Reforms to Superannuation Governance

14 October 2015

AIST Submission –
Senate Economics Legislation Committee

Reforms to superannuation governance

AIST

The Australian Institute of Superannuation Trustees (AIST) is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the $650 billion not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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1 Executive summary

AIST does not support the proposed governance changes in the Superannuation Legislation Amendment (Superannuation Governance) Bill 2015.

Flexibility needed not quotas: As the idea of imposing a quota of independent directors on superannuation funds has developed in recent years, AIST has been an active contributor to the debate and has maintained its support for the equal representation model. However, AIST has also recognised the limitations in the Superannuation Industry (Supervision) Act 1993 which allows equal representation fund boards to only appoint one independent director to their board in addition to the representative directors. Recognising the autonomy of superannuation fund entities, and their right to make decisions in the best interests of their members, AIST has recommended changes to the SIS Act to allow equal representation boards to appoint up to one-third independent directors to their boards, thereby allowing them to retain equal representation across the remaining two-thirds.

The proposed changes however, abolish the legislative basis for equal representation on superannuation fund boards and disrupt the governance structures of the sector that has consistently outperformed, providing the highest returns for members. Representation of members and employers on super fund boards ensures a balance in decision-making, and a true understanding of the membership base. This continued focus on understanding and knowing the membership base has meant that the not-for-profit superannuation funds have been at the forefront of implementing MySuper, delivering better performing, lower fee outcomes for members while for-profit funds have only slowly transitioned to MySuper, and continue to overall underperform the not-for-profit sector.

International recognition of equal representation: The majority of top performing pension funds in the world (including those in Australia's APRA-regulated superannuation industry) have an equal representation model, or at a minimum, have a degree of member representation on the board. This is evident from the strong correlation between the Mercer Melbourne Global Pension Index 'integrity' scores for individual countries and pension governance structures in which equal - or member - representation is prevalent. Of the ten countries rated highest for pension governance in the 2014 Melbourne Mercer Global Pension Index, seven countries have pension funds with an equal representation governance model. The international shift away from defined benefit funds towards defined contribution systems has added weight to the view that member representation at board level is vital, since it is the member who ultimately bears the risk of poor investment performance. Significantly, even in countries where there are independent directors on pension fund boards, member representation – in particular - is highly valued and is commonly a legislative requirement.

Real conflicts ignored: While there have been recent and numerous financial planning scandals involving the bank parent companies of for-profit superannuation funds, there have been no prudential failures or losses suffered by members of not for profit superannuation funds. Yet the proposed governance changes will have a bigger impact on equal representation boards than the for-profit retail sector.

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Reforms to superannuation governance

Profits-to-members super funds have a unique culture where the direct alignment of members and employer representative directors ensures a continuous commitment to the best interests of members.

The proposed changes do nothing to address the real and demonstrated conflicts associated with board structures and the vertical integrated commercial model in the retail superannuation sector. It will still be possible for the staff of a bank to form the majority of the bank superannuation fund board, where those directors responsible for maximising profits for the bank's shareholders are required to also act in the best interests of super fund members. This is an almost impossible conflict.

Regulator already has the power to act: AIST disputes the need for change in light of the existing prudential framework and the powers available to the regulators to rectify or address any issues that arise. In a recent advice received from Hall & Wilcox Lawyers, AIST was advised that "it is difficult to identify existing gaps or areas where APRA does not already have significant powers to step in if it identifies an issue of concern." This includes APRA having the power to address any concerns it may have with current trustee director skill levels including the power to remove directors.

Disruption comes at a cost: AIST is concerned at the level of board disruption that is proposed within a short timeframe and cautions against such significant changes being implemented in haste. The impact on decision-making and boardroom culture poses a risk to the best interest of members. Coupled with the proposed removal of the two-thirds voting rule, AIST believes that good governance practices will be diminished as a result, with members bearing the cost.

AIST submits that the proposed changes will impose significant costs (both through implementation and ongoing higher director fees) and introduce risks to the industry for no good reason. The changes also take Australia in the opposite direction to the rest of the world by removing guaranteed member representation from boards of occupational-based retirement savings funds.

There will be unintended consequences to these proposals, as well as a range of unreasonable risks that will naturally flow.

Key positions: AIST submits the below key positions in relation to the changes proposed:

- The single governance model proposed to sit across all regulated superannuation funds is not fit-for-purpose as it dismantles the successful equal representation model.
- The equal representation governance model should be retained, with flexibility for up to one-third independent directors in a principles-based framework of good governance. AIST opposes the abolition of the equal representation system outlined in the Bill.
- Both a member and an employer voice in a mandatory savings system are vital and this arrangement should be preserved in all sectors of the APRA-regulated superannuation industry. The representative model ensures a deep knowledge of the membership, representation of their

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respective interests in a mandatory retirement savings system, and a balancing of considerations in the pursuit of the best possible outcomes for members.

- The choice of Chair should be a decision for the superannuation fund board, and should not be subject to legislative intervention. The Chair should be the best person for the role.
- The proposed one-size-fits-all definition for not-for-profit and retail for-profit sector funds is unworkable. AIST supports a principles-based approach for any new governance-related definition, with inherent flexibility and adaptability for the specific differences that exist in the two sectors.
- There should be no power for APRA to make determinations on a person's independence; only the capacity to give guidance, such as exists in CPS 510.
- The transition period for implementing the proposed changes is inadequate and inherently dangerous to the stability of the financial sector and the operation of each super fund.
- The proposed majority independent director reporting requirement should be abandoned. Funds should not be required to report against a benchmark that is not a legal obligation as this will only confuse members.
- The two-thirds voting rule for board decision-making should be maintained.

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2 Introduction

The equal representation model of governance has been the cornerstone of member representation and accountability in the superannuation industry for decades. AIST continues to defend this model of governance that has served the best interests of members well, consistently providing the best returns in the industry.

The equal representation governance model withstood the pressures of decision-making during the global financial crisis, providing the Australian economy the strength to weather the consequences of financial collapses around the world. Aside from better performance, the equal representation model has also provided better accountability to members as a result of the direct alignment of interests of member and employer representation on the board.

Far from a governance system peculiar to Australian super funds, the representative trustee system is prevalent in many overseas occupational pension funds, providing an important accountability mechanism to members. OECD data in 2008[1] found that at least half of the funds examined appoint directors using the representative trustee system.

The 2014 Melbourne Mercer Global Pension Index rates 25 countries on the adequacy, sustainability and integrity of their pension fund system. In 2014, Australian ranked second in the world. Comparing the other high performing pension systems on that list however, AIST found that:

- The top six of all featured an equal representation system of governance;
- seven out of the top ten adopted a governance model with mandated member representation on the board; and
- Countries with member representation on their board performed much better on the 'integrity' indicators with an average score out of 100 of 76 v. 63 for those without member representation requirements.

Equal representation is, however, not the only governance model in the superannuation system. The sectors in the industry are distinctly different and a one-size-fits-all approach to changing the governance arrangements of regulated super funds fails to recognise these differences. Accordingly, the proposed changes do not meet their objective.

2.1 Evidence-based reform

In a listed company context, independent directors are there to protect minority shareholders and to ensure independence from management. In the not-for-profit superannuation sector these protections are

[1] Stewart, F. and Yermo, Y. (2008). Working Paper on Pension Fund Governance, Challenges and Potential Solutions, Organisation for Economic Co-operation and Development. Available at: http://www.oecd.org/finance/private-pensions/41013956.pdf

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neither relevant nor necessary - minority shareholders don't exist and superannuation funds are required by law to act in the best interests of all beneficiaries. A trustee is not a listed company in function or in form, and these changes fail to recognise that fundamental difference.

Consultation on board composition and the introduction of a quota of independent directors onto superannuation fund boards has been ongoing for a number of years (including the Cooper Review of 2010, the Assistant Treasurer's Discussion Paper released in November 2013 and the recent Financial System Inquiry), and to date no evidence has been presented that:

- The current representative trustee model of governance is broken;
- The proposed model will improve member outcomes;
- The proposed model will not result in less favourable member outcomes;
- Explains why a mandated number of independents must be applied to equal representation models of governance when the concept of independents – and therefore the need for them - arose where structural conflicts exist in companies acting as trustees of for-profit 'retail' superannuation funds. These structural conflicts – which exist between the duties of executives as directors and their duties to the shareholders to maximise profit - simply do not exist in not-for-profit superannuation funds.

Superannuation funds are highly regulated and the prudential regulator, APRA, has a significant suite of powers currently at its disposal. Governance matters in the regulated superannuation industry can be dealt with under existing legislation and prudential standards, including the power to remove a trustee. The legal obligations imposed on individual trustee directors were heightened in the Stronger Super reforms, and all-in-all this has seen the Australian superannuation system's governance star rise even further at a global level.[2]

The lack of evidence to support governance changes highlights a significant flaw in this proposed reform process. Regulated superannuation funds are a major contributor to the Australian economy, with the not-for-profit superannuation sector representing more than $650 billion in funds under management. While good governance practices should be encouraged and pursued at all times, AIST submits that mandatory changes to board composition will mean significant changes to the culture of these large financial institutions and disruption to fund activities, without any evidence of the need for such reform, or an articulated benefit to the members. These changes will also come at a substantial cost (both through implementation and ongoing higher director fees) - to be borne by the members.

AIST supports a principles-based regulatory framework for superannuation fund governance where the law allows superannuation funds to make decisions in the best interests of their members, taking into

[2] Australian Centre for Financial Studies and Mercer, (2014) *Melbourne Mercer Global Pension Index*, Melbourne. Available at: http://www.globalpensionindex.com/

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consideration the unique nature of their fund's size, business mix and complexity of their operations. AIST supports a framework that preserves accountability to members, a voice for both members and employers and a board of trustee directors drawn from a wide pool of appropriately skilled individuals with no material conflicts of interest or duty.

Professor Donald C Clarke notes that:

> "Despite the surprisingly shaky support in empirical research for the value of independent directors, their desirability seems to be taken for granted in policy-making circles. … Independent directors have long been viewed as a solution to many corporate governance problems. Well before the Enron and WorldCom scandals, the New York Stock Exchange already required the presence of independent directors on audit committees, and in the United States, insider-dominated boards have been rare for years. … Some studies have even found a negative correlation between board independence and corporate performance." [3]

AIST does not dispute that independent directors can add value to a board, however the significance of their contribution depends on the individual needs of that board and an alignment with the skills and competencies of the independent director. A structural reorganisation of boards by the legislature to require a number of independent directors on equal representation boards, without the context of individual board needs, will not bring about the desired results. On a retail for-profit fund board, independence from management and the profit-driven parent company are vital. These considerations, however, are not present in not-for-profit super fund structures. AIST submits that in an equal representation context it is not the perceived higher state of independence of a director that adds value, but rather how their skills and values' alignment adds to the collective competency of the board.

Corporate scandals and failures in Australia have arisen as a result of structural and systemic conflicts of interest within for-profit structures, where – as was the case with Enron and the WorldCom scandals - the inclusion of independent directors on boards failed to prevent these crises. The demise of OneTel, for example, resulted from poor corporate governance practices, in particular a situation where the independent directors failed to exercise adequate monitoring and oversight of management, as a result of the strong executive representation on the OneTel board.[4] Having independent directors on boards does not in-and-of-itself ensure that such poor practices are avoided. AIST argues that goes to the culture of the board and the ethics of individual directors, regardless of any 'independent' classification.

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[3] Clarke, P. (2007). *Three Concepts of the Independent Director*. [online] George Washington University Law School. Available at: http://tinyurl.com/pfy5gfk [Accessed 16 Jul. 2015].

[4] Monem, Reza (2009), The OneTel Collpase: Lessons for Corporate Governance, Griffith University. Available at: http://www98.griffith.edu.au/dspace/bitstream/handle/10072/42673/74746_1.pdf

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Reforms to superannuation governance

The not-for-profit superannuation sector, with its equal representation governance model, has performed consistently well for members, and consistently outperformed the retail superannuation sector. This remains the case even after the introduction of My Super, and the Financial Services Council's requirement for majority independent directors on their member boards. There is no objective reason for board composition requirements to be imposed on not-for-profit superannuation funds.

APRA's latest Quarterly Superannuation Performance report (20 August 2015) again highlighted the not-for-profit sector's outperformance of its competitors. Over the last 12 months to June 2105, industry super funds outperformed the bank-owned retail funds by an average of two per cent. SuperRatings' data to 30 June 2015 mirrors this. On a rolling 10-year basis the outperformance is a materially significant 1.94 per cent[5] , amounting to many thousands of dollars extra in retirement savings for not-for-profit members. This trend has persisted since the introduction of compulsory superannuation.

The Financial System Inquiry report to Government earlier this year suggested that there was evidence that independent directors could deliver an additional 1% in returns. There is, however, evidence to the contrary as well, so this is not a well-settled argument.

Retail super fund boards, through professional standards imposed by their professional association, are required to have a majority of independent directors. This is because the vertically-integrated model of the retail sector results in directors being drawn from the management within the corporate group. Such directors have far more actual conflicts of interests than directors in the not-for-profit super sector. Many directors of retail funds have historically been managers of the profit-making entity, such as the bank or insurer, and they have a conflict of duty between their responsibilities to the shareholders of the bank, and the members of the super fund entity. Since the new professional standard requiring majority of independent directors in retail funds was introduced in 2013 there has been no demonstrable improvement in their financial performance for super fund members.

With not-for-profit funds consistently outperforming their competitors, and no evidence that the mooted 1% of additional returns that the FSI report refers to being transferable to the superannuation trust fund structure, AIST submits that there is no cause for making the suggested governance changes on the basis of that assertion.

Research conducted by APRA in 2008 also highlighted that the time commitment of the trustee directors of not-for-profit funds far outweighed that of directors on retail fund boards (1,364 director hours compared with 559 director hours for retail funds).[6] There is no evidence to suggest that there is a flawed culture, lack of commitment, or poor performance by representative directors.

[5] SuperRatings' Fund Crediting Rate Survey to June 30, 2015.

[6] APRA Insight (2008), Issue 1, page 8.

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Current Prudential Standards provide a robust framework for the regulator to supervise, monitor and require funds to adopt the necessary systems and behaviours that meet the best practice governance obligations set out by APRA. The Fit and Proper Standard (SPS 520), together with the Conflicts of Interest Standard (SPS 521), and the requirement for adequate resources clearly set out what is expected of industry. Importantly, it also gives the regulator the ability to deal with any concerns it may have, even allowing it to make adjustments or exclusions under the standards that are particular to an individual RSE licensee.

The Prudential Standards regime has been in place for only two years. New regulatory frameworks need to be allowed sufficient time to become a part of business as usual. So while we submit that APRA has sufficient powers in its existing framework to deal with governance-related issues, both the regulator and the industry need to adjust to the new normal. More supervisory direction will no doubt be forthcoming as APRA continues to move away from its facilitative approach to the Prudential Standards' implementation.

Accordingly, AIST believes that a robust principles-based framework for high governance standards is already in place. Moreover, there is no evidence to suggest that the existing framework could not be utilised by the regulator to address any of the issues outlined in a new Part 9 of the Superannuation Industry (Supervision) Act 1993 (SIS Act) or that the regulator itself needs additional powers, as proposed, to deal with such issues.

AIST submits that the current equal representation governance model satisfies good governance practices. AIST opposes the proposed abolition of the equal representation system of governance outlined in the Bill.

2.2 Broader pool of experience and expertise already exists

Equal representation boards are drawn from a broad pool of talent. Through the nominating bodies, and in many cases elections, equal representation boards recruit directors from multiple stakeholder sources, naturally broadening the pool of candidates. The diversity this creates on boards has been central to the success of the not-for-profit superannuation sector.

Unlike many of the directors in corporate Australia, not-for-profit directors are not cut from the same cloth. AIST's membership data reveals that of a pool of nearly 600 trustee directors, nearly 100 employee, union and employer groups are involved in nominating or electing directors. In addition, to the many different unions that nominate directors, employer-nominated directors come from a variety of sponsoring organisations including State and Federal Governments and religious institutions. While nominating bodies do in fact nominate individuals for Board positions, those individuals are not necessarily officers or employees of those bodies, and come from a variety of different walks of life.

Not-for-profit funds, with their representative trustee governance structure, have also led the way in gender diversity on boards. Twenty-two per cent of AIST's member fund boards are made up of female directors, with the majority of these appointed by employee representative organisations.

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In considering governance in financial institutions post-Global Financial Crisis, the European Commission in 2010 said: "Empirical evidence highlights the benefits of diversity for corporate governance both in terms of efficiency and better monitoring. Diversity, not just of gender but also of race and social background, and the presence of employee representatives, broadens the debate within boards and helps, as some say to avoid the danger of narrow group think."[7]

AIST supports diversity on boards and believes that the representative trustee system delivers a broad range of backgrounds and skills to the board table. A system that necessarily reduces the diversity of the talent pool diminishes the quality of board discussion and ultimately decision-making, and should be resisted.

2.3 Director skills and training

The independent director debate has in the past centred on director skills and competencies. This discussion is absent from the current reform package presented for consultation, however it is important that this be addressed here.

It is the collective skills, knowledge and expertise of the trustee directors that make a highly functioning and effective board. Diversity of skills, knowledge and expertise, as well as background and life experience are therefore important in challenging the development of 'group think' and provides for better decision-making and outcomes.

It is an APRA requirement that trustee directors have knowledge of the industry they are operating in. Any new independent trustee directors will therefore require appropriate training in superannuation, as expertise in one area (e.g. investments) will not provide the director with sufficient understanding of the superannuation industry as a whole.

Appropriate skill and knowledge requirements already exist in APRA's Fit and Proper Standard (SPS 520). Appropriate education or technical knowledge, and the knowledge and skills relevant to the duties and responsibilities of an RSE licensee are required. The regulator can use the powers it currently has to address any concern with current trustee director skill levels, and the management of director skills and ongoing professional development is a key focus of all super funds. The need for complementary skills on the board is sufficiently addressed within the current regulatory framework and the introduction of more independent directors does not in-and-of-itself strengthen existing requirements.

[7] European Commission, (2010). Commission Staff Working Document, Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices. Accompanying document to the GREEN PAPER Corporate governance in financial institutions and remuneration policies. [online] Brussels: European Commission. Available at: http://tinyurl.com/awmq2xn

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2.4 Independents and other directors with conflicting interests

According to the Explanatory Memorandum, the proposed changes to superannuation governance 'allow for an increased accountability of decisions made by other directors who may have conflicting interests'. This principle stems from corporate boards where the independence sought is primarily from the executives of the company who – as outlined above - might act in their own interests and not those of the shareholders. Yet on not-for-profit superannuation fund boards all of the directors are independent of the management.

Each director, and class of directors (representative and independent), on the board has the same fiduciary responsibilities, and the same obligations to act in the best interests of members above any other interest or duty they may have. While directors may be appointed by particular nominating bodies and referred to in Part 9 as 'employer representatives' and 'member representatives', all are required to set aside the interests of their nominating bodies when serving on the board. The 'conflicts covenants' in sections 52 and 52A of the SIS Act reinforce that position.

AIST is not opposed to independent directors, and recognises the valuable contribution many such independents make on super fund boards. However, the governance of a super fund - an organisation established within a trust structure- has high levels of fiduciary accountability attached, as well as a structure which prohibits the use of trust assets for the personal benefit of the trustee. A trust preserves the assets for the use of beneficiaries, and in the case of super funds, is also highly regulated.

In a not-for-profit context, the directors of the super fund are not required to produce a profit for shareholders and cannot procure the sale of the fund to make a profit for themselves or someone else. There is no economic advantage to be had that creates the kind of conflict that could materially influence decision-making contrary to the best interests of members. Director fees are paid to directors on most super fund boards; however the amount of this remuneration is immaterial and does not create a conflict warranting the need for independent directors.

On retail fund boards, with super funds being a related entity of a parent bank or insurance company that has profit-seeking shareholders, pecuniary conflicts are more apparent. Meeting the obligations to serve the best interests of members is sometimes incompatible with the obligation to maximise profits for shareholders in the parent company. In a paper commissioned by AIST in 2009 on superannuation fund governance, Dr Mike Rafferty and others[8] noted that no person can serve two masters. In terms of the fiduciary duty concept, an agent should not have more than one principal.

[8] Dick Bryan, Gillian Considine, Roger Ham and Mike Rafferty, (2009). Agents with Too Many Principles? An analysis of Occupational Super Fund Governance in Australia. Workplace Centre, University of Sydney

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Reforms to superannuation governance

APRA's 2010 report[9] into related-party transactions in the superannuation industry highlights the fact that retail funds have significant financial conflicts at play in their related party transactions, and that these conflicts have resulted in significant additional costs to the super fund members. In the case of administration fees, for example, APRA revealed that the fees paid by members of some retail funds were more than twice that of not-for-profit funds.

More recently, an investigative report by Fairfax journalist Michael West revealed how super customers of bank-owned super funds were being "short-changed" because the trustees were settling for lower returns by investing only with parent banks, "rather than seeking the best returns in the market".[10]

It is these conflicts in the retail sector that the introduction of independent directors seeks to address. It is these considerations that should be central to what is meant by 'independence' – overcoming the impact of relationships and associations that due to the potential personal benefit to the director, could influence their decision-making in a way that does not prioritise the best interests of members.

Queens University Belfast academic, Sally Wheeler, in discussing the corporate governance failures of HIH, Enron and Northern Rock said:

> *History tells us that independence neither guarantees good financial performance nor freedom from scandal … Structural rules around independence fails on all counts … The injection of new blood is forced. … Policies that assume that structural independence is a panacea capable of addressing failures in group decision making are simply a recipe for disappointment.*[11]

[9] Liu, K. and Arnold, B. R. (2010) 'Australian superannuation outsourcing: fees, related parties and concentrated markets', Australian Prudential Regulation Authority Working Paper.

[10] West, M. (2013) 'Short-changed on super cash', *The Sydney Morning Herald,* (Online), 20 December 2013. Available at: http://www.smh.com.au/national/shortchanged-on-super-cash-20131219-2zo5f.html [Accessed 13 Oct. 2015]

[11] Wheeler, P. (2013). *Do we really need 'independent' directors on super boards?*. [online] UNSW. Available at: http://tinyurl.com/or7t7ap [Accessed 16 Jul. 2015].

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3 Government proposals

Despite our opposition to the changes for the reasons outlined above, we respond to the proposals set out in the Bill below.

3.1 Removal of equal representation from the SIS Act reduces the voice of both members and employers

The proposed repeal of Part 9 of the SIS Act, and other related amendments, will remove legislative recognition of the equal representation governance model. Currently, Part 9 sets out the rules for the representation of employers and members on standard employer-sponsored superannuation fund boards.

We oppose the removal of equal representation from the legislation and consequently the guaranteed voice of the members through their representation on the board, or alternatively on a policy committee. Similarly, the removal of equal representation eliminates the guaranteed voice to employers. This is especially significant in the case of defined benefit funds where the employers take the investment risks on behalf of the members.

There are three distinct sectors in the superannuation industry and AIST supports maintaining equal representation as a valid and successful governance model in the industry. Inside the APRA-regulated superannuation fund industry both retail and not-for-profit funds thrive despite their different governance and ownership structures. A third sector, being the self-managed sector is also allowed to thrive, yet it sits outside of prudential regulation requirements, and avoids scrutiny on board composition and director competency.

The repeal of Part 9 of the SIS Act seeks to allow for new governance rules to be applied across the regulated superannuation industry. It seeks to bring into alignment the board composition requirements for not-for-profit superannuation funds that are currently operating under an equal representation governance model, and retail superannuation funds, that generally utilise an independent trustee. In doing so, however, it has removed the guaranteed voice of the members and of the employers – in removing equal representation for not-for-profit funds, and policy committees for non-equal representation funds.

AIST submits that both a member and an employer voice in a mandatory savings system are vital and that it should be preserved in all sectors of the APRA-regulated superannuation industry. The representative model ensures a deep knowledge of the membership, representation of their respective interests in a mandatory system, and proper consideration of all relevant issues in the pursuit of the best possible outcomes for members.

The Explanatory Memorandum states that the proposals seek 'to promote good governance by broadening each board's pool of experience and expertise' as well as 'allow for an increased accountability of decisions made by other directors who may have conflicting interests' (page 2). Both these principles are valid and

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important governance objectives and are supported by AIST. However, we disagree that the proposed reforms will achieve those aims.

The proposed changes do nothing to address the real and demonstrated conflicts associated with board structures in the retail superannuation sector where it will still be possible for the staff of a bank to form the majority of the bank superannuation fund board (even two-thirds), where those directors are responsible for maximising profits for the bank's shareholders while simultaneously preserving the best interests of the super fund members.

Because these conflicts do not exist in the not-for profit superannuation sector, AIST maintains its support for the equal representation model and supports the amendment of the existing section 89 of the SIS Act to allow RSE licensees to have a Board including up to one-third independent directors, should they so choose, as opposed to a mandated quota.

3.2 An appropriate proportion of independent directors – flexibility not prescription needed

We acknowledge the desire to consolidate the prudential requirements of APRA-regulated entities and the CPS 510 requirements regarding independent directors. However, CPS 510 independence issues are particularly targeted at executive directors, who owe duties to members as well as duties to shareholders. These considerations do not apply to the not-for-profit superannuation fund sector.

AIST does not support further government intervention in board composition of equal representation boards when a strong regulatory framework already exists, and the regulators have sufficient powers to ensure the fitness and propriety of directors, as well as how the management of conflicts is handled. The governance models of Australia's superannuation industry should be left up to individual entities to decide to ensure appropriate agility and capacity for innovation, within a strong regulatory framework.

The proposed requirement for one-third independent directors is not proposed in the context of any demonstrable benefit to members. AIST maintains that the true conflicts reside only in the retail superannuation fund sector, and therefore reform in the equal representation model is not warranted.

The intention that these independent directors would then also be required to sit on - and potentially chair - board audit and board remuneration committees, as proposed in draft APRA Prudential Standard SPS 510 Governance, is also problematic. This suggestion potentially narrows the qualifications and experience of the new directors to those suitable for the mandated committee commitments, excluding other expertise, such as investment for example.

AIST therefore supports the retention of equal representation.

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3.3 Chair should be the best person, not a mandated 'independent'

AIST does not believe that the case has been made for changing leadership of board requirements. The Chair plays a fundamental role in leading and steering board discussion and setting the culture for the board and ultimately the organisation as a whole. This key role should be undertaken by the best person for the job regardless of whether they are independent as per the legal definition. The role of the Chair in leadership of the board and setting its culture is vital, and should be at the discretion of the privately owned trustee entity.

AIST submits that the choice of Chair should be a decision for the superannuation fund board, and should not be subject to legislative intervention.

Furthermore, AIST questions the prudence of requiring a minimum of one-third of the board, including the Chair, to change within a proposed three-year time frame. Such a significant change to board composition poses risks to the corporate memory of the board, its knowledge and the culture. These are not insignificant concerns and, without a demonstrable benefit to members, these changes should not be pursued with such haste.

3.4 Meaning of independent is unclear and unworkable

The definition of independent director in a superannuation context has proved challenging for the Government and industry alike. The existing SIS Act definition relates only to equal representation governance models and has little relevance in the retail sector. Similarly, the ASX Corporate Governance Guidelines definition has little relevance in the superannuation industry due to the different ownership structures that exist, and superannuation's foundation in trust law. The Bill proposes a definition that seeks to be appropriate to both the not-for-profit and retail superannuation sectors, despite their vastly different ownership structures and interests of key stakeholders. Such a broad-brush approach raises the likelihood of serious unintended consequences and perverse outcomes, particularly given the diversity of ownership structures and director backgrounds that already exist across the not-for-profit superannuation sector.

The definition proposes to deal with ownership-related issues and relationship-related issues that potential directors may have. The definition proposes to exclude certain directors or potential directors with those ownership or relationship issues from eligibility for independent director status.

Section 87(1)(c)(ii)

With regard to the ownership provisions, AIST is particularly concerned with proposed section 87(1)(c)(ii) where the effect is not only to capture upstream entities of the RSE licensee, but also those downstream, such as subsidiaries or investee entities. Directors or executive officers of related bodies corporate to the RSE licensee, during a preceding three-year period, are not considered to be independent.

This requirement should not extend to internal companies of the RSE licensee that are established for investment purposes i.e. an investment vehicle interposed between the fund and the holding of the

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investment for good reason (normally to restrict recourse to the rest of the funds' assets in the event of some failure) which may be wholly or partially held by the fund. RSE licensees in the not-for-profit superannuation industry establish such companies for three main reasons:

1. Tax benefit purposes
2. To manage joint ventures in a more administratively efficient way
3. To allow for borrowing in an entity

These stated purposes are for the benefit of members, and directors of the RSE licensee are often selected to be directors on these companies. The directors on these investment-purpose companies have no rights to profit from those directorship interests. This practice should not result in trustee directors of the RSE licensee being deemed not independent.

We have attached (Appendix A) - an extract from AustralianSuper's Register of Relevant Interests and Duties - that demonstrates the existence of such holding companies for investment purposes.

Other examples of internal subsidiary companies owned by super funds include:

- A wholly-owned administration company (often self-administered funds set up a company to provide member administration services to the fund)
- A wholly-owned financial planning service company (since under SIS funds cannot provide non-super advice most funds who wish to provide a financial planning service to members do so via a separate corporate structure)

AIST submits that clause 87(1)(c)(ii) not extend to internal companies established to manage fund investments or companies established to facilitate services to members, that meet the best interests test.

Sections 87(1)(d)-(e)

With regard to the relationship provisions, these are concerned principally with material business relationships, employer sponsors' associations or employee representative bodies.

A 'business relationship' for the purposes of proposed sections 87(1)(d)-(e) can be interpreted differently, depending on the perspective. The words read together emphasise the legal relationship. Read the words severally and the interpretation becomes much broader, e.g. does the person have a relationship, if so, is it in a business context? AIST suggests that the latter interpretation could produce wider outcomes than the legislature intended.

The word 'material' also poses potential ambiguity. It appears to have two different meanings depending on whether it relates to the person in consideration for 'independent' status or to the RSE licensee. If it relates to the RSE licensee then it relates to APRA's Prudential Standard and Guidance SPS 231/SPG 231 Outsourcing and captures the business activities of the RSE licensee. In relation to a person, it has a different test, i.e. the Explanatory Memorandum states at 1.60:

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> "*The RSE licensee would be expected to consider the effect on the other person if the business relationship was to cease for example, they would lose a significant portion of their revenue.*"

This extends the definition of 'materiality' into new territory away from RSE licensee's existing practices with outsourced providers and would capture consultants. In many cases we believe this would go too far.

There is also ambiguity around the meaning and relevance of the 'preceding three years' time frame in proposed sections 87(1)(d)-(e). A one-off business relationship that lasted a short time within that three-year period would potentially be covered. The Explanatory memorandum adds to the ambiguity at 1.5:

> "It would be open to an RSE licensee to consider a relationship to not be a material business relationship because the engagement is for a limited time and a limited scope (in terms of the issue and in terms of the overall impact on the fund)."

The inclusion of 'employees' involved in the 'business relationship' at proposed section 87(e)(ii) reaches too deep into the relationship. The provision should only apply to employees with the potential to influence outcomes in those material business relationships.

The combination of the different potential interpretations of 'business relationship', 'material' and the operation of the time frame are not sufficiently clear for boards to be able to make certain decisions.

AIST submits that the provision be further tested for unintended consequences and not exclude potential independent directors by virtue of other positions they hold that are immaterial for the purpose of their independence on the super fund.

Section 87(1)(f)(i)

Proposed section 87(1)(f) attempts to address independence considerations that particularly impact on equal representation funds. Section 87(1)(f)(i) excludes large employer sponsors with 500 or more contributing members from meeting the independence criteria.

Not all super funds are of the same size, with the same employer and member demographics.

For example, HESTA provides us with the following analysis of large employer-sponsors. Employers with 500 contributing members would qualify as representing only 0.06% of HESTA's total membership, and 0.08% of the active membership. We suggest that this is an immaterial representation, and that in the case of HESTA, such employer-sponsors should not fail to meet the independence criteria, as their influence is insignificant on the basis of those numbers.

AIST submits that the provision should be redrafted to take into consideration the different sizes and compositions of superannuation funds, their members and their contributing employers. The exclusion from independence should extend only to employer-sponsors representing a material percentage of the fund.

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Sections 87(1)(f)(ii) and (iii)

Under existing equal representation rules, an equivalent number of representative directors from employer-sponsors of the fund, and trade union sponsors of the fund are typically appointed to the super fund board. (This excludes funds where elections for board positions take place.)

Section 87(1)(f)(ii) is drafted to capture 'representative organisations' of employer sponsors of a fund, such as the Retail Council in the case of REST Industry Super However, it is drafted so widely that it might also potentially capture anyone who has a 'representative' relationship with employer sponsors of a fund such as lawyers or accountants, for example. This is no doubt an unintended consequence of the drafting but it should be rectified or risk further limiting the field of potential candidates for independent director roles.

AIST submits that clause 87(1)(f)(ii)-(iii) be reviewed for unintended consequences.

Sections 87(1)(g) and 87(3)

Proposed sections 87(1)(g) and 87(3) create a new regulation-making power to add additional circumstances relevant to the definition of 'independent'. The Explanatory Memorandum at 1.66 says:

> "*This provision has been included to address possible structures and relationships that may emerge in the superannuation industry and may mean a person could be considered independent even though they might otherwise be captured by new section s87(1).*"

As APRA will also have powers to make determinations on a person's independence (though it has indicated that it would use these powers rarely,) and the definition in the legislation is expected to provide the industry with "sufficient certainty" (Explanatory Memorandum at 1.86) and there is now an identified need for further regulation-making powers, it is clear that sufficient certainty has not been delivered in the proposed changes. We query how these provisions will operate together in practice, and how they will provide RSE licensees with the requisite certainty.

3.5 APRA's powers to determine independence is too broad

AIST is concerned that the Bill allows for the prudential regulator to determine whether a person is or isn't independent.

AIST remains opposed to the broad determination powers granted to APRA in these provisions with regard to a person's independence, or non-independence. Sub-clause (2) of sections 88 and 90 require that APRA 'must have regard to' the elements of the definition of independent in proposed section 87. Also, APRA's determination rests on their assessment, having regard to those elements, of the likelihood of the person being able to exercise independent judgement. Again, this is not a sufficiently objective test for making such a determination, and the consequences are significant.

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CPS510's definition of independent director also refers to a director's ability to exercise independent judgement, but only in the context of any of the person's associations or shareholdings materially interfering with that capacity. Entities regulated under CPS510 are able to seek guidance from APRA on the question of independence and there are no determination powers such as proposed in this Bill.

In any event, the requirement that all directors exercise independent judgement in their director role is a long established part of corporate governance law.

AIST submits that there should be no power for APRA to make determinations; only the capacity to provide guidance such as exists in CPS510.

AIST also has concerns about the inter-relationship of section 89(6) with the requirement to give reasons for decision in section 88(3)(b)(ii). If APRA fails to make a decision within the requisite timeframe, and that is deemed as a refusal, the trustee is left in a difficult position, and with no reasons for a decision. The Explanatory Memorandum merely suggests that the RSE licensee is not precluded from resubmitting its application for a determination (at 1.83).

3.6 Transition to the new arrangements

A transition period to the new governance arrangements of three years is proposed in the Bill. This period appears to have been chosen to align with director terms under board renewal policies. AIST has found however that a significant number of its member funds have four-year terms (in some cases five-year terms), and the proposed transition period may therefore not allow them sufficient opportunity to rotate existing directors in a manner that protects the best interests of members or that complies with existing contractual arrangements.

AIST submits that the transition period for implementing the proposed changes is inadequate and that a five year transition period is more appropriate in the circumstances.

Also, as the proposed changes potentially require turnover of one-third of the board, including the Chair (AIST estimates that two-thirds of its membership may need to appoint a new Chair), we caution against the haste of transitioning in light of the potential risks. Board renewal policies were introduced from 1 July 2013 and for some funds this means that new directors have been recently appointed to their boards. Requiring turnover of a further one-third will result in the loss of corporate memory and knowledge, and a shift in culture. The quality of decision-making may be impacted and AIST submits that this risk is contrary to the members' best interests.

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4 Conclusion

The recent Stronger Super reforms have fundamentally changed the governance landscape for superannuation to the extent that the duties and obligations currently imposed on super fund directors are in fact higher than the banking and insurance industries face. They are the key reason why Australia's super industry is recognised the world over as a governance leader.

Super fund directors operate in a climate of heightened legal obligations and regulations, underpinned by harsh penalties. Breaches can lead to legal action and directors can be held personally liable for the payment of monetary penalties and, in extreme cases, end up in jail.

The introduction of APRA's 12 new prudential standards in 2013 including new fit and proper processes – together with key amendments to the SIS Act – have significantly raised the bar on the level of skill, duty of care and due diligence required of directors. Even before these standards came into play, Australia was ranked third out of 18 countries[12] in relation to pension fund governance – this ranking has now improved to second (out of 25 countries) following the Stronger Super reforms.

Additionally, and importantly, superannuation is underpinned by trust law, which requires superannuation trustees to take extra care as fiduciaries of other people's money.

Sitting on the board of a super fund is not a job for the faint-hearted, the time-poor or those looking to wind down from the hectic pace of full-time work. Trustees are very cognisant of their responsibilities and there has been a greater focus on training and improving risk management frameworks.

Super fund governance requirements not only match the vast majority of the corporate governance requirements for banks and insurers – including ASX listed principles – they have higher governance responsibilities because of the overarching requirement to act in the best interests of members as required under trust law and codified in legislation.

There are two distinctly different operating models in the regulated superannuation industry, and a one-size-fits-all approach, as these proposed changes are, will not meet the Government's stated objectives. A principles-based approach that can then be applied flexibly to the different models is what is required.

APRA's already enhanced powers in superannuation are sufficient to deal with governance issues that might arise.

There is no evidence to support the need for changes to board composition and AIST opposes the disruption, unnecessary cost (both for implementation and ongoing higher director fees) and potential

[12] Australian Centre for Financial Studies and Mercer, (2012) *Melbourne Mercer Global Pension Index*, Melbourne. Available at: http://tinyurl.com/qzlsxkg

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harm that the government's proposed governance changes may have on the best interests of super fund members.

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Reforms to superannuation governance

Appendix A

Extract from AustralianSuper Pty Ltd's

Relevant interests and relevant duties register as at 30/06/2015

TRUSTEE - AUSTRALIANSUPER PTY LTD SUBSIDIARY COMPANIES	PERCENTAGE OWNERSHIP
AS Infrastructure No. 1 (Holding) Pty Ltd	100% fully owned subsidiary
AS Infrastructure No. 1 (Operating) Pty Ltd	100% fully owned subsidiary
AS Infrastructure No. 2 (Holding) Pty Ltd	100% fully owned subsidiary
AS Infrastructure No. 2 (Operating) Pty Ltd	100% fully owned subsidiary
AS Property No. 2 LLC	100% fully owned subsidiary
AS Property No. 2 Pty Ltd	100% fully owned subsidiary
AS Residential Property Pty Ltd	100% fully owned subsidiary
AustralianSuper Property No. 3 LLC	100% fully owned subsidiary
AustralianSuper Research Pty Ltd	100% fully owned subsidiary
AustralianSuper Property No. 1 LLC	100% fully owned subsidiary
AustralianSuper Property Pty Ltd	100% fully owned subsidiary
AustralianSuper Investments Pty Ltd	100% fully owned subsidiary
AustralianSuper Icon Parking No. 1 Pty Ltd	100% fully owned subsidiary
AustralianSuper Icon Parking No. 2 Pty Ltd	100% fully owned subsidiary
Battye Street Investments Pty Ltd	100% fully owned subsidiary
No. 1 Charles Street No. 1 Pty Ltd	100% fully owned subsidiary
No. 1 Charles Street No. 2 Pty Ltd	100% fully owned subsidiary
Western Australian Mindarie Investment Company Pty Ltd	100% fully owned subsidiary

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