fraud except where the ISC has suspicions. If fraud is discovered the matter is referred to the appropriate fraud squads of the various Australian police forces.

The objective of financial auditing is to uncover any material deviations and variances from standards of acceptable accounting and auditing practices and provide the auditor with a degree of assurance to enable the rendering of an opinion as to whether a set of transactions is fairly presented in terms of generally accepted accounting standards and principles.

The financial auditor concentrates on the present relying on the adequacy of internal controls, often assuming management integrity, reasonableness tests, the reliability, validity and mathematical accuracy of the entries being audited. Accounting frauds, embezzlements and thefts are not generally discovered in the course of routine financial audits. Knowledge of their existence usually comes to light on the basis of:

- an allegation, complaint or rumour,
- the sudden discovery that something is missing or so out of the ordinary that further investigation takes place,
- suspicions of a person senior to the suspect.

Accounting type frauds are usually accompanied by the modification, alteration, destruction or counterfeiting of accounting information. Accounting data can be either intentionally or accidentally modified, altered, destroyed or lost by human error or omission. If the discrepancy cannot be attributed to human error or accident then it must be assumed fraud has taken place.

One of the best examples of financial auditing failing to detect massive fraud was the National Safety Council in Victoria where the auditors accepted the word of management who were drawing up false invoices and borrowing millions of dollars on the security of empty shipping containers supposed to contain valuable rescue equipment. Insufficient sampling and checking was carried out in relation to these items. Creditors in the case lost A$255 Million.

Fraud Auditing or Forensic Accounting, as it is becoming known, is a discipline which is more focused on possible fraudulent activity within the body being audited, rather than looking more generally at the broader issues of creating an audit trail, transparency, accountability and efficiency, which are the object of normal auditing activity. Its aim is to create an environment that encourages the detection and prevention of fraud in commercial transactions. Fraud Auditing cannot be reduced to simple check-lists.

It looks behind and beyond ignoring assumptions and focuses on substance. It is more an analytical process that seeks out the unusual rather than the usual. While Financial Auditing is designed to detect large differences Fraud Auditing concentrates on small differences which in turn show the path towards large differences. It occupies itself as much with the past as the present, seeking historical perspective and insight, looking behind and beyond the transactions in question without any scope limitations (*see* Bologna & Lindquist, p. 19, ch. 2).

It would be extremely difficult to combine the two different types of audit into one audit as they require different approaches, methodologies and attitudes. Combined fraud and financial audits would be unnecessary in the majority of cases and would involve an additional expense to be ultimately borne by the beneficiaries.

Auditors who sign ISC Annual Return audit certificates are not necessarily looking for theft and fraud and it would be a false notion to rely on the audit as a guarantee that no fraud exists. While it is not their responsibility ISC auditors should be taking into account forensic accounting issues so that while they are conducting compliance audits they can also recognise possible fraud indicators and techniques used to defraud superannuation funds.

Australian Taxation Office

Currently the Commissioner of Taxation administers the provisions of the Income Tax

Assessment Act that relate to determining the taxable income of a superannuation fund. However the ISC determines whether the fund has met the required operating standards to qualify for concessional tax treatment.

The ATO has a number of audit teams specialising in the audit of superannuation funds. Most of the work done has involved grey areas of the law and tax planning issues. For example, is a particular receipt of money a capital gain or assessable income? No examples of funds making large understatements of income have been found.

During the course of ATO audits if information comes to light which suggests that a fund may have breached the requirements of the Occupational and Superannuation Standards Act and therefore not entitled to be taxed at the concessional rate the matter is referred to the ISC for determination as the ATO does not have this power.

ISC Compliance Certificates : Cross Matching

Prior to 1 July 1994, when a superannuation fund lodged its annual income tax return it had to indicate whether it has, or expected to receive, a notice of compliance from the ISC thus entitling it to the concessional rate of tax. Under self assessment the claim for the concessional rate of tax is accepted as lodged. A recent matching exercise carried out by the ANAO that compared 1992 and 1993 ATO and ISC data in respect of notices of compliance found that approximately 3500 more claims for the complying rate were made than the number of notices of compliance actually issued by the ISC.

Under SIS, the principal enforcement tool available is not the loss of tax concessions as it was under OSSA, but action directly against the trustee or other persons responsible for breaches of the Act. Funds will not have the option of deciding each year whether or not to lodge an annual return; they are obliged to do so. Likewise, they will not receive an annual compliance certificate. A certificate will be issued only in the first year of their regulation for new funds, or the first year in which they are complying funds for which their last certificate was one of non-compliance under OSSA. The ATO has advised that it has acquired enhanced data matching capacity. This combined with the clean data set of regulated funds obtained as a result of the SIS election process, provides the capacity for a much better matching process by the ATO than has been possible in the past.

The Superannuation Guarantee

The ATO has the responsibility to administer the *Superannuation Guarantee (Administration) Act 1992* which requires employers, from 1 July 1992, to make contributions to a complying superannuation fund for its employees at the prescribed rate. If an employee fails to make the necessary contributions it must pay a non tax deductible guarantee charge to the government via the ATO.

Employers can specify the superannuation fund the contributions are paid into and the contributions must be fully vested in the employees name. Employers are required to self assess their superannuation guarantee. No returns need to be lodged by those employers who have provided the prescribed level of payments. However, employers with a shortfall are required to lodge a superannuation guarantee statement with the ATO together with payment of the amount of the superannuation guarantee.

Non payment by employers has no effect on Commonwealth revenue but it does adversely effect employees who are being denied what is rightly theirs. The ATO, which has the responsibility to enforce the payment of the requisite contributions, during 1993-94 tested the level of compliance with the superannuation guarantee. The Australian Bureau of Statistics, Statistical Consultancy, provided a sample design that the ATO used to select a sample of 4242 private sector businesses, with pay-rolls of less than $50 Million, for an audit check. The results of the survey indicated a high level of compliance with the legislation. Only 17 per cent of businesses did not fully comply with the Act. Of that 17 per cent, almost one third, or 5 per cent of the total, did not comply in any way at all. In other words of the 17 per cent, 12 per cent made superannuation guarantee payments but due to various technical reasons did not fully comply, while 5 per cent did not make any payments at all.

On the basis of the sample the report estimated the dollar value of non compliance Australia wide to be A$47 million. This represents a significant loss to those employees who did not receive all or some of what they were legally entitled to. No particular patterns of avoidance were discovered. An ongoing audit program is in place and as of June 1995 two prosecutions have been commenced.

Criminal Law Enforcement

State and Territory police forces have a role in protecting superannuation funds from fraud, in their responsibility for enforcement of criminal law, especially fraud, theft and secret commissions. In a number of instances the various Fraud Squads of State and Territory police forces have investigated alleged criminal conduct by trustees or fund managers where losses to beneficiaries have resulted. Such investigations focus on breaches or possible breaches of State or Territory criminal law, and thus there is no requirement for the police to involve any other agencies, including the ISC. While police may from time to time approach the ISC for assistance, it appears that most police investigations in this area are undertaken independently of any other regulatory agency, including the ISC. It would be of great benefit to the ISC in relation to its prudential supervision program that it be informed about any superannuation related criminal investigations so as it could ensure that the service provider is not involved with other superannuation funds in a way which puts those funds at risk.

The Report of The Review Of Commonwealth Law Enforcement Arrangements (February 1994) recommended in chapter 9.103 that all Commonwealth agencies cooperate readily and fully with the Government's generalist law enforcement and prosecution agencies, the AFP and the DPP, in dealing with criminality which affects or involves their program responsibilities. To put this into effect the ISC is involved in the Commonwealth Law Enforcement Co-ordination and Monitoring Liaison Group and is also working towards developing a Memorandum of Understanding with the DPP.

The National Crime Authority also has a role in this area, and has undertaken one significant investigation into alleged superannuation fraud as part of a larger white collar crime investigation. In that particular case a lack of admissible evidence caused the investigation to be wound up. Of course the Authority's investigative role is limited to investigating relevant criminal activity or organised crime, and while such superannuation fraud may fall within that definition there is no sign yet of organized crime penetrating the superannuation industry. The NCA has no mandate to investigate the conduct of individuals acting alone. As a matter of policy and parliamentary intent the NCA concentrates its activity on priority national threats from organised crime. This assessment did not identify any organised crime group engaged in fraud on superannuation funds.

Analysis of Case Studies in Australia

From law enforcement agencies around Australia twenty-one cases of superannuation fraud were discovered and analysed. Details of these cases cannot be listed here as a number of them were provided by the ISC in confidence. It needs to be remembered that nearly all of these examples took place prior to 1 July 1994, the date when many parts of the SIS Act came into operation. Also a number of the provisions of the Act only apply in respect of a funds 1994-95 and subsequent years of income.

Prior to 1 July 1994 the ISC had to enforce compliance using its inadequate powers under the *Occupational Superannuation Standards Act 1987* which were so limited that it was often unproductive to carry out extensive investigations. Its main punitive tool was to declare a fund non-complying and thus forfeiting its right to concessional income tax treatment. This was often deemed to be an unsatisfactory course of action as the only people who it really penalised were the funds beneficiaries, not the persons responsible for the misconduct.

A summary of the examples showing the identity of the alleged perpetrators and the nature of the offences they committed are as follows.

ALLEGED PERPETRATOR	**NO OF EXAMPLES**
Trustee	11
Fund Manager	6
Employer/Trustee	4
Accountant	2
Auditor	2
Superannuation Product Vendor	2

NATURE OF OFFENCE	**NO OF EXAMPLES**
Fraudulent conversion	5
Theft of employee contributions	4
Overpayment of benefits	2
Excessive charges	2
Extortion	1
Secret commissions	2
Unlawful conduct	6

Problems Identified

Trustees and Fund Managers.

The examples collected show that beneficiaries funds are at their greatest risk in the hands of trustees and fund managers. This is to be expected as those who have their hands on the money are in the best position to misuse it. A significant problem that is emerging in this area is the theft of employee contributions and the non payment of employer contributions to employees funds, by employers, who are also the trustee of their employees superannuation fund. With the growth of compulsory superannuation and increases in the percentage rate of the superannuation levy this is an area that will need to be closely monitored in the future to ensure the integrity of the industry.

Under the provisions of the SIS Act beneficiaries will be in a better position to protect and control their own funds. As from 1 July 1995 funds with between 5 and 50 members will have a choice of appointing an independent trustee or employees will be entitled to have equal representation on the board of trustees with the sponsoring employer. Also members will have access to documentation relating to them, or which has commercial value.

Breaches of Fiduciary Responsibilities.

In its 1992-93 Annual Report the ISC highlighted the need for greater compliance with the in-house asset rule. (A fund may not invest in or give a loan to the employer sponsor, or an associate, in excess of 10 per cent of the cost of all the funds assets.)

A trustee's or fund manager's responsibility to avoid conflicts of interest is frequently a major concern of superannuation fund members particularly when the trustee is investing beneficiaries' funds in the sponsor company or when a fund manager is directing funds into companies that are associated.

There are number of examples set out where trustees and fund managers have breached their responsibilities and have directed funds to associated companies. These types of non-armslength investments are often not made on a sound commercial basis and often fail because they are used to prop up ailing companies heading for bankruptcy.

When the company does fail and the loans cannot be repaid it is the fund's beneficiaries who suffer, not the person who has breached their fiduciary responsibility. Beneficiaries would have a right to bring a civil action against the fiduciary but the high costs and uncertainty of court actions usually precludes this happening (*see* Senate Select Committee on Superannuation. Byrnwood Ltd. February 1993).

Under the SIS Act the ISC now has the power to remove trustees and institute legal proceedings against them to pay compensation to a fund for the amount of the loss caused by their breach of the act. These powers along with the employees rights to equal representation on the board of trustees, which must formulate an appropriate investment strategy, should have a positive effect in curtailing these sorts of problems.

Excessive Charges and Secret Commissions

Discussions with superannuation industry regulators in the USA revealed that the greatest threat to funds is coming from service providers (fund managers, accountants, auditors, consultants, employees, vendors of superannuation products) acting on their own behalf or in concert with dishonest trustees.

The discovery of four examples of this type of conduct shows that this trend is also emerging within the Australian industry. It will continue to grow as the strengthening of the regulatory regime under the SIS Act will cause people hoping to prey on the industry and profit from it to be more circumspect in their actions.

Secret commissions and excessive charging will not usually be discovered in the course of normal compliance audits carried out by fund auditors or by the ISC. To deal with this problem trustees will need to be vigilant and have in place strict internal controls governing the operation of the fund.

Money Laundering

While the detection of money laundering and the criminal activities associated with it is not the responsibility of the ISC, it needs to be aware that the insurance and superannuation industry may have the potential to be used by criminals to launder funds. An awareness of this problem and the ability to inform other law enforcement agencies when it is observed would be of great assistance (for overview of money laundering issues, *see* Graycar & Grabosky 1996).

The G7 Financial Action Task Force on Money Laundering (FATF) in its 1992-93 Annual Report noted the trend towards greater use of non-bank financial institutions, including insurance companies, as a means of getting the proceeds of crime into the financial system.

Large amounts of money can be paid at any one time on a superannuation product particularly if the purchaser is in the 40s to 50s age group and has never before been in a superannuation fund. To fund their maximum retirement benefit limit a person could in theory be entitled to make yearly payments of between A$25 000 to A$62 000.

By structuring payments through a broker trust account or smurfing (the process of breaking a large transaction into smaller non reportable amounts) by purchasing bank cheques the first steps in a money laundering process could be taken.

Life insurance policies are subject to a 14-day cooling off period so it is possible, after cash or other smurfed funds have been paid over, to withdraw from the policy and receive a cheque back from the insurance company, which on the face of it could be represented as a legitimate receipt. Another way to set up a mechanism to void a policy at any time is to deliberately misrepresent a known fact say about the state of health or the existence of a known ailment. A person could at a time that suits them, after paying a number of years premiums in cash, make this information known to the insurer who would then cancel the policy and again a cheque would be received from the insurance company.

In the United States of America the Federal Bureau of Investigation, in 1993, issued a report entitled "Money Laundering—a Guide for Insurance Companies" (*Money Laundering Alert*, June 1993). The report described common laundering methods to which the insurance industry was vulnerable and suggested ways by which suspicious transactions could be identified. The report stated that the most frequent money laundering method utilized in the insurance industry was the single premium contract to purchase annuities, life insurance policies and superannuation products. The report said that recently a drug trafficker was found to have attempted to hide his illicit proceeds by purchasing a life insurance policy by way of an overseas wire transfer.

According to that report, characteristics of suspicious transactions by agents and clients are as follows:

- dramatic sales increases or exorbitant single premium policy sales;
- unusually large purchase of an insurance product by a client;
- third party cheques;
- payments by large foreign wire transfers;
- large investments which are cancelled quickly and paid to a third party;
- a request for a loan for the maximum value of a single premium policy soon after its purchase.

The FBI has recently marked out the insurance industry as its niche for primary focus in the money laundering field. A number of investigations are under way including one into scam insolvencies.

Conclusions

One of the reasons for undertaking this study was the concern that, because of the very large amounts of money now being put into superannuation funds, those funds may be infiltrated by organised criminal elements with a view to their stealing those funds or using the funds for illegal purposes.

In the United States environment, it is apparent that there has been a problem with infiltration of major organised crime syndicates into labour unions, very often with the primary purpose of obtaining access to the union pension funds.

It is no coincidence that the Office of Labor Racketeering and the Labor Law Unit of the FBI have both been very actively involved in pension fund fraud investigations. While the involvement of organised crime in pension fund fraud in the United States is still an issue, it appears to be somewhat less of a problem than it was a number of years ago.

However, in the Australian environment law enforcement agencies have not discovered any significant indication of involvement of organised criminal groups in superannuation funds. While this does not mean we should necessarily assume that there is no involvement by organised criminal groups in superannuation funds, equally we do not have a basis, on current evidence, for concern about that involvement. Nevertheless, the enormous amounts of money involved in superannuation (and growing exponentially) are reason enough to maintain vigilance.

The analysis of the cases of superannuation fraud discovered in Australia (see para 76) disclose a wide variety of offences committed by the full range of people involved in administering superannuation funds. Notwithstanding this the current structure of the industry with 80 per cent of all superannuation monies controlled by life assurance companies, is in itself a significant protection against fraudulent attack. Monies placed in the hands of reputable life assurance companies are protected by being out of the control of dishonest trustees and fund managers. Life assurance companies in Australia enjoy a good reputation of stability and financial security, thus they can be relied upon as a safe place for superannuation contributions much the same as banks are relied upon as a safe repository for deposits.

One thing which has come through in virtually all of the examples has been the lack of any means of early detection of criminal conduct, and therefore the ability to quickly curtail the perpetrators who continue with that conduct and reduce the amount of the loss.

Thus it is considered that any controls or systems which can improve the prospects of early detection of this criminal conduct would be an effective remedy, bearing in mind that no amount of regulation will completely deter people from trying to defraud superannuation funds.

In concentrating on early detection, consideration should be given to both detection by the official superannuation industry regulators and other affected parties, in particular supervision and detection by the beneficiaries who are those most affected by the criminal conduct. Under the provisions of the SIS Act which give beneficiaries of funds with five or more members equal representation on the board of trustees, employee trustees, are now in a position to take an active role in the administration of their own funds and to closely monitor the actions of employer trustees, managers, administrators, etc.

The strengthening of the regulatory regime via the SIS Act will greatly assist in safeguarding the industry and will make the perpetration of fraud much more difficult. But as well intentioned as the changes brought about by the SIS Act are, they will not eradicate fraud. What will most likely happen is that the direction and the nature of fraud against superannuation funds will change with service providers becoming the main perpetrators. The Employee Retirement Income Security Act (ERISA) legislation, which is similar to the SIS Act, has been in force in the USA for twenty years. It is a significant deterrent and the Pension & Welfare Benefits Administration (PWBA) take pride in the fact that Maxwell did not plunder the superannuation funds he controlled in the USA; but it has not stopped fraud in that country.

The ISC describes its role as a prudential supervisor; it is not specifically involved in fraud detection and its audits are not directed at it. Given this and the nature of the financial audit certificate the only barriers to fraud are the systemic controls and mechanisms contained in the SIS Act. Thus it would appear that no one agency is taking a role in detecting criminal attacks on superannuation funds.

Police forces or the ISC are contacted after the event by trustees or beneficiaries who have found out that they have suffered a loss. The evidence gathered during the course of this study shows that there have been only a relatively small number of funds subjected to criminal attacks. To confirm this trend and to gauge the effectiveness of the regulatory regime embodied in the SIS Act it would be appropriate to review the situation in 5 years time.

Given that there are no acceptable absolute barriers to fraud, what is required now is that the ISC use its new set of laws and regulations to mount a rigorous and imaginative audit program with its audit staff trained in the latest fraud detection techniques.

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4

Police and Superannuation Crime

ALLEN BOWLES

As we move towards the next century, the community is facing a range of issues dealing with criminal activity. One of these issues will be superannuation funds. The sheer size of these will no doubt attract the dishonest and unscrupulous members of the community who will attempt to illegally access these funds.

The current policy of the Federal Government is to have working Australians contribute to their retirement by some form of superannuation. The size of various funds is dependent upon the number of employees and their contribution rates. Superannuation funds can range from a single self employed to large Government and non Government enterprises. The Superannuation Guarantee Charge under Federal legislation in 1992 required all employees to contribute a minimum amount to employee superannuation funds. At present this is set at 3 per cent of employee wages, rising to 9 per cent by the year 2002. It is anticipated that such a fund will be at least A$300 billion by the year 2000. It is from this perspective that this paper will canvass the problems that investigators are going to be confronted with as we approach the year 2000.

This paper will review how the Major Fraud Group (MFG) intends to address the vulnerability of superannuation funds to fraudsters. Some superannuation matters that have been investigated by the MFG will be discussed. This will then be followed by an analysis of the difficulties encountered by investigators. Finally, a number of indicators that employees should look for in assessing the security of their superannuation and will be addressed. Comments will focus on employer and self employed funded superannuation.

Case No. 1

The offender was a Director and sole signatory to company cheques. He was responsible for the wages of the 15 employees. This included the responsibility to pay both the employer's contribution and the authorised member's deduction. The business was forced to close after about two years of trading. It was then discovered that the Director (employer) had failed to pay either the employer or employee contributions during the relevant period, even though the deduction appeared on the employee pay slips.

Comment

The employees did not receive any statement from the fund as to their superannuation. It was only after the business closed that enquiries were made. There were no enquiries from the approved fund as to the non payment of the appropriate funds. There needs to be some mechanism by which the regulatory authority (Insurance and Superannuation Commission) is notified in these instances.

Case No. 2

Funds were invested with a solicitor (a long-term personal friend) with instructions to invest in a freehold first mortgage security, no more than 70 per cent of sworn valuation, as part of a private superannuation fund. The money was not invested as instructed. The client did not receive any documentation and did not ask for any. He trusted the solicitor to invest as instructed, and "assumed" that all was in order. The solicitor in this case had also created false documentation to facilitate the fraud (forged authorities). This was repeated with a number of clients.

Comment

This is another example of not requesting documentation to verify that instructions had been acted upon. No ongoing written information was provided to inform how investment was performing. The solicitor had abused the trust of client (and personal friend).

Case No. 3

A firm of accountants had a long-term professional relationship with a client (over 50 years). The staffing of the firm had changed in this time. This firm managed both the client and his employee superannuation fund. Numerous other business interests were also administered by the firm. There was no documentation. Instructions were given to re-invest interest in a compounding manner with the invested principal. The client became suspicious of lack of information and his questions were continually fobbed off. The following comments were given by the offending accountant, when eventually confronted by client:

- they were difficult to get out;
- the funds were locked in for two years (commercial bills);
- the funds were in unidentified real estate;
- the funds were available next week.

Numerous phone calls were not returned.

This firm administered a number of small self employed superannuation funds that became the subject of fraud.

Comment

Once again, no documentation was made to confirm instructions. Prevarication by the accountant to verbal requests should not be permitted to overcome a reasonable request of the client. The client should always ask for details of real estate: certificate of title, lease agreement, address of property. None of these were provided.

Case No. 4

An accountant with longstanding clients administered a number of small superannuation funds on their behalf through a trustee company. The judge in this case when passing sentence, commented, "this project was perhaps the first of a series of risky, over-ambitious and ill-fated ventures which seem to be the product of the loss of judgment of those who are almost inevitably destined for financial ruin".

Comment

A personal friendship was abused to the extent that little or no documentation was provided to clients.

Trust is good– Control is Better

Superannuation is perhaps the most important investment made by a person outside the purchase of a home. Why then doesn't it receive the same degree of accountability associated with the investment in real estate? It is an asset that is more vulnerable to criminality.

What is obvious from these case studies is that there is little or no documentary material to confirm instructions, or to advise on investments. It is also evident that the trust has been the first casualty in the relationship between the fund manager and the beneficiary. Far too often trust is used as a substitute for hardcopy documentation explaining investments, and how they are performing. Documentation does not guarantee fidelity, but it does give a degree of accountability. Furthermore, it can assist one in assessing a funds performance. Investigators would also appreciate this documentary material in the event of fraudulent activity being suspected or reported.

Police and other law enforcement agencies should not have to accept ultimate responsibility for investigating allegations of dishonesty dealing with superannuation funds. Contributors to such funds must accept some responsibility. They can do this by asking employers, fund managers, and others to provide written documentation of the status of their superannuation. This is especially pertinent in relation to the smaller employer sponsored funds.

Recommendation

In the case of self-employed superannuation, all instructions and communications should be confirmed in writing from both parties. Any changes should also be similarly recorded. At the first sign of a breach in this practice, enquiries should be immediately made to ascertain why the breach occurred. It is trite to say that friendship and business should be kept at arms length. In our experience it is this breach of trust arising out of friendship and transported to the business that facilitates fraud.

We need increased public awareness in relation to employer and self-employed superannuation funds along lines that currently exist in the larger corporate and government sponsored funds.

Difficulty for Investigators

The difficulties confronting investigators when faced with an allegation of fraud involving superannuation is basically the same as any other allegation of major fraud. Usually there is a considerable time delay between the discovery of the fraud, the report and subsequent investigation. This delay only benefits the alleged fraudster. It stands to reason that the earlier investigators are involved, the less chance there is that evidence will be lost or destroyed.

Another factor in this initial delay period is the necessity to have some form of preliminary analysis by an accountant or auditor. It has been our experience that accountants and auditors prepare reports that are inconsistent with the evidentiary requirements of the criminal process in our courts.

Indicators of possible fraud are as follows:

- lack of documentation confirming instructions;
- lack of documentation as to investments;
- lack of documentation as to how fund is performing;
- irregular forwarding of statutory contributions to the approved fund;
- slow response to fund queries;
- prevarication as to fund performance;
- financial difficulties of employer (cash flow problems);
- former beneficiaries having problems receiving their entitlements;
- poor performance from fund;
- unexplained variables in fund performances.

These indicators are a compilation of problems associated with superannuation frauds investigated by the MFG.

Conclusion

For a number of years there have been predictions as to the vulnerability to fraud within the superannuation industry. This has not been reflected in investigations conducted by the MFG. To date we have only had a small number of complaints totalling less than A$10 million. They have been persons generally relying on accountants and solicitors acting as trustee managers for small superannuation funds. This is not to say that we should be less vigilant as to superannuation fraud. Undoubtedly there will be a number and variety of deceptions to commit superannuation frauds in the future. But at this stage, generally, we have not had the spectacular superannuation frauds that have been committed overseas. Of the 48 major investigations we are conducting, only one relates to superannuation.

5

The Regulator's View

ROGER BROWN

Enforcement Agency or Supervisor: The Role of the Insurance and Superannuation Commission in the Context of Superannuation Crime

Although the Insurance and Superannuation Commission is an enforcement agency, this is not its sole or even primary role. The Commission focusses to a greater degree on its role as the prudential regulator of the superannuation industry. Its aim is to protect fund members' superannuation benefits as well as promote the sound growth and careful management of superannuation savings, by preventing problems from emerging in individual funds or in parts of the industry.

With more than 140 000 funds in Australia, it is unrealistic to expect that we will be able to prevent all funds from running into problems. Checks and balances and prudential rules have to be set out in law because it is not possible to know the management and trustees of each fund.

In terms of the role of the ISC, two Government positions have been crucial in determining the relative weightings given to preventing, detecting and fighting crime in superannuation.

The first is to refuse to guarantee funds against losses due to fraud, poor management or investment losses. It considered that any such guarantee could lead trustees to be less diligent in their internal processes, and adopt riskier investment practices, with taxpayers generally having to underwrite the consequent losses.

Secondly, it has endorsed the ISC's market oriented approach to its prudential supervision of the industry. The approach under SIS is to establish a regulatory framework which is effective in reducing the risks to members' savings, while not imposing stifling compliance costs (which of themselves could severely reduce members' eventual retirement benefits) or unduly inhibiting commercial developments.

The diversity of the industry also works against preventing every loss due to fraud, theft or poor management. Each type of fund has a different risk profile, meaning that the imposition of a uniform regime of regulation is not feasible.

The approach adopted by the Government and implemented by the ISC has therefore been to regulate for multiple layers of defence to minimise the risk of loss at the lowest practicable cost and the minimum interference in the marketplace.

Through the *Superannuation Industry (Supervision) Act*—or SIS—the Government has established structures which enlist the aid of the various participants in the industry — such as trustees, auditors and members themselves — to support our objectives as the regulator.

At the same time, every time that the ISC conducts a prudential review of a superannuation fund, the review officers are required to assess the potential for the fund to be exposed to fraud. In the rare instances where there are indications that fraud may actually have occurred (or be occurring) we liaise as a matter of urgency with the relevant police force.

The system is not perfect. Fraud has been discovered in some superannuation funds. It must be expected that wherever there are large amounts of money, criminals will be attracted. On that basis, it would be disturbing if some fraud had not been found, because that would indicate that our review techniques were inadequate.

The good news is that, of the cases of fraud against superannuation funds identified over the period 1988-96, total known losses are in the order of A$17 million, or 0.007 per cent of the current total assets of A$230 billion, spread over an eight year period.

Aspects of Superannuation Crime

Crimes Under SIS

Superannuation crime is broader than just fraud. It includes crimes under the SIS legislation.

The ISC has been given direct enforcement powers which range across the whole spectrum of industry regulation, from entry control through operational control to exit control.

The SIS Act contains some 95 offences, relating to breaches of the Act which are of such importance that they undermine the prudent operation of a fund for the benefit of members' retirement savings. The most serious breach is the contravention of a "civil penalty provision", punishable by a maximum pecuniary penalty of up to A$200 000 or, if the contravention can be proved as an offence, up to 5 years imprisonment. For a corporate trustee, the maximum penalty is A$1 million.

Civil penalty provisions include such things as:

- the sole purpose test (S62);
- prohibitions on lending to members of superannuation funds (S65) and on borrowing (S67);
- in-house assets rules (S84);
- prohibition of transactions on other than an "arms length" basis (S109); and
- making payments to an employer sponsor other than as authorised under the Act (S117).

Where a contravention of a provision of the Act is detected, it is in the first instance a decision for the ISC on whether to proceed with an investigation and ultimately to recommend that the Director of Public Prosecutions initiate a prosecution. At that stage, of course, the DPP has the ultimate responsibility for deciding whether an alleged offence should be prosecuted. These powers are not to be used lightly and, to date, we have not had to prosecute any trustees for offences under SIS, although a couple of cases are under active investigation.

Fraud and Misappropriation of Assets

The main types of criminal act which can be perpetrated against superannuation funds to the direct detriment of members are theft, fraud, conspiracy and payments of secret commissions or inducements. Fraud is a generic term that refers to the numerous and diverse criminal activities in which dishonesty and deception are the key ingredients.

Superannuation fraud and misappropriation of assets attracted a lot of attention with the Maxwell case in the UK. But because of the SIS regime, such large scale fraud has a significantly lower — though still finite — chance of occurring in Australia. In this context, it is worth noting that the British Government appointed a Committee of Inquiry headed by Professor Roy Goode to review pensions law in that country as a result of the Maxwell scandal. Committee members visited Australia in 1993 to examine our regulatory system, and as a result recommended that many of the features of SIS be incorporated into the revised British legislation.

In the heterogeneous Australian superannuation industry, the specific nature of the risk will vary according to the nature of the particular superannuation fund. Identified cases of fraud in Australia have been on a much smaller scale, and have been opportunistic rather than systematic.

The largest thousand funds account for 90 per cent of all members and 85 per cent of assets. Medium to large funds may face the traditional risk of internal fraud perpetrated by an employee of the fund, or the employer-sponsor, or even by a trustee. Where services such as fund administration are outsourced, the fund faces risks of fraud from within the service provider. The quality of the contracts between the trustee and the service provider then becomes a very real issue for both trustees and members.

Funds with fewer than five members, which number around 135 000, are not expected to have as many problems with fraud because the control of the fund is generally in the hands of the beneficiaries. However, some of these "mum and dad" funds have "arms length" members. For some, the trustees have ceded almost all control to service providers. And for some a primary motivation might be an inappropriate reduction in the tax bill rather than saving for retirement. These are all things that lead to complexity in monitoring "mum and dad" funds.

In small funds, a major risk is associated with an inexperienced trustee not undertaking an adequate due diligence process before handing over the fund's money to a third party. We have seen a number of instances where this has happened and the money has been misappropriated.

Case A

In one such case, the trustee of a small "mum and dad" fund relied entirely on his accountant who took on the additional roles of investment adviser and auditor. With no segregation of duties, it was a recipe for disaster.

When a new auditor took over the fund, he discovered that A$300 000 of the fund's money had not been invested as claimed by the previous auditor. The new auditor advised both the ISC and the police of the suspected fraud.

The police were contacted and they advised that the suspect was involved in a number of fraudulent activities. Charges were laid but later dropped by the police when the accountant agreed to repay the money and the trustee declined to offer evidence.

The ISC has targeted a number of other superannuation funds audited by the same accountant and has found that these assets appear to be safe.

Case B

In another recent case in New South Wales, a combination of lax internal controls and an auditor who let the fund members down led to a loss of A$800 000 of superannuation moneys.

The fraud occurred after a company allowed one key employee to hold sway over the full range of its financial affairs — there was no separation of duties whatsoever.

Two years after the fund's benefits were purportedly transferred into a large industry fund, we received a complaint from a member stating that the industry fund had no record of the transfer. When we started asking questions, the key employee disappeared. We conducted an investigation and found that the fund auditor had relied on counterfeit documents provided by the key employee in order to sign unqualified audit reports over a period of years.

The perpetrator of the fraud is currently in gaol. It is believed that he subsequently paid restitution to his employer and the fund by selling his assets.

Other work of the auditor is being examined to see if the failing in this fund was an aberration, or if other action should be taken.

Secret Commissions

The ISC is aware of instances where some fund administrators have obtained commissions in relation to group life insurance policies. Where an administrator obtains an advantage of this sort which is not disclosed to trustees, and is therefore not passed on to members, they may be guilty of obtaining secret commissions.

Although the law regarding the treatment of secret commissions varies from state to state, there is one commonality: it is a criminal offence to obtain and offer a secret commission that has not been disclosed to the principal - in this case the superannuation fund trustee.

One such case is currently under investigation by the Commission.

To deal with this possible problem, trustees need to be vigilant and have in place strict internal controls governing the operation of the fund.

Money Laundering

Another potential type of superannuation crime is the laundering of money through superannuation funds. One way money laundering could occur would be through the establishment of ghost members with account balances of less than A$500. Since balances of less than A$500 are not required to be preserved, the balances can be paid out when those ghost members leave the fund.

A review of one fund was conducted after receiving allegations that this practice may be occurring. A complete membership check was carried out and cheques were vouched for all payments of less than A$500. No problems were found.

There are of course other ways in which money laundering could also occur. However, the ISC does not see investigation of the potential for a fund to be used for this purpose as a core part of its prudential supervisory activity. Investigatory powers are used to examine particular funds if there are indications of this, or other types of malpractice.

The Commission's Approach to Prudential Supervision of Superannuation

Preventing Superannuation Crime

The Superannuation Industry (Supervision) legislation has been operating for nearly two years. It imposes explicit obligations on superannuation fund trustees and some other players in the industry. Insofar as it is possible to legislate for prudent behaviour, SIS seeks to do so.

Full compliance with SIS will bring in to play each of the lines of defence against loss of member benefits, and so will help ensure that a fund is well run.

Role of Members – the First Line of Defence

An informed membership provides the most effective universal control over trustees. That is why SIS requires meaningful and timely annual reports to be provided to members and why we will continue to monitor their issue. Even while only a small minority of members take an active interest in their fund, this will improve as member balances become larger, and especially when compulsory member contributions come into effect. Already, some of our most valuable tip offs about problems in funds have come from member enquiries or complaints.

The Trustee Board

SIS places the responsibility for the prudent operation of superannuation funds firmly on trustees. At the same time it allows trustees to run funds in a commercial manner and the industry to operate competitively. Trustees have complete commercial freedom in setting investment strategies, within the boundaries imposed by their fiduciary obligations. Trustees decide on risk and return trade-offs to maximise members' benefits according to their circumstances.

SIS puts a number of checks and balances in place so that trustees do not depend solely on the regulator to keep their funds operating in a prudent manner.

SIS requires trustees to:

- be fully in control of the fund;
- act in the interests of the membership as a whole;
- formulate an appropriate investment strategy;
- communicate with members;
- keep adequate accounts and records and have those accounts audited annually; and
- lodge an annual return with the Commission.

SIS aims to decrease the risk of things going wrong and puts preventative measures in place. Trustees who operate their funds in line with SIS are going a long way to ensuring members' retirement benefits are safe.

Equal Representation

Under the SIS Act, members are in a better position than ever before to protect and control their own superannuation savings. Equal representation of members and employers on the boards of funds with at least five members provides some assurance that member interests will be properly considered in the trustees' decision-making processes.

Also, decisions can only be made if agreed by two-thirds of all trustees. This ensures that every decision of the trustee board must have support of at least some directors nominated by each of the employer-sponsors and the members.

SIS recognises the traditional power imbalance between employer and employee, and its potential impact when they are brought together as supposed equals on the board of trustees of a superannuation fund. The SIS Act specifically prohibits direction of trustees by a third party, and their victimisation. A person who intentionally or recklessly commits an act of victimisation against the trustee of an employer sponsored superannuation fund may be gaoled for two years in addition to being sued for damages by the victim. Because the concept of equal representation is so central to the checks and balances which SIS imposes on the operation of superannuation funds, the ISC is committed to vigorously pursuing any claim of victimisation by a trustee; we believe that this commitment would help redress the imbalance of power between an employer and employee. To date we have had no complaint of a trustee being victimised under SIS. There has been one incident of claimed victimisation dating from before SIS came into effect. Notwithstanding the lack of formal legislative authority to do so, senior ISC officers conducted a detailed investigation with the cooperation of the trustee board, the individual and the senior management of the employer sponsor. The matter was resolved to the satisfaction of the individual.

How is the ISC Educating Trustees?

The ISC is conscious that member representatives on trustee boards may feel daunted by their task, especially when they are inexpert in financial matters. That is why we place emphasis on trustee education as part of our prudential supervision. In particular, we seek to reassure trustees about the positive value of asking questions about the operation of the fund until they are satisfied with the response—even if their questions appear “dumb”.

The ISC also works with trustees to teach them about their responsibilities under SIS through a variety of trustee education activities. We have produced several booklets including *The Trustee Guidebook to Superannuation* and *A Guidebook for Small Superannuation Funds*, and have conducted several seminar programs. One such program is currently underway.

Fraud Detection Seminars

In September last year the Insurance and Superannuation Commission received funding from the Commonwealth Government’s Confiscated Assets Trust Fund to conduct a training program for trustees on the detection of superannuation fraud.

Eighteen seminars are now being presented in State capitals around Australia. The seminars are targeted at trustees of superannuation funds with five or more members. Trustees are briefed on fraud indicators, detection techniques, fraud control strategies and control checklists, supported by practical case studies.

Participants receive a free toolkit containing a *Best Practice Guide to the Detection of Superannuation Fraud* and a *Superannuation Fund Fraud Control Review Checklist* to help them establish and maintain appropriate fraud controls within their fund.

For public offer funds, there is no requirement for equal representation—though there may be “policy committees” established with equal representation of employer-sponsors and members to advise the trustee.

The safeguard equivalent to equal representation for public offer funds is the requirement that the trustee be approved by the ISC. These approved trustees must satisfy quite stringent conditions including a capital adequacy requirement. This is so the trustee has a sufficient level of resources available to rectify any reasonably conceivable problem with the fund.

External Auditors

The annual review of a fund’s financial condition by an approved auditor, together with a limited compliance review and the whistleblowing provisions of SIS, ensure regular independent scrutiny of every fund.

In every instance where a significant loss in a superannuation fund was found, the external auditor has appeared to be either negligent or complicitous. On the other hand, well informed and professional external auditors help educate trustees in their roles and add positive value for fund members.

ISC Review Program

The ISC's targeted review program provides scrutiny of a selection of funds across all sectors of the industry, particularly focussing on choosing funds which may represent a higher than average level of prudential risk.

Our review program concentrates on preventative measures. We encourage appropriate controls and good practice in order to minimise the risk of losses to members' benefits.

A few years ago, ISC reviews under the old Occupational Superannuation Standards Act were largely limited to compliance audits. The job of a Commission review officer has become particularly challenging under the SIS regime. It is no longer good enough to simply undertake an exhaustive, "matter of fact" check on whether the fund has complied with all the details of the SIS requirements. Prudential reviews necessarily involve making a number of value judgments about the fund. ISC review officers identify the medium to high risk areas of a fund's operation. It is determined whether policy and procedures, including relevant internal controls, are in place and operating to detect errors and deter fraud. There is a particular focus on whether trustees are aware of and complying with their obligations under SIS.

Because of the newness of the SIS legislation, funds are being reviewed that have elected to become regulated as recently as 1 July 1995. Many of the potential problems found are largely the result of funds coming to terms with the enhanced prudential requirements of the new regime.

Probably the most significant achievements in ISC direct supervision of superannuation funds are not visible to the public at large. Where potential weaknesses are discovered, the regulator often takes a low key approach and works with trustees in a cooperative manner to rectify them.

In these cases, no actual risk to member benefits has emerged and the ISC's formal powers under SIS have not been required. Yet the net effect is an improvement in the long-term security of the benefits of the members of that fund.

Detecting Superannuation Crime

For the ISC, the detection of superannuation crime is in large part a sub-set of the process of detecting broader problems in a superannuation fund. To this extent, the layers of defence which are important in preventing superannuation crime also provide a first line alert capacity when problems, including crime, have occurred.

The ISC's program of prudential review of superannuation funds is designed to detect weaknesses in funds, and help trustees rectify them. While ensuring that some funds from each segment of the industry are included in each year's review program, we seek to direct a higher proportion of ISC review resources to funds exhibiting characteristics associated with a higher potential for problems. These are identified from the annual returns lodged by funds as well as general industry intelligence. Examples of risk factors include rapid change in fund members or assets, or a lower level of per capita assets than would be expected given the nature of the fund.

As already mentioned, the ISC is a prudential supervisor. As such, fraud detection is not the principal role. Primary responsibility for fraud prevention and detection, and for risk management controls generally, rests with the fund trustee. Notwithstanding that, every fund review includes active examination for fraud indicators. If there is evidence that fraud may in fact be occurring, the relevant State police fraud squad is immediately contacted.

Members and trustees can and do contact the ISC when they perceive that there are problems in their fund. SIS gives the ISC broad ranging powers to monitor and investigate funds, though these are available only in relation to events which have occurred after the fund has elected to be regulated under the SIS regime. The newness of the Act therefore means that we can still be constrained at times in seeking information relevant to a possible crime. The breadth of our investigatory powers has been subject to review by the Federal Court when an individual declined to provide fund records, claiming legal professional privilege. Kiefel J upheld a very broad view of the ISC's information gathering powers (*Insurance and Superannuation Commissioner vs Robertson* (1995) 30ATR 239).

The ISC has ensured that its review staff are exposed to some training in investigative techniques. However, investigation with a view to enforcement action is definitely not the main function of review staff in general. The Commission has recruited a small core of staff with investigative experience, and supplements this as necessary with specialist contract staff.

Of course, crime in superannuation funds is also detected from time to time by other agencies, usually as a spin off from an investigation of other criminal activity on the part of a person who is incidentally associated with one or more superannuation funds. The ISC has assisted in such investigations in the past, and is eager to assist other enforcement agencies wherever possible.

While police may from time to time approach us for assistance, most police investigations of financial matters are taken independently of any regulatory agency, including the ISC. It would be of great benefit to us in our supervision of the industry if we could be informed about any superannuation related criminal investigations being conducted by police. This would enable us to ensure that the service provider or trustee is not involved with other funds in a way that puts them at risk.

Fighting Superannuation Crime

When we deal with enforcement, we are to a degree shutting the stable door after the horse has bolted. Of course there are valuable ongoing results from taking enforcement action; it helps retain public confidence in the effectiveness of supervision of the industry, and it may help remove undesirable players from operating in the industry.

If we find that a trustee may be intentionally or recklessly breaking the rules and placing members' interests at risk, we will not hesitate to respond vigorously and take enforcement action to protect members. Most commonly this will take the form of administrative sanctions rather than criminal or civil legal action. Suspending or removing trustees, imposing stop orders or appointing investigators are often more effective means of protecting members' interests than taking punitive action. Notwithstanding this, in the course of investigating funds where significant breaches of the law appear to have occurred, the ISC actively considers whether the public interest would be served by recommending criminal prosecution or civil legal action, and whether there is likely to be sufficient admissible evidence available to support a prosecution.

In view of the central role of external auditors in providing independent review of a fund's financial status, the ISC places particular weight on the way in which they fulfil that function. Where an auditor has failed to properly fulfil his or her duties as an auditor under SIS, or under other Commonwealth or State legislation, or is otherwise not a fit and proper person to be an approved auditor, the ISC has the power to disqualify the person from auditing superannuation funds, and/or to refer him or her to the relevant professional body for disciplinary action.

Continued Cooperation in the Fight Against Superannuation Crime

Whilst SIS gives the ISC the power to conduct an investigation and penalise trustees for specific offences, it also contains the power for an ISC inspector to report his findings to bodies outside the Commission: the National Crime Authority, Director of Public Prosecutions and relevant police forces, to name a few.

Because the Insurance and Superannuation Commission is the regulator of the superannuation industry, it follows that it has more contact with industry participants than has any other enforcement agency. So long as the ISC continues to be vigilant and alert to the prospect of crime associated with superannuation, it is the agency most likely to come across the first indications of such crime. The ISC has established links with the Australian Federal Police and State police fraud squads, the Director of Public

Prosecutions and the Australian Securities Commission, amongst others.

The ISC's track record to date demonstrates a willingness to pass information to other agencies with more appropriate powers in particular cases and to work with them in addressing those cases. That level of co-operation will continue into the future.

6

The View from a Big Fund

KEVIN CASEY

Wherever there are large amounts of money and large volumes of financial transactions, there is the possibility of dishonesty, misappropriation or fraud.

Currently, the Australian superannuation system has approximately A$240 billion in funds under management and this is expected to grow to A$2000 billion by the year 2020. It is difficult to comprehend the enormity of these figures, but to give some relativity to it, this represents about 10 times the current foreign debt.

The compulsory nature of superannuation, and the rules regarding preservation of funds until genuine retirement, provide for an increasing pool of investments which will not plateau until well into the 21st century (when the amounts being withdrawn due to retirements will match the income of the fund). Again, the compulsory nature of contributions drives the number of transactions which run into the tens of millions per annum.

The number of funds registered with the Insurance and Superannuation Commission has now topped 100 000. The vast majority of these funds are personally managed superannuation funds for working directors and so on. However, there are some five to ten thousand funds which invest for members ranging from the "mum and dad" type funds to very large industry and master trust funds with membership of more than 1 million members.

It is very difficult, if not impossible, for any regulator to adequately oversee that number of participants. Therefore, it is up to trustees, who are the custodians of the assets, to ensure that the investments and operations of the fund are secured from misappropriation or fraud.

How should a large fund approach this problem?

AMP Superannuation Limited (ASL) is trustee for 11 master trusts covering around 1.2 million members with assets under management of approximately A$11 billion. The largest of these funds has 300 000 members and assets of roughly A$4 billion. Cash flow is of the order of A$540 million per annum and the number of individual transactions is between 1 and 1.2 million.

These funds are overseen by the ISC and are subject to audit scrutiny by the ISC on a random basis. ASL, as an approved corporate trustee, is subject to control both by the ISC (as a trustee) and by the ASC (as a corporate entity). However, does this scrutiny provide adequate protection for members and the assets which the trustee is caretaking?

The answer is, of itself, no; but with internal controls, monitoring and audit, the potential for misappropriation of funds and for fraud is significantly reduced. It cannot be eliminated—but the legal framework is in place to bring to justice those who do step out of line.

What then are the safeguards for the members of large funds such as those for which ASL is trustee?

Regulatory Control

Currently, superannuation must be operated under a trustee structure for which the regulatory control is primarily the Superannuation Industry Supervision (SIS) Legislation. Trust law and criminal law apply in respect of misappropriation and fraud by trustees or their delegates.

The SIS legislation requires that any fund, which offers an interest in the trust to the public, must have a corporate trustee which is approved by the ISC. In approving such a trustee, the ISC requires capital adequacy (A$5 million or similar surety) and sets down conditions in respect of the approval, for example, adequate processing systems with disaster recovery/contingency plans.

ASL was approved as a public offer trustee in April 1994 and in August 1994 was subjected to an audit by the ISC which lasted for 4.5 months.

The audit covered such matters as:

- audit of two of the master trusts;
- computer and administrative systems;
- procedural documentation;
- internal controls and audit/monitoring procedure;
- structure of trustee company;
- record-keeping;
- knowledge and understanding of role and the law;
- investment strategies and mandates;
- administrative agreements.

The end product was confirmation of our approval but a recommendation on matters where ASL could implement improvements. The ISC is in the process of following up on these matters to ensure that ASL has taken the appropriate action.

The vast majority of public offer trustees have been subject to this form of audit (not as lengthy as the ASL audit—we were the first and processes have been refined) and a number of approved trustees have had their approval revoked.

These revocations have not been due to fraud or misappropriation of funds but have been due to either the inadequacy of the trustees' systems or the lack of competence to carry out the duties of a trustee in an acceptable manner. Additionally, each superannuation fund (regardless of size) must lodge an annual return which must be countersigned by the fund's auditors.

The auditor is responsible for auditing both the financial affairs statements of the trust and the ongoing compliance with the SIS operational standards. If any problems are detected, the auditor has a legal obligation to notify the ISC if no action is taken by the trustee. Thus funds are subject to at least an annual audit of the financial transactions and the processes which the trustee has in place for the ongoing investment and security of members' benefits.

Agreements with Delegates

Most trustees of large funds delegate the administration and investment activities of the fund to professional bodies. This delegation passes the day-to-day duties to the third party but in no manner passes the responsibility from the trustee to the delegate. The ISC requires such delegations to be formalised in a legal agreement and therefore is enforceable by law.

These agreements cover such matters as:

■ Administration Agreements:

- record-keeping requirements;
- cash receipting and disbursement requirements;
- interaction with investment managers;
- system requirements;
- service standards;
- reporting to trustee;
- termination conditions.

■ Investment Agreements:

- investment objectives, strategies and mandate;
- discretions of the investment manager, for example, operate within strategic ranges;
- reporting requirements for tax and trustee monitoring;
- trustee policy on derivatives;
- termination conditions.

Trustees must monitor the performance of the delegates to ensure that the trustee requirements and standards are being met. The monitoring of the performance of the delegates is an imperative aspect of the trustee responsibilities—it is not sufficient to say "XYZ is a reputable organisation which will do the right thing". Trustees need to test the performance. This can be via a number of mechanisms, including:

- obtain a comfort letter from the auditors of the delegate that the processes have been tested and that no substantive weaknesses exist;
- include in its own audit brief to the trust auditors testing of the functions delegated;
- direct audit of sample transactions by the trustee.

ASL employs all three mechanisms to test various aspects and to ensure continuous audit testing.

Complaints Handling

One area where the trustee can very quickly learn of problems or trends of unacceptable standards of its delegates (and its own retained functions) is to closely monitor complaints and contribution arrears.

If members complain regarding the late payment or lack of payment in contributions, this may be because of weaknesses in the systems adopted by the administrator. Also delays in the payment of members' benefits can demonstrate weaknesses. Such weaknesses may provide the opportunity for misappropriation and fraud.

Particular attention should be paid by trustees to the reconciliation process adopted for the receipt and disbursement of moneys. This applies equally to administrators and investment managers who must be scrutinised to ensure that effective procedures and controls are in place.

Conclusion

The trustees of large funds must recognise that they are the custodians of large amounts of money and that the volume of transactions provides greater opportunities for misappropriation or fraud.

The Australian superannuation system has been fortunate that little fraud or misappropriation of funds has taken place. With the increase in fund size and transactions the opportunity and temptation is growing. Therefore, the fact that we have been fortunate in the past cannot be taken as a comfort for the future. The key to the situation is to limit the opportunity and to ensure that the audit/monitoring process is constant and targeted.

Where delegates are appointed, the trustee remains responsible for their actions and it is the trustee that the members will come looking for. Be protected by instituting appropriate policies and ensure that the trustee and any delegates have appropriate insurance cover.

As trustees, we are charged with managing and protecting the members' benefits—therefore if any moneys go missing we should endeavour to ensure that the members' liability is minimised.

The Government has the power to assist members in the case of fraud by placing a levy on all superannuation funds. However, trustees should not rely on such a policy being implemented.

Nor can trustees rely solely on the regulator to oversee the welfare of the fund or the participants in the superannuation industry. We have to be alert to the potential, be responsible and vigilant in our efforts to detect problems and not be afraid to say to delegates "I need to be assured that all is being managed appropriately".

These steps will assist to provide a continuing clean sheet for Australian superannuation funds and to fulfil our obligations as trustees to protect the benefits of the members of our trusts.

7

The Auditor's View

ROBERT ANDERSON

This paper will discuss the auditor's role in the prevention and/or detection of superannuation crime under the following headings:

- What is an auditor?
- What does an auditor do?
- The audit focus on crime
- Level of security afforded by an audit
- Types of superannuation crime
- Conclusion

What is an Auditor?

An auditor is an independent person with the appropriate qualifications to express an opinion on the operations and accounts of the superannuation fund. Superannuation fund auditors comprise those people who are members of either the Australian Society of Accountants or the Institute of Chartered Accountants in Australia. They are usually in sole practice or in partnership. It is important that any auditor of a superannuation fund is, as well as being suitably qualified, suitably experienced.

What does an Auditor do?

An auditor has a duty to report to the members and the trustees on the annual accounts and whether those accounts are presented fairly in accordance with the relevant legislation.

The auditor will also report on certain aspects of compliance with the SIS legislation.

In order to achieve these two objectives the auditor must devise an audit plan and construct an audit program appropriate to the needs and nature of the client. This audit program will set out the various steps that the auditor needs to undertake on the books and records of the fund in order for the opinion to be expressed.

Typically an auditor will conduct a minimum of two visits per annum to carry out these audit steps. Depending on the nature and size of the client and the wishes of the trustees, a greater number of visits may occur. The first visit which is usually during the financial year under review is conducted to test the day to day records of the fund. This testing will include the sampling of transactions of the fund, tracing them to the relevant records and determining whether those transactions are in fact properly dealt with. In determining the sample size, the auditor must look at the risks associated with the level of internal control maintained within the fund. If the level of risk is high, that is, if there are insufficient checks and balances within the system to prevent or detect frauds occurring, then the auditor will decide to test a greater level of transactions. This will incur more time and thus cost to the fund.

Conversely, if the level of internal control risk is low, the auditor may conduct less substantive testing, that is, testing for monetary error. At the conclusion of this phase of the audit, should there be any serious weaknesses of internal control discovered by the auditor, these should be reported to the trustees to enable them to rectify that position for the future.

The second major visit by the auditor will typically occur when the year end accounts have been produced by the trustees and are ready for audit. The auditor will update the work that he/she has done on the transactions since the last visit to complete his confirmation of the day-to-day transactions. The auditor will then study the balance sheet and will verify all those material items contained therein. The auditor will look at matters such as custodianship of investments, ownership of investments and will call for independent confirmation of the existence and ownership. He/she will also look at other items on the balance sheet, for example, cash, and obtain bank confirmations and will examine bank reconciliations. On the liabilities side of the balance sheet the auditor will conduct audit tests on such items as benefits payable, creditors, and so on. The auditor will also, from his/her knowledge of the fund and from its operation, make enquiries as to whether there are any omissions from creditors.

During this time, naturally the auditor will pay close attention to the operating statement of the fund which discloses the financial results and conduct certain tests as required on those balances.

After having carried out all of these steps and expressing his opinion on the accounts, the auditor may inform the trustees in writing of any further service issues that may need to be addressed by them. An audit as required by the legislation, only requires the auditor to express an opinion on financial matters, and only in the context of materiality. Materiality is generally accepted as being somewhere between five and ten per cent of an account balance, or an account balance together with several other criteria. An audit does not give comfort as to the absolute accuracy of the accounts.

Audit Focus on Crime

As discussed previously, materiality is the key word in audit. If the accounts are not materially misstated then the auditor has no obligation to qualify his audit report. There may be instances where a theft or a fraud may have occurred in a superannuation fund and that theft or fraud was not picked up by the auditor. The auditor can only be held liable or responsible where a fraud has occurred and the financial statements have been materially distorted, and the audit report does not contain the appropriate qualification. The audit focus therefore is not directed primarily to the prevention, nor detection of superannuation crime. These aspects are of only secondary consideration.

Level of Security Afforded by an Audit

One has to look at the frequency of the visits by an auditor to appreciate that because an auditor is not continuously auditing the client on a day to day basis, a risk of a theft or fraud being perpetrated and not detected by the auditor in a timely manner is very high. The result of an audit, however, could very well help to reduce these risks by recommending to the trustees ways in which they could strengthen internal controls and design a system that would better detect crime in a timely manner.

So far, only compulsory audits of superannuation funds has been considered. Auditors can provide valuable services to the trustees and can to some extent become their watch dogs. A prudential review is one such service that all conscientious trustees should at least be contemplating. This prudential review would, amongst other things, require the auditor to examine and report on the system of internal control of the fund, that is, those checks and balances that are in place to prevent one person from defrauding the fund. The trustees should be mindful of the recommendations made by the auditors and act quickly to strengthen those internal controls where necessary.

At this point it is useful to pause for a moment and reflect on the difference in an audit of a corporation as opposed to that of a superannuation fund and comment on the vulnerability applicable to many funds.

A typical corporation in the manufacturing industry, for example, may have a turnover of say, A$30-A$40 million. It will have a sizeable accounting staff to manage the complexity of this business, maybe ten people. Due to the number of people, this company has the potential to achieve a reasonably high level of internal control. Should this company have an internally managed superannuation fund, it may have two or three people to handle similar sums. It is therefore patently obvious that the same level of internal control on a superannuation fund is difficult to achieve under these circumstances. Therefore an extra level of supervision is required and that is a higher degree of vigilance over the fund's operation by the trustees.

Types of Crime

From an auditor's viewpoint there are only two types of crime that are perpetrated on a superannuation fund. They are firstly, theft, that is, stealing of money without any attempt to cover it up and secondly, a fraud which is theft with an attempt to cover the traces so that discovery becomes more prolonged. The auditor would rarely be responsible for detecting straight out theft from the fund, due to the likelihood that such a crime would be detected fairly early through the fund's system of internal control and by the fund's officers. Thefts like this often occur, followed by the disappearance of the perpetrator. A theft can often be as simple as signing a cheque, having it paid into the perpetrator's bank account and both perpetrator and money disappearing, or waiting for an opportune time to disappear. An example of an internal control factor that would reduce this risk is to have two cheque signatories authorised to sign cheques. This control is only as good as the diligence of both cheque signatories in examining each transaction before they sign.

A fraud is where more sophisticated methods are employed by the thief in order to cover his tracks sufficiently for him to be able to enjoy the benefits of his ill gotten gains. These sorts of frauds could include the custodianship of certain assets, the pledging of those assets for private gain, and so on. These frauds are more difficult to detect and can be conducted over a long time scale. It is these frauds that can accumulate to large amounts.

Conclusion

The auditor does play a very important role in the detection of fraud, particularly concealed theft, as a by-product of the audit. The contribution to such detection only extends to those more material amounts. The auditor can additionally contribute to the detection by timely recommendations to the trustees on improving their system of internal control and by those systems being amended accordingly.

The Superannuation Industry Legislation (SIS) is very tight and is now a pacesetter for the rest of the world. This legislation has probably already minimised the incidence of fraud to date. In addition, the legislators have embarked on measures to further reduce crime or increase its detection. In particular, trustee education courses have been run over the period of the last two to three months to make trustees aware of their responsibilites in relation to their superannuation funds and their vulnerability to superannuation fraud. Trustees are our front line "Generals" in fighting the crime battle.

An emphasis must be placed on strong systems of internal control. The legislators, being the Insurance and Superannuation Commission are also focussing on the performance of superannuation fund auditors by conducting their own review of the work of the external auditors. This keeps us on our toes and is in the interests of the superannuation industry generally.

Whilst it is true that all of these legislative controls are in place and the supervision exercised by auditors, legislators and trustees are working, it is still possible that we will experience a significant fraud/theft in the future. We do not want another Maxwell. Constant vigilance is required by us all.

8

The Practitioner's View

ANDREW FAIRLEY

At the ASFA Conference in 1992, I presented a paper dealing with the opportunities for fraud in Australian superannuation funds. It followed the Maxwell disclosures in the UK and sought to identify the way in which frauds could be promulgated on Australian superannuation funds. Since that time a number of superannuation frauds have been implemented on unsuspecting members, and the practitioners have been left to pick up the pieces.

This conference is all about the way in which to deal with the fraud, and the relevant stakeholders who might commit that fraud. My role, as a superannuation lawyer, is to deal with the practical effect of frauds being perpetrated on superannuation funds, and the difficult, complex and often distressing results that arise both from a regulatory and human perspective.

For purposes of this discussion, the word "fraud" has a very broad canvas. The term "fraud" is defined in the Shorter Oxford Dictionary as criminal deception — the use of false representations to obtain an unjust advantage or to injure the rights or interests of others. A fraud can be committed knowingly, on the basis that the person misleads and deceives knowing the impact that this will have, or the fraud can arise in circumstances where a person is careless or reckless as to whether a particular action will mislead or deceive.

I have been involved in a number of frauds in this country which have been committed on superannuation funds and fund members, where my role has been to assist the trustee in dealing with the regulatory and financial implications of the losses. Three cases with which I have been integrally involved where monies have been lost, either as a result of fraud or incompetence bordering on recklessness are discussed in this paper.

The cases are as follows:

- Small fund losses from dishonest accountant;
- Legal Life Staff Superannuation Fund; and
- AS Nominees Ltd.

The Dishonest Accountant

Graham Jacobs was a chartered accountant practising in Melbourne for many years. He accumulated a range of quality clients over that time, and gained their trust.

When he suggested to them that they establish personal superannuation funds, a number of his clients installed his company, Salvarson Nominees Pty Ltd as the trustee. All transactions which were undertaken by the fund occurred through that entity, being controlled by him. It is a matter of public record that Graham Jacobs used over seven hundred thousand dollars of his clients funds for his own purposes, and he was charged and duly convicted of that offence. The monies that he stole from the superannuation funds was recovered as to approximately 10 cents in the dollar, thus leaving those funds with a significant shortfall.

However, the difficulty the funds had was not solely that they had lost their money. The problem was that they had also breached the provisions of the *Occupational Superannuation Standards Act* (OSSA), in that the trustee had not conducted the funds as complying superannuation funds.

Taxation Position

A fund receives concessional taxation treatment and the income is taxed at 15 per cent where it is conducted as a complying superannuation fund. Where, however, the trustee breaches the investment rules or other compliance requirements, the fund is classified as a non complying fund, and tax is payable at 47 per cent on its earnings.

In one of Graham Jacobs funds, the documentation was established on 26 June. A contribution of A$100 000 was made to the trustee of the fund on 28 June, and the money had disappeared by 30 June. It is unclear where the money actually went, but it has never been seen again.

The employer which made the contribution received a tax deduction, because that was available irrespective of the complying nature of the fund. The fund trustee did not deal with the assets of the fund in a manner which was consistent with the obligations of OSSA or the trust deed, and accordingly, as at 30 June, the auditor was unable to give an unqualified audit certificate. Accordingly, the fund was non complying for the year and tax of A$46 000 will be payable by the fund.

It did not become clear until a number of months later that the money was not in the fund, by which time further contributions had been made. Even after the fraud had been discovered, the clients elected to continue to use the fund for future contributions. The new fund trustee is now facing the circumstance of a tax assessment for A$46 000 in respect of monies which have been stolen, which it will be required to pay from assets in the fund subsequently acquired. Even if our application to the ISC is successful, and complying status for the first year is given, a A$15 000 liability will still arise.

Because much of the money stolen by Graham Jacobs came from superannuation funds, there are many such stories and experiences, given that the trustee of the funds was his company.

In addition to the additional tax payable, there has of course been many thousands of dollars applied, from other sources, in respect of professional advice as to how the regulatory and taxation problems are to be addressed.

Regal Life Staff Superannuation Fund

Regal Life and Occidental Life were the subject of a significant fraud in 1990. The facts of the case are well known and on the public record, with charges and convictions having been obtained in respect of the crime.

At the time at which the event occurred, the trustees of the Regal Life Australia Staff Superannuation Fund (the Fund) had the totality of their assets invested in a policy with Regal Life. The fund was a defined benefit fund, with over 100 members, many of whom had been with Regal Life, and its predecessor, Royal Life, for 20 to 30 years. These assets represented their life's superannuation savings.

Significant Disruption

After the dust had settled on the fraud perpetrated on the statutory funds of Regal Life, it became evident that, in a worst case scenario, the members of the Fund would only receive 50 per cent of their benefits under the defined benefit fund, with an employer that had no capacity to make up the balance of cost.

An additional complicating factor was that for the months leading up to the sale of Regal Life, negotiations had been taking place between the trustee and the employer to enhance member benefits in the fund, and to remit a significant surplus back to the employer as part of that benefit enhancement process. The members thus went from a position of believing that they had augmented benefits, to the terrifying realisation that they had lost half of their entitlements.

A Judicial Manager was appointed to Regal Life, and legislation was then introduced, being the Life Insurance Policy Holders Protection Levies Collection Act 1991, which guaranteed that the maximum loss to any policy holder of Regal Life would be 10 per cent , with a levy being imposed on the industry if that was necessary.

During a period of years, a minimal benefit was credited from the Fund on the benefits of former employees of Regal Life who were retrenched, and no enhanced benefits were paid.

As a result of successful actions for recovery of some of the assets of Regal Life, it ultimately became clear that the trustees of the Fund would make a full recovery of 100 per cent of the member benefits, but by that time, it was too late for any augmented benefits to be paid to members who had departed. The trustees had determined, in view of the ongoing difficulties, to terminate the fund.

Continuing Litigation

Having made a full recovery of fund assets, but not earnings during the period in dispute, the trustees were in the ironic situation of having a A$1.8 million surplus, which they held on behalf of the remaining members of the fund, being 17 people. Under the terms of their trust deed, the trustees were then not in a position to be able to distribute those funds to any of the former members.

The matter continues to be litigated, having been in the Federal Court now on two separate occasions, and the Superannuation Complaints Tribunal. The matter is again listed for hearing in the Federal Court for resolution.

However, the Regal Life case highlights both the grief that is associated with significant superannuation loss, and the need to approach the unwinding of arrangements affected by fraud with flexibility, understanding, patience and common sense.

AS Nominees Ltd

Mr Justice Finn gave a judgment in a matter involving AS Nominees Ltd (ASN), and other companies in November 1995, upon the application of the ISC and the ASC for the company to be wound up. At this stage, no fraud has been proven, although allegations have been made. What His Honour found in relation to the matter was breathtaking neglect of fundamental trust principles, and a complete failure by the company to meet its fiduciary duties and to meet the necessary standards of care in the management of trust funds.

ASN acted as trustee of a number of client superannuation funds. Another respondent in the matter, Ample Funds Ltd (Ample) was a trustee of a number of unit trusts.

ASN marketed to the public through a series of intermediaries, and did not advertise in its own right. Members of the public who became investors would execute their own superannuation fund trust deed with ASN as trustee, with contributions being made to the plan and invested by ASN either at the direction of the individual, or in one of the pooled superannuation funds which had been established by Ample.

In his judgment, Mr Justice Finn was scathing of ASN and its management. He made the following comments:

> *There has been misconduct and mismanagement in the conduct of trust business in such degree as to make it unacceptable for these three companies to solicit, hold, manage and deal with investors money on a fiduciary manner. Investors .... have been misled. Their funds have on occasion been hazarded—and lost—in reckless or improvident ways .... trustee decision making has often been partial and tainted with conflicts of interest* ([1995] 13 ACLC 1596).

His Honour went on to state that whilst wanting to provide the greatest protection to the beneficiaries possible in the circumstances, regardless of any order he made, further legal proceedings by or against the companies is to be expected.

In this paper, I will not visit the issues discussed in that case. Rather, I will review the position from the perspective of some of the superannuation funds which had ASN as the trustee, because their future is far from certain. There remains a long and tortuous process of recovery.

Substantial Losses

IFS Fairley acts for a number of the small funds which invested through financial intermediaries in ASN and its associated companies. Substantial losses have occurred as a result of the accounting and investment practices adopted involving entities associated with ASN. This has occurred primarily through the use of their in house pooled investment trusts.

Two (2) cases will suffice:

- Case 1: of fund assets totalling approximately A$296 000 an amount in excess of A$195 000 has been lost;
- Case 2: a fund with total assets of A$139 000 an amount in excess of A$117 000 has been lost.

In respect of each fund the sole member/beneficiary, was self employed and in their late forties. They have had modest retirement plans almost totally destroyed, and this occurred under a regime administered by the Insurance and Superannuation Commission.

Need for New Trustee

Following representations by solicitors acting for client superannuation funds of ASN, and with the assistance of the Court, the ISC appointed an Acting Trustee as the trustee of the regulated superannuation funds previously under the trusteeship of ASN. This took place pursuant to the provisions of SIS.

The assistance of the Court was required because the powers of the ISC did not extend to non regulated superannuation funds or other trusts established by ASN. When making its decision, the Commissioner exercised its powers under Section 135 of SIS and determined the terms and conditions of the appointment of the Acting Trustee.

The primary function of the Acting Trustee is to implement a program for the recovery of assets and identification of losses arising from the ASN trusteeship.

From the perspective of superannuation funds controlled by ASN, the ISC's action is welcome but it must be remembered that member beneficiaries endured a waiting period of in excess of 6 months from the appointment of a Liquidator by the Court in November 1995 to the appointment of an Acting Trustee and the adoption of a program for recovery in May 1996.

Implementation of the recovery program is no doubt in the best interests of the client superannuation funds, but completion of the tasks required of the Acting Trustee will be complex and time consuming and will only add to the grief and uncertainty already experienced.

Recovery Program

The completion of the recovery program is likely to be a complex task. ASN was the trustee of a number of trusts, not just superannuation funds and inevitably there will be a divergence of interests between beneficiaries of those trusts.

Without seeking to describe the program in detail the following features are highlighted in order to demonstrate the complexity of the process.

Separation of Assets

The Acting Trustee is required to identify that property held on trust by ASN as at 17 November 1995 and separate that property from all monies received by ASN after 17 November 1995. Whilst simple to describe, the process will be difficult because of the number of trust funds and unit trusts within the ASN group.

Where a client superannuation fund has no further interest in property “quarantined” as at 17 November 1995, the Acting Trustee is required to appoint a new trustee to that fund, chosen by a process of consultation with the member/employer participants of the fund. Where quarantined property is involved and this involves the majority of funds, the opportunity for the early appointment of a new trustee will not arise.

Recovery Action

The viability of legal action on behalf of member beneficiaries of client superannuation funds must be assessed and determined. In addition, the Acting Trustee must determine whether or not to support legal action which may be brought by the Liquidator against the directors of ASN or associated companies or third parties.

Determining Entitlement to Assets

With respect to property held on trust by ASN for superannuation funds as at 17 November 1995, the Acting Trustee is required to determine a method by which the entitlements of the client superannuation funds to the quarantined property is to be ascertained. The preferred method must be approved by the Court.

This in itself will be a complex and difficult task involving the use of "tracing" techniques where assets have been purchased from a pooled money source. There will be instances where such "tracing methods" will be inappropriate.

Disputes – The Consultative Committee

The Acting Trustee is to establish a consultative committee comprising the Liquidator, an officer of the ISC and one person representing the interests of distinct classes of client superannuation funds identified by the Acting Trustee. The purpose of the committee is to make recommendations to the Acting Trustee with respect to the management of quarantined property.

As comprehensive as the recovery program tries to be, particularly for the purpose of recovering losses arising from the investments sustained by ASN, it does not take into account the interests of investors in various unit trusts who are outside the reach of the ISC's regulatory powers.

Given that the total amount of the assets under management exceeded A$45 million, and if the experience derived from Regal Life is any guide, there is the potential for significant and complex litigation occurring which will significantly prolong finalisation of the distribution of assets of these funds.

Substantial Disruption

For the member beneficiaries of small superannuation funds caught up in the liquidation of ASN and its associated companies, the damage done cannot be measured solely in financial terms. In addition to the substantial legal, accounting and administrative costs incurred in recovering the losses sustained by these funds, the loss of control over assets comprising the superannuation fund has also been a body blow to the retirement plans of many member beneficiaries.

It will be essential for all participants in the recovery program to approach their tasks with flexibility, understanding and commonsense so as to facilitate the circumstances of those so seriously effected.

Conclusion

Where a fraud is perpetrated on a superannuation fund, nobody wins except the people picking over the rubble, and there is plenty of that.

Our role as participants in this industry is to ensure that we do everything possible to preserve the integrity of the system, and to improve the processes so that atrocities cannot be committed. At the end of the day, they are paid for by the members, and they are the ones who can least afford it.