GOVERNANCE

Putting members first

SUBMISSION TO THE SUPERANNUATION LEGISLATION AMENDMENT (TRUSTEE GOVERNANCE) BILL 2015

Issue date 14 October 2015

Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of Industry SuperFunds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

Cath Bowtell
Senior Advisor

Matt Linden
Director of Public Affairs

ISA Pty Ltd ABN 72 158 563 270 Corporate Authorised Representative No. 426006 of Industry Fund Services Ltd ABN 54 007 016 195 AFSL 232514

PUTTING MEMBERS FIRST

Contents

Figures

PUTTING MEMBERS FIRST

1. Introduction

Industry Super Australia welcomes the opportunity to have input into the Committee's deliberations on the Superannuation Legislation Amendment (Trustee Governance) Bill 2015. This submission reiterates and supplements our submissions to the Government on the Exposure Draft Bill released in July.

While there has been some redrafting since the release of the Exposure Draft, the Bill before Parliament retains the policy and architectural flaws that we previously identified, and ISA unambiguously calls for the Bill to be rejected.

Industry super funds support strong and effective governance arrangements that promote a sound strategy, robust risk management, ethical behaviour, accountability and transparency. Having the right people around the board table - properly motivated and with the right mix of skills, experience and expertise - is integral to good governance.

The Bill would remove the equal representation model from the law. This reform would eradicate from the law books the most successful model of fund governance in favour of a model that has been adopted by the bank super funds which has failed to prevent scandals and misconduct.

Under the equal representation model, all directors are independent of management, and must act independent of all other duties in performing their role.

The equal representation model embeds members' voice into the governance of funds ensuring boards retain a single-minded focus on the beneficiaries. It is integral to the success of the not-for-profit sector, which has a track record of consistent outperformance.

It simply makes no sense to impose change on the not-for-profit sector, while leaving largely unchanged the model that has underperformed and been ineffective at preventing widespread misconduct. It certainly makes no sense to undercut the governance obligations that retail and bank owned funds have only recently adopted on a voluntary basis.

We also oppose the Bill on the following grounds:

- The measures are ill-conceived. Board composition does not lend itself to prescriptive regulation. To the extent regulation is warranted it should be principles-based and capable of flexible application.
- The measures are unnecessary. APRA's new prudential standards, introduced as part of the Stronger Super reforms, dealing with board and director evaluation, risk management and conflicts management provide a robust regulatory regime to address concerns about board composition.
- The measures are not supported by evidence. No effort is made to identify the benefits of the reforms, and no rigour has been applied to assessing the evidence regarding the impact of board composition on fund (or indeed corporate) performance.
- The measures are costly. The Government's own (in our view conservative) estimate is that they will impose direct costs of at least $70 million in the first five years. There is a real risk of substantial indirect costs, and no evidence that they will result in any benefits to fund members.

- The measures are poorly focused. The Bill fails to recognise the strengths and weaknesses of the various sectors of the superannuation industry – and the very different governance issues that can arise due to the different structures, objectives and incentives in each sector.
- The measures are ineffective. They will not advance the Government's stated objectives of a broader pool from which directors are drawn, better management of conflicts of interest or ensuring boards are separate from management. Loopholes in the drafting would allow individuals who suffer material conflicts to be classified as independent directors, particularly in the for-profit sector.
- The outcomes are unexpected. The definition of an independent director contained in the Bill will result in some erratic outcomes, which are not consistent with the stated policy objectives, and which will diminish confidence in the application of the law.

Australia's retirement incomes system is at a cross-road. Commentators across the political spectrum are calling for a more sustainable and equitable retirement incomes system. There are substantial policy issues that demand the attention of policy-makers, lawmakers and stakeholders in the superannuation system.

We urge the Government to abandon this Bill, and instead turn its attention to measures that will secure decent living standards for older Australians and a sustainable retirement incomes system to serve our country for decades to come.

RECOMMENDATION 1. **That the Bill be rejected.**

2. Abolition of the equal representation model

ISA opposes in the strongest terms the repeal of Part 9 of the SIS Act, and related amendments. These amendments would remove the equal representation governance model from the law.

This affects consumers across the superannuation system, as it removes the current requirement that public offer funds that do not adopt an equal representation model for their boards, instead establish policy committees comprising equal numbers of members and employer representatives for each employer that has more than five contributing members. While policy committees are a far less effective mechanism for ensuring member and employer representation, it at least provides some opportunity for member input into for-profit fund governance arrangements.

The effect of the repeal is to abolish a legislative guarantee for member and employer voice in fund governance, and undermines the not-for-profit model of governance that has delivered boards comprised of people from diverse backgrounds united by their strong belief that superannuation funds should be run only to benefit members.

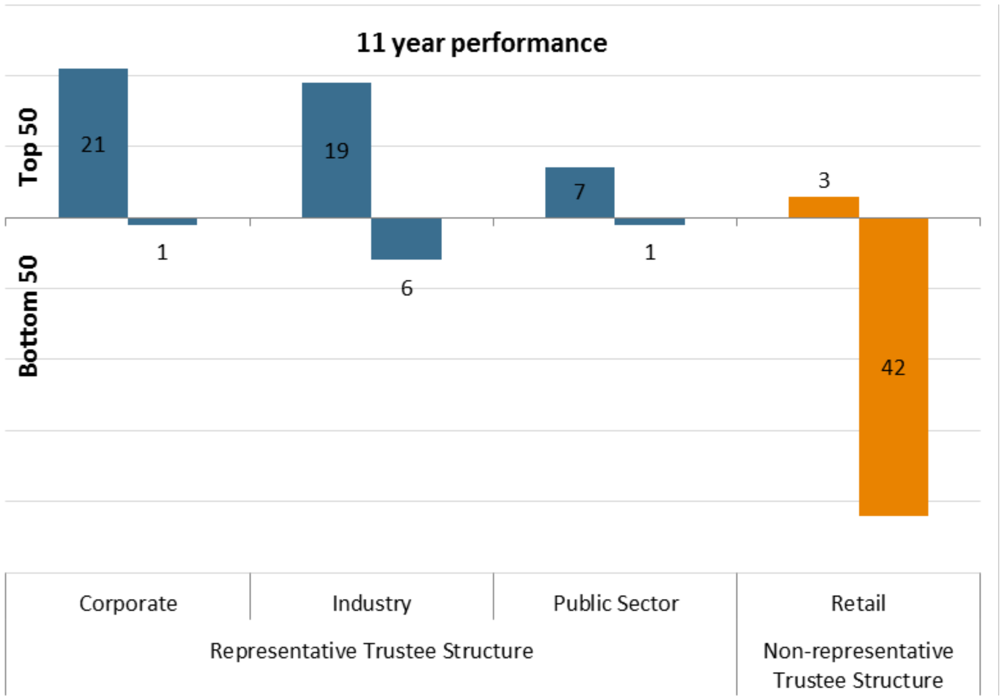
This model was purposefully developed three decades ago as a distinct and efficient alternative to the model used by banks and insurance companies. Not-for-profit funds with equal representation boards provide a competitive counterbalance to for-profit providers and the attendant agency risks arising from their involvement in our mandatory savings system. It ensures boards and management are structurally separate; it embeds diversity, accountability and a consensus culture into the governance arrangements. The representative nature of the directors complements and re-enforces the directors' duties under the trustee structure, because their interests are aligned with those of the fund members.

2.1 The proof of the pudding is in the eating

These boards have a single focus on advancing members' best interests, and the proof of the pudding is in the eating. Over the 25 years to June 2015, funds with representative trustees have outperformed non-representative trustees (i.e. retail funds) by 1.84 per cent per year on average, while avoiding the scandals that have plagued the vertically integrated for-profit financial services sector.[1]

APRA's fund-level rate of return data shows that over an 11 year period, 94 per cent of the top performing 50 funds are representative trustee funds. At the other end of the scale, the majority (84 per cent) of the lowest performing 50 funds were non-representative trustee funds.[2]

Figure 1 – Top 50 and bottom 50 performing funds based on average annual net returns to June 2014



Source: APRA Fund Level Statistics to June 2014 and ISA analysis

The key factors leading to the outperformance are not-for-profit orientation (low fees) and asset allocation, both of which derive from the culture and decisions of the trustee, and therefore ultimately from the unique trustee structure – the equal representation model.

With respect to asset allocation, APRA research has found that funds with representative trustees invest greater amounts in illiquid assets such as infrastructure, which leads to superior returns to members, while retail funds, despite in many cases having the fund characteristics to do so, do not invest in this way.[3]

2.2 The repeal of equal representation is a radical reform

The repeal of the equal representation model is radical. It constitutes the most significant change to superannuation since the advent of compulsory superannuation. This reform is neither modest nor benign.

[1] The McKell Institute, The Success of Representative Governance on Superannuation Boards, June 2014.

[2] Analysis excludes ERFs

[3] Cummings, James R and Dr Katrina Ellis, 'Risk and return of illiquid investments: A trade-off for superannuation funds offering transferable accounts', *APRA Working Paper*, November 2011

It strikes at the heart of employer and employee representation on fund boards, and will weaken rather than enhance the accountability of trustees to fund members and employers.

The Explanatory Memorandum[4] suggests the representative trustee model is no longer appropriate in the context of the modern pressures on super funds. Yet, members and employers are represented on the boards of pension funds across the OECD, and there is broad agreement that their input is integral to strong governance.

In the majority of OECD countries, equal representation for occupation pension schemes is a requirement of the regulatory regime, rather than being left to the scheme sponsors and/or members. In almost all cases, member representation is protected by law.[5]

In a recent report on board composition across the OECD, Mercer argues that member representation enhances accountability to the members and beneficiaries of the fund, particularly in defined contribution schemes, where members bear the risk of poor investment performance. Mercer argues that the introduction of more independent directors[6] should not occur at the expense of member representation in the fund's governance structure.

A voice for employers is also important in our compulsory system where employers are key stakeholders in the system, responsible for compliance with superannuation guarantee obligations, including the obligation to select an approaved fund on behalf of their employees who do not exercise choice of fund. An employer voice is also important in defined benefit funds where the employers take the investment risks on behalf of the members.

The importance of representative directors is reflected in community attitudes. Research conducted by UMR in June this year found that 67 per cent of Australians say it's important that super funds are run by people who have a direct connection to the people in those funds, such as representatives of fund members and employers.

If the Government insists on a more uniform model of governance, it would be sensible to retain the strengths of the equal representation model and extend the requirement for member representatives to all boards.

The Explanatory Memorandum reassures funds that the Government's policy still allows employer and member representation on superannuation boards.[7] ISA takes no comfort from this reassurance.

- First, it takes no account of the fact that equal representation is not guaranteed in the constitutions of all not for profit funds and its removal from the law would leave it open the prospect – depending on how the shares in the trustee company are distributed - that the remaining two thirds of the board are appointed only by employer organisations, or only by organisations representing members.

- Second, regulatory creep could also dilute member and employer representation. The Government has already foreshadowed amendments to the Corporations Act Regulations to require funds to explain, on an annual basis, why they do not have a majority of independent directors, while APRA's Draft Standards and Practice Guides[8] suggest that APRA will encourage boards to consider

[4] Explanatory Memorandum Paragraph 1.17, page 9

[5] Stewart, F. and J. Yermo (2008), "Pension Fund Governance: Challenges and Potential Solutions", OECD Working Papers on Insurance and Private Pensions, No. 18, OECD publishing: p 14-15 and more recently Mercer, *Governance of Superannuation Funds*, May 2015, 16.

[6] Mercer, *Governance of superannuation funds:* May 2015, while the Mercer report does support the introduction of independent directors, the definition of independent is principles based, aimed at identifying directors who are free from material conflicts.

[7] Explanatory Memorandum Paragraph 2.51, page 42

[8] APRA, August 2015 Draft SPS 510 – Governance and Draft SPG 510 Governance

appointing a higher proportion of independent directors. Indeed in an initial letter to RSEs[9] rules were foreshadowed to require a majority of independents on sub-committees of the board which would in practical terms necessitate funds appointing more than one-third independent directors on the main board to meet the subcommittee requirements. This would override fund constitutions or force their amendment.

- Third, proposed section 86(1)(c) would enable APRA to intrude into the nominations, appointment and removal process for independent directors, diminishing the role of member and employer bodies in nominating directors to the board. Again, the draft Standards, which apply to all appointments, including the non-independent directors (those who may not count towards meeting the statutory quota) suggest a dilution of the role of the nominating bodies.
- And finally, as noted above, in most OECD regulatory structures for pension funds, equal representation requirements have legislative underpinning, because they are recognised as critical to sound governance and better member outcomes. The proposed approach contrasts with the prudential framework for ADIs and Insurers in CPS 510 which provides far greater autonomy for boards in appointing suitable independent directors.

RECOMMENDATION 2. **That equal representation be retained.**

To be clear, ISA does not oppose independent (or non-representative) directors. We recognise that many independent directors (in both the non-representative and non-associated sense) make significant contributions to the boards on which they serve, and we support measures that ensure equal representation funds and their sponsors have the flexibility they need to respond to the different challenges they face, while retaining the integrity of the representative trustee model.

ISA recognises that the SIS Act constrains the ability of trustees to appoint more than one non-representative director, if this suits the fund's circumstances. We would support changes that would allow funds to appoint more non-representative directors and chairs on funds while retaining the strength of the equal representative model.

RECOMMENDATION 3. **That the Bill be amended to permit funds to appoint additional non-representative directors on the boards of superannuation funds that adopt the equal representation model. This could be achieved by amending section 89(2)(a) of the SIS Act to refer to "one or more" additional independent trustees or directors, and by deleting section 89(2)(d) of the Act.**

3. The measures are ill-conceived - a prescriptive approach is not justified

"Any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature, corporate governance is not something which 'one size fits all'."

Mr Justice Owen, HIH Royal Commission

[9] APRA, 26 June 2015 – Letter to RSE's consultation on proposed amendments to SPS 510

Governance experts around the world argue that improving board performance involves a complex set of relationships that do not lend themselves to prescriptive regulation. Yet the regulatory approach adopted in the Bill would hard-code board composition and a definition of independence into law without regard to the context within which that relationship operates.

As explained in the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations, there is little value in a checklist approach to corporate governance that does not focus on the particular needs, strengths and weaknesses of the company.

The AICD has recently submitted to the Senate Committee on Finance and Administration:

"As a general proposition we are of the view that mandated standards of corporate governance result in a "one size fits all" approach which should be avoided wherever possible. Appointments to boards need to be made on the business needs of an organisation, including the skills and abilities that needs to be represented on its board." [10]

The measures depart from well-settled approaches to governance regulation. ASX corporate governance standards have been accepted because they are flexible and recognise that one-size doesn't fit all. The ASX model enjoys consensus support, and the Bill's radical departure from that approach is a clear indication it is designed to achieve something other than governance reform in the public interest.

While we don't subscribe to the view that the governance of super funds should necessarily align with the governance of listed companies, we note that the ASX principles do not include a definition of relationships that will give rise to a loss of independence, but rather provide examples of interests, positions, associations and relationships that may raise doubts about independence and require consideration.

This approach recognises that a relationship that could create a conflict of interest in one context might not in another (or could even be beneficial in a different context). As an example, a relationship with a substantial shareholder of the RSE licensee raises very different considerations where that shareholder demands profit, compared to where the trustee is not expected to and does not provide a profit to the shareholder.

And, importantly, under the 'if not, why not' approach, the ASX principles provide that if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it - tempered by the requirement of public disclosure of the rationale for this choice, so that its shareholders, academics and others can evaluate it.

This recognises that the company- and its stakeholders – not the Government – are best placed to understand the context within which board composition decisions are made, including the skills, experience, character and other qualifications being sought, as well as the available candidates.

In stark contrast, the Bill provides no opportunity for trustees to consider whether meeting each of the obligations in the Act is consistent with the best interests of members.

The proposed Bill is inconsistent with the principles-based approach which is the hallmark of modern regulatory practice and which is particularly suited to the regulation of trustees whose primary obligations are determined by the fiduciary relationship and the covenants.

It is also inconsistent with APRA's stated supervisory approach, which is to be 'forward looking, primarily risk based, consultative, consistent and in line with international best practice'

---

[10] AICD, 2015 Submission to Senate Finance and Administration Committee inquiry into the Australian Government Boards (Gender Balanced Representation) Bill 2015

4. The measures are not supported by evidence

"…[T]here is a lack of compelling evidence to suggest that any one model of board structure should be viewed as clearly preferable in all cases. Therefore, the Commission does not consider it appropriate at this time for a particular structure to be mandated. Further, the Commission would not want to see restrictions placed on board structures without such restrictions having a sufficient evidentiary basis."

The Productivity Commission[11]

The use of Government power in relation to private firms – from environmental regulation to OH&S regulation, to consumer protection laws – is usually limited to restrictions on business conduct to ensure corporate activities do not run afoul of the public interest. It is exceedingly rare for the laws of Anglophone jurisdictions to intrude into the internal affairs of corporations, such as to specify corporate governance and other arrangements. Instead, Governments typically "enable" corporate structures with arrangements that shareholders can modify as they see fit.

Policy makers typically require a strong evidence base – such as major corporate scandals – before setting aside the presumption against intrusive laws.

In this instance, no evidence is advanced to support the proposition that changing the governance of super fund boards will have a positive effect on members or the retirement income system more broadly. No attempt has been made to identify the beneficial impact for members of the regulation of board composition. No rigour has been applied to the cost-benefit analysis.

The Explanatory Memorandum assumes that amending board composition will improve fund performance without testing this assumption. There is no available evidence that mandating independent directors on not-for-profit superannuation funds would improve fund performance.

Industry super funds have previously provided detailed analysis of the academic literature regarding board composition, and the incidence of independent directors, and company or fund performance. In summary:

- A study looking at the governance and performance of APRA-regulated funds found no evidence that board and chair independence affect funds' performance.[12]
- Empirical research on US public pension funds indicates that the proportion of "outside" trustees on the board has no significant relationship with funds' excess outperformance and may lead to differences in asset allocation that impact on plan funding levels.[13]
- Studies undertaken by international and Australian academics show that the introduction of majority independent arrangements on company boards either add limited or negative value to boards.[14]

---

[11] Productivity Commission, Default Superannuation Funds in Modern Awards Inquiry Report, No. 60, 5 October 2012, p 102

[12] Liu, K., 2014, Governance and Performance of Private Pension Funds: Australian evidence, School of Risk and Actuarial Studies, University of New South Wales, Australia http://papers.ssrn.com.ezlibproxy.unisa.edu.au/sol3/papers.cfm?abstract_id=2484380

[13] Harper, J., 2008, Board of Trustee Composition and Investment Performance of US Public Pension Plans. International Centre for Pension Management

[14] See Lawrence, Jeffrey, and Stapledon, Geof, 'Do Independent Directors Add Value?', Centre for Corporate Law and Securities Regulation Faculty of Law The University of Melbourne 1999; Tung, Frederick, 'The Puzzle of Independent Directors: New Learning', Boston University Law Review, Vol. 91, No. 3, pages 1175-1190, May 2011; Fischer Marc-Oliver and Swan Peter L, 'Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment', Australian School of Business, University of NSW 18 November 2013; Koerniadi, Hardjo and Tourani-Rad, Alireza, 'Does Board Independence Matter? Evidence from New Zealand', Australasian Accounting, Business and Finance Journal, 6(2), 2012, 3-18; Jeremy Leibler, 'Let's drop independence obsession', The Australian October 16, 2013.

- The Executive Director of the AICD's Governance Leadership Centre has recently acknowledged that "*research over the last 20 years has produced inconclusive results, with evidence that increasing the proportion of independent directors can have a positive, negative or indeterminate effect on firm value.*" [15]

There is a strong relationship between the representative trustee model and the outperformance of the not-for-profit sector.

- APRA has published a series of working papers demonstrating the outperformance of not-for-profit funds which are almost exclusively governed by representative trustees.[16]
- The Grattan Institute has found that these not-for-profit funds have lower fees and higher returns across a variety of investment options.[17]
- The McKell Institute found a direct and strong relationship between the representative boards and the higher returns delivered by the not-for-profit sector.[18]

There is evidence that the representative governance model has promoted higher levels of diversity among trustees, and more effectively minimises conflicts.

Significant evidence points to structural governance problems in the for-profit sector where boards more closely resemble the governance model favoured by the Bill. Evidence shows:

- Greater prevalence of multiple directorships on the boards of for-profit funds.[19]
- For-profit fund directors spend much less time than representative directors on fund matters. [20]
- Service providers to for-profit funds are much more likely to be owned by the same parent company as the fund, and research shows they are more likely to be paid above market rates. In comparison, the not-for-profit funds were more likely to pay market rates to related parties for services.[21]

A more detailed summary of the evidence is attached as Attachment A.

Rather than engage with the evidence, the Explanatory Memorandum points to the findings of the Cooper Review (2010) and the Financial System Inquiry (2014) to justify the introduction of these reforms.

This is mischievous, given that the proposals do not faithfully adopt the recommendations of these reviews. For example, the Bill does not adopt the Cooper Review recommendation to adopt a modified equal representation model in the not-for-profit sector, and to introduce different governance requirements in

---

[15] AICD Governance Leadership Centre commissions research on the value of independent directors, http://www.companydirectors.com.au/director-resource-centre/governance-leadership-centre/governance-driving-performance/aicd-governance-leadership-centre-commissions-independent-director-research

[16] See Coleman, A., Esho, N. and Wong, M., 'The investment performance of Australian superannuation funds', APRA Working Paper, APRA, 2003, Ellis, K., Tobin, A. and Tracey, B. 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', APRA Working Paper, APRA, October 2008, Sy, W. & Liu, K., 'Investment performance ranking of superannuation' APRA Working Paper, APRA 2009 and Australian Prudential Regulatory Authority, Response to Submissions - Fund level disclosure from the APRA superannuation statistics collection, APRA, 2009.

[17] Grattan Institute, Super Savings, April 2015, p 20-22

[18] McKell Institute, The Success of Representative Governance on Superannuation Boards (2014)

[19] ISA analysis

[20] APRA Working Paper, Wilson Sy, August 2008; *Superannuation fund governance: An Interpretation*

[21] Kevin Liu and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', APRA Working Paper, 12 July 2010

respect to retail funds to overcome the misalignment of interests between fund members and dominant, profit seeking parent companies.

More pertinently, neither of these reports provided an evidentiary basis for their recommendations on this matter. Indeed, of the three recent reviews to consider the question of independent directors on super fund boards, only the Productivity Commission engaged with the evidence.

In its 2012 review,[22] the Commission examined all of the arguments and evidence in relation to the proposal to require a minimum number of independent directors on fund boards. Having thoroughly considered the material, the Commission found no compelling evidence to support one model of governance over another, and recommended against prescribing any particular structure for superannuation fund boards.

5. The measures are costly, with no offsetting benefit

"Culture is a nebulous concept, much more difficult to define and observe than capital adequacy. But strengthening culture, like strengthening capital, is critical to long-run stability."

Wayne Byers, Chairman APRA

Good law making not only requires an evidence base, it requires that the benefits of any reform justify the costs. The Government proposal fails this test.

5.1 The benefits are not quantified

First, the government has made no attempt to quantify the purported benefits of its reforms. Instead the Government asserts that independence in superannuation funds is "*fundamental to improving governance, and thus improving member outcomes.*" However, it cannot support this claim, and concedes that "*the full benefit will only be identified over the longer term*." [23]

5.2 Indirect costs are not quantified

Second, the RIS focuses solely upon the direct costs of the reforms, and fails to take into account indirect costs. These costs are difficult to quantify with precision, but are the consequence of a loss of cultural alignment within not-for-profit funds.

Mandating changes to the composition of superannuation trustee boards creates a number of risks, which over time may have a significant impact on the retirement outcomes of superannuation members. It would be a reckless assumption that the strong outperformance of the representative trustee system will be preserved under a new governance model.

Research on US public pension plans indicates that board composition has an effect on asset allocation and funding levels of US pension plans. Specifically the research suggests independent directors possess different investment beliefs and risk appetites than representative directors. Significantly the research found a higher proportion of representative directors (and by implication a lower proportion of outside

[22] Productivity Commission, *Default Superannuation Funds in Modern Awards Inquiry Report*, No. 60, 5 October 2012

[23] RIS, paragraph 2.74

independent directors) had “a positive effect on funding levels of the pension plans and are more focused on a stable, sustainable plan to provide future benefits”.[24]

The clear alignment between member interest and the objectives of the employer associations and unions that nominate representative directors has underpinned the high ethical standards and culture of accountability that prevail in the representative trustee sector. There is a risk that finance sector norms will be imported into the not-for-profit sector, undermining the member-first culture of the boards, leading to ‘group think’ and homogeneity rather than diversity around the board table.

5.3 The Government’s estimate is too low

Third, the Government’s assessment of direct costs is unrealistic and understates these costs. The estimate is flawed because it (i) ignores the inevitable upward pressure on director fees that will occur with the appointment of a large number of directors (ii) does not consider the costs that retail funds will bear in implementing the charges; and (iii) makes no provision for knock-on costs arising from the need to restructure the boards of subsidiaries of funds.

The Government estimates the cost of compliance is $70 million in the first five years whereas ISA originally estimated the direct costs of the reforms to be between $89 and $168 million over the first five years. In light of changes to the definition of independence between the Exposure Draft Bill and the Bill before Parliament, even the ISA estimate is now too low. A copy of ISA’s original estimates is at Attachment B.

The original ISA estimates are higher than the Government’s, as we made provision for the upward pressure on director remuneration that will inevitably occur with the appointment of large numbers of new independent directors, and we have taken into account the costs that retail funds will bear in developing transition plans. The Government makes no provision for these costs.

5.4 There are new costs that are not included in the cost-benefit analysis

In addition, the Bill before the Parliament introduces concepts of director independence that were not contemplated by the Exposure Draft of the Bill. The new definition gives rise to new costs, specifically in relation an independent directors’ ineligibility to serve as a director of entities that are related bodies corporate.

In not-for-profit funds it is common for directors to serve on the boards to wholly or partly owned entities, to ensure that those entities act in the interests of the fund. The Bill would require funds to identify and nominate replacement directors on these subsidiary boards, or to substantially reorganise their operating model.

ISA has been unable to estimate a cost of his rule, because of the uncertainty about how funds would respond. This new definition of independence could prove enormously disruptive for many industry super funds, triggering a restructure of their operating model, or the appointment of a plethora of new directors to serve on the boards of wholly-owned subsidiary companies. ISA estimates that around one third of not-for-profit funds will be affected. We also understand this provision would disrupt the arrangements within some of the retail funds.

In the not-for-profit sector, all costs will be necessarily borne by fund members. In the retail sector, it is likely that these costs will also be passed on to members.

---

[24] Harper, J., 2008, Board of Trustee Composition and Investment Performance of US Public Pension Plans. International Centre for Pension Management

Finally, the RIS considers only two flawed policy options, and fails to consider other alternatives that would impose fewer costs on industry, and would introduce fewer risks to members.

5.5 A note on fund mergers

One of the more spurious arguments advanced in support of the reforms is that changing the composition of the boards of super funds will promote fund mergers. Curiously, this argument is advanced by the Financial Services Council to this inquiry, who in previous submissions have resisted regulatory intervention to encourage mergers.

It's a very long bow to suggest the proposed governance changes will drive merger activity. Indeed an independent director whose livelihood may solely depend on the number of board positions they hold may face an even more difficult decision than a representative trustee director who has an alternate main form of employment.

There is no empirical evidence to suggest that mandating independent directors would give rise to increased mergers. In Attachment C we analyse the evidence in full. Our analysis finds:

- Where retail and bank-owned funds do have a majority of 'independent' directors, the number of super funds has increased.
- In contrast, there has been significant merger activity in corporate and industry fund sectors that utilise representative trustee boards.
- APRA data shows that over the 11 years between 2004 and 2015 the number of industry funds has more than halved with a 59 per cent reduction and the number of corporate funds has fallen by 97 per cent.
- The weakest merger activity has been evident in the retail sector, where the number of funds has fallen by 36 per cent. Curiously the number of retail entities has actually increased in the last four years and as a sector continues to have the largest number of funds and lowest average assets per entity. Indeed, the four major banks own 30 RSEs managing small-scale funds.
- Moreover, where not for profit funds have leveraged scale, the benefit has been passed on to members. This does not appear to be the case, in the retail sector. According to APRA data the largest bank-owned and retail super funds ($25 billion or larger) delivered on average lower returns than the smallest funds (less than $2 billion) from either sector.
- The application of the scale test, [25] introduced as part of the Stronger Super reforms, has the potential to have a much more profound effect on merger activity. The key issue is not the number of funds but rather whether funds are efficient, can access scale, and ultimately deliver good outcomes to members.
- The introduction in 2006 of a requirement upon credit unions to increase the number of independent directors has not seen any increase in merger activity since that time.

[25] This test requires RSE licensees that offer a MySuper product to determine, on an annual basis, whether members who hold a MySuper interest are disadvantaged by insufficient scale compared to members who hold a MySuper interest in other funds. This requires the RSE licensee to consider, amongst other things, the number of members and assets at both the MySuper product level and the fund level, and to satisfy itself that members are not disadvantaged over time in terms of the net returns from the MySuper product, irrespective of the size of the RSE.

The proposition that disrupting the governance structures of the best performing sector of the superannuation industry will improve outcomes for fund members is devoid of any factual basis and should be given no weight whatsoever.

6. The measures will be ineffective

"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…"

Professor Donald C Clarke

Independence is not an end in itself. In order to determine whether the Bill will be effective, it is necessary to understand the objectives of the regulation. Without clarity about the harm that director independence is designed to address, any regulatory response is likely to miss the mark, and ISA submits that this Bill has fallen into that trap.

In some jurisdictions, independent directors are used to ensure that majority shareholders act in the interests of all shareholders, while in other jurisdictions, independent directors are used to ensure managers act in the interests of the shareholders, not themselves.

In the current debate, director independence variously means non-conflicted directors, non-executive directors, and non-associated directors. It is also used to describe individuals with particular skills found outside the trustee and its sponsors. This ambiguity creates an appearance of many voices in support of director independence, whereas in fact there is little consensus.

The Explanatory Memorandum suggests that the Government's objectives are:

- to broaden the pool of directors' experience;
- to ensure an external viewpoint, and provide a check on management;
- to improve accountability, particularly where directors have a conflict of interest; and
- to achieve uniformity across the industry, based upon the ASX principles.[26]

Unfortunately, the Bill will fail to meet any of these objectives. Significantly, the Bill stops short of securing a proper separation of management and boards and fails to control the influence of conflicted directors particularly in retail funds.

6.1 The Bill will not enhance diversity

There is nothing in the Bill that will broaden the skills or experience of directors, and the Committee should be wary of claims that it will do so. While the provisions of the Bill rule certain classes of person ineligible to serve as an independent director, they do not prohibit people with similar background, experience or training serving as an independent director. Indeed, as we note below, in respect to the retail sector, the Bill will allow a return to the days of boards dominated by bank executives and finance sector insiders serving across multiple entities within a conglomerate.

[26] Explanatory Memorandum, Paragraph 2.43 at page 40.

6.2 The Bill will not ensure separation of the board and management

There is general agreement that boards should be independent of management, not least so that boards can oversee and evaluate the effectiveness of the management.

For this reason, executive directors have not been a feature of not-for-profit funds. More recently the FSC introduced binding regulations requiring its members have a majority non-executive directors on super fund boards.

Staggeringly, this Bill would sanction a return to boards comprised of majority of fund executives, unable to exercise appropriate oversight of their own work. By adopting a weaker standard than that adopted by industry, the Bill sends a signal that the Government approves a return to executive-dominated boards.

It appears that APRA has similar concerns. Draft Prudential Standard 510 would provide that *"A majority of directors present and eligible to vote at all Board meetings must be non-executive directors."* [27]

The fact that APRA has seen it necessary to introduce by subordinate regulation a different quota in respect to executive directors to the quota proposed by legislation for independent directors begs the question – how could the legislation that has been the subject of several rounds of consultation – fail to address this fundamental issue? It highlights the folly of a "one size fits all" approach, and the weakness in the focus on the existence of relationships and not on the existence of competing motives and incentives.

APRA's proposed Standard also begs the question – why would the Parliament amend the law to sanction boards dominated by non-executive directors, only to see the Regulator introduce provisions that would neutralise those directors' influence? Law-makers should be wary of sending confusing or ambiguous signals about the outcomes expected from regulation.

6.3 The Bill will not curtail the influence of conflicted directors

It is also broadly accepted view is that directors should also be free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with their ability to act in the best interests of the fund.

Unfortunately, this Bill will not ensure that directors are free from material conflicts. Up to two thirds of an RSE Board can be comprised of people with a material conflict of interest sitting as non-independent directors.

Again, by sanctioning the establishment of boards dominated by individuals who owe a material competing duty, the Bill sends a signal that these arrangements are consistent with high standards of governance, and flies in the face of the expectations established by APRA in respect to the management of conflicts.

While the Bill appears to clearly deal with executives and directors of related entities , APRA has signalled that it intends to issue further guidance in relation to directors within conglomerates. ISA is apprehensive

[27] While this aspect of the Draft Standard 510 is welcome, it does contain a carve-out which it would permit individuals who are "board members or senior managers of the parent company of the RSE licensee or of the parent company's subsidiaries" to count as Non Executive Directors. This carve out fundamentally weakens the purported protection offered by the proposed provision. While such executives many not formally count as "insiders" they are nonetheless conflicted, with a significant portion of their remuneration linked to the financial performance of the common parent. This gives rise to an incentive to prioritise returns to the shareholder parent over returns to the fund members.

that the APRA guidance will sanction the appointment of otherwise conflicted individuals, through a carve out for directors of related entities within a conglomerate.

It is not currently uncommon in retail settings for individuals to sit as independent directors across multiple entities, and be classified as independent directors.

This may occur where the executive of an entity with the same corporate parent as the RSE (a sibling of the RSE Licensee) even if where a substantial portion of the person's remuneration is linked to the success of the corporate parent, giving rise to an incentive to prioritise the success of the parent over the interest of the members.

It may also occur where a director holds multiple directorships on the boards of sibling entities within a conglomerate, including serving as an independent director on the RSE Licensee. It is also not uncommon in these circumstances for the director's fees to be paid by the corporate parent – in effect their livelihood is wholly drawn from a single corporate parent.

ISA urges the Committee to ensure that these types of conflicts are sanctioned as a result of this regulatory package.

6.4 The Bill will not secure consistency with the ASX standards

The final objective of the Government is to secure consistency with ASX corporate governance arrangements.

While ISA has reservations about the desirability of this objective, to the extent it is considered desirable to align the governance obligations across the corporate and superannuation sectors, the Bill falls short of this objective.

There are three significant distinguishing features between the ASX Principles and the current proposal.

First, unlike the current Bill, the ASX guidelines do not rule certain classes of persons as independent or not independent. Instead they list interests, positions, associations and relationships that a board should consider in assessing whether a person could act in the best interest of the corporation, leaving it to the board to make the determination as to a person's eligibility to serve as an independent director, having regard to all the facts.

Second, unlike the current Bill, in each case, the materiality of the interest, position, association or relationship needs to be considered.

And finally, ASX listed companies have the flexibility to depart from the guidelines where that is determined to be in the best interests of the corporation, provided that they explain the reason for the departure.

Clearly the regulatory regimes are materially different, and the drafters of the Bill have failed in their task to align the governance obligations of corporate Australia and the superannuation sector.

7. The measures are unnecessary

APRA's new prudential standards constitute a robust regulatory regime to address concerns about board composition, board performance and managing conflicts of interests. The Prudential Standards include requirements that each RSE licensee:

- Has a risk management framework that covers governance risk,

- Undertakes regular external assessments of board performance and of the performance of individual directors;
- Has a formal board renewal policy;
- Ensures that directors, collectively, have the necessary skills, knowledge and experience; and
- Has a robust conflicts management policies and processes.

In respect to the skills required of directors, RSE licensees must, amongst other things:

- Clearly define the competencies required of the director role;
- Consider competence, character, diligence, experience, honesty, integrity, judgment, education or technical qualifications, knowledge and skills;
- Consider whether the person has a conflict in performing director duties, or, if they do have a conflict, whether it would be prudent to conclude that this conflict will not create a material risk that the person will fail to perform their director duties properly;
- Conduct annual fit and proper assessments in relation to each director, including the making of reasonable enquiries to obtain relevant information; and
- Take reasonable steps to assist APRA to conduct its own fit and proper assessment of directors.

Each RSE licensee must have a robust conflicts management framework. This must be reviewed annually by the trustee and comprehensively every three years by an independent expert.

APRA can apply to the Federal Court to disqualify a person from being a director of a trustee of a superannuation entity where the Court is satisfied the person has engaged in serious contraventions, or is satisfied a person is not otherwise fit and proper.

These Standards provide APRA with a numerous points to engage with RSE Licensees - on a system wide level or at individual fund level - where the regulator identifies concerns about the composition of boards.

This point was made in a briefing note prepared by Hall and Wilcox Lawyers (available at Attachment D). Having considered the Government's stated objectives – broadening the pool from which directors are drawn, curbing the influence of conflicted directors, and ensuring separation from management -Hall and Wilcox say:

"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. In particular, the focus on accountability around conflicting interests is curious in light of the extensive attention to conflict issues in SPS 521 Conflicts of Interest and the very clear obligations of directors in relation to conflicts under the SIS covenants."

8. The measures are poorly focused: not all super funds are the same

"Trustees have a legal duty to act in the best interests of fund members. …In the case of a public sector, corporate, or industry fund, the trustee is organised on a not-for-profit basis. In the case of a retail fund, though, the trustee (or the corporate group to which it belongs) has the strong expectation of profiting from its superannuation business. That retail trustees must reconcile their (group's) profit motives with their fiduciary duty to act in the members' best interest gives rise to agency risk."

Kevin Liu and Bruce Arnold, APRA Working Paper, July 2010

The Bill ignores the fact that different corporate structures and business models within the superannuation sector face very different governance challenges. The pursuit of uniformity in this environment makes no sense.

While the Explanatory Memorandum makes a virtue of uniformity, the different sectors face different governance challenges, which command different responses. According to APRA, retail trustees, especially those within a financial conglomerate, face unique and potentially significant conflicts. [28]

The Cooper Review observed the same point and concluded that due to the difference in governance arrangements and potential conflicts, the value that independent directors bring differs between the for-profit and not-for-profit sectors.[29]

This focus on uniform obligations exposes a fundamental flaw in the Bill. In seeking to reconcile the competing demands of the different operating models in the superannuation sector, the proposed reforms end up disturbing a successful model in one sector, and at the same time same time fall short of standards that the retail sector has recognised are essential if it is to restore trust and integrity within that sector.

8.1 Governance challenges are in the for-profit sector

"Trust is a very hard slope to go up and very easy to slip down; trust has to be built. There's no good complaining about it."

Greg Medcraft, Chair ASIC

In recent months, Australian regulators have voiced their concerns regarding the misconduct and scandals which have emerged across for-profit financial institutions. The breadth and frequency of the misconduct has lead regulators to voice concern about the overall governance and risk management systems in the for-profit sector.

These failures have material and negative impacts on consumers, and it seems that independent directors on the boards of the for-profit finance sector have been ineffective in managing the conflicts which result from vertical integration and potential misalignment of shareholder and consumer interests.

The Financial System Inquiry (FSI) found in 2014 that "Previous collapses involving poor advice, information imbalances and exploitation of consumer behavioural biases have affected more than 80,000 consumers, with losses totalling more than $5 billion, or $4 billion after compensation and liquidator recoveries". This estimate does not include the more recent losses from advice scandals at Macquarie Bank, Commonwealth Financial Planning, National Australia Bank and ANZ that are the subject of ongoing parliamentary and regulatory scrutiny.

There have been no such scandals in the not-for-profit sector.

Previous research by APRA has found that *"In the case of a retail fund, though, the trustee (or the corporate group to which it belongs) has the strong expectation of profiting from its superannuation business. That*

---

[28] In 2008, an APRA working paper articulated the difference in governance structures and related challenges in the following way: "Unlike non-retail trustees who negotiate the best possible terms for investment management services for their funds, retail trustees who often have investment managers as executive directors on their boards have impaired incentive to negotiate best terms for investment management services. Retail pension firms are expected to maximize profit for company shareholders by setting or accepting prices for pension products (including managers' fees) within a competitive market. Note that this resolution of the multiple conflicts of interest does not imply per se that there is any breach of regulation." Wilson Sy, 'Superannuation fund governance: An interpretation', APRA Working Paper, August 2008, p 12

[29] Super System Review, *Final Report*, 2010, p 55

retail trustees must reconcile their (group's) profit motives with their fiduciary duty to act in the members' best interest gives rise to agency risk." [30]

This suggests that the poor consumer outcomes in the for-profit retail finance sector signal broader deficiencies in governance underpinned in large part by misaligned incentives.

8.2 The response to the problems has not proven effective

Since 2013 superannuation companies that are members of the Financial Service Council (including banks) have been subject to an FSC Standard requiring a majority of directors and a chair who are independent of management, the parent company, service providers within the same group, and other material service providers (more or less the definition of independence in the ASX guidelines).

Unfortunately, having a majority of independent directors on the boards of these for-profit funds has not solved their governance problems.

Testimony to the Senate Economics References Committee during the Scrutiny of Financial Advice Inquiry in 2015 revealed that serious misconduct including fraud, much of which was not reported to AISC in a timely manner, if at all, had been occurring at ANZ Bank's superannuation and wealth management business (Onepath) since 2012, CBA's superannuation and wealth management business (Colonial First State and Commonwealth Bank Financial Planning) since 2011,and NAB's superannuation and wealth management business (MLC) since 2009.

During the periods in which the misconduct occurred, the boards of each superannuation trustee, as well as the parent bank, had a majority of independent directors (as defined by FSC/ASX).

This is not to suggest there is a causal link between independent directors and misconduct, but it does establish that a mandated proportion of independent directors does not in itself achieve improved governance, or deliver a good corporate culture.

In so far as a mandatory majority of independent directors has not resolved the conflicts of interest or cultural problems in the major for-profit financial services firms (just as independent directors did not prevent misconduct or failures at other firms, from Trio to HIH), there is a case for reforms to manage their conflicts of interest.

Increased public reporting on conflicts of interests, related party transactions and all direct and indirect profits by retail super funds and their corporate parents might go some way to identify the extent to which for-profit superannuation businesses may be prioritising corporate group profits rather than super fund beneficiaries.

Imposing a requirement that all related party transactions must be conducted on terms no more favourable to the related party than would be reasonable if the fund were dealing at arm's length, and that related party transactions must be disclosed, would be a meaningful adjunct to the prudential regulation of conflicts of interest.

RECOMMENDATION 4. **All related party transactions should be disclosed and conducted on commercial 'arms-length' terms.**

RECOMMENDATION 5. **The obligations to disclose details regarding the identity of directors, their backgrounds and qualifications, and their attendance at board and committee meetings contained in section 29QB of the SIS Act should be**

[30] Kevin Liu and Bruce R Arnold, *Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets*, APRA Working Paper, 12 July 2010, Page 6.

	extended to the directors of all material service providers engaged by the RSE licensee.
RECOMMENDATION 6.	**Remuneration of directors, and key executives and highest paid employees, as appropriate, should be disclosed using listed company methodology.**
RECOMMENDATION 7.	**Super funds should disclose significant information regarding each material professional and financial service provider it retains, including the fees paid to that service provider, and whether the service provider is a related entity of the RSE licensee.**
RECOMMENDATION 8.	**Material professional and financial service providers should disclose their revenues from superannuation.**
RECOMMENDATION 9.	**RSE Licensees should be required to ensure that all related party transactions are conducted on terms no more favourable to the related party than would be reasonable if the fund were dealing at arm's length.**

9. The outcomes are inconsistent and unexpected

There is a broad understanding in the sector and among commentators that industry super funds have already gone some way to complying with the measures in the Bill, either by appointing independent chairs or, in some cases one-third independent directors. While it is true that many funds have appointed non-associated independent directors where they will add value to relevant boards, their status under the Bill is uncertain. The current classifications of industry super fund directors as either independent or representative do not correlate to the definition of independent in the Bill. ISA has assessed the implications of the Bill across the boards of five large industry super funds as an example and identified instances where:

- The entire boards of funds that are currently considered to have one-third of the board independent directors will be left with no independent directors
- Directors who currently qualify as independent, will no longer meet the definition of independent
- Directors who are currently classified as representative directors will meet the new definition of independent
- Senior professional directors that would be seen as an asset to any board would fail to meet the definition due to the fact that they sit on the boards of large employers who are likely to be employer-sponsors of the fund

Of the five funds in ISA's sample:

	HOSTPLUS	HESTA	CBUS	AUSTRALIANSUPER	MTAA SUPER
Current independent directors that are likely to cease to be independent	3	1	0		1
Current non-independent directors that are likely to classify as independent			2		3

Professional directors who would likely qualify as independent if they didn't sit on the boards of large employers		1		2	

10. The detail of the Bill

Despite our misgivings about both the objectives and the architecture of the Bill we offer the following comments on the detail of the Bill.

10.1 The core obligations

The first part of our submission details with our objections to the imposition of an inflexible quota. Proposed section 86 will also require that the chair of the fund be independent, and to comply with any APRA Standards relating to the appointment and removal processes of independent directors.

The independent Chair

Proposed section 86(1)(a) would require that the chair of the boards of all RSE Licensees meet the definition of an independent director, apparently reflecting the pivotal role of the chair.

ISA does not underestimate the important role that chairs play in leading an effective organisation. The fund chair drives strategy, ensure high ethical standards and culture of accountability, lead the board in evaluation and renewal, liaise regularly with management and build relationships with key external entities and persons. But boards should be at liberty to select the best person for this role.

There is nothing to suggest that directors who do not meet the proposed definition of an independent director are less qualified to perform the role than a director who does meet the definition.

While we are reluctant to identify individuals, there are a number of highly regarded independent chairs of large industry funds will not meet the new definition of independent, and will no longer qualify for their role.

10.2 Appointment and removal practices

The Bill would require that the appointment and removal of independent directors comply with any relevant prudential standards. It is accepted that APRA should be satisfied that a trustee is a competent trustee, and that shareholders or other bodies with nominating rights must appoint directors capable of diligently performing their role. However, this intervention into the appointment of directors impinges on the rights of shareholders to nominate the board of the companies that they own. It will also impinge on contractual relationships between directors and shareholders. In the absence of evidence of failure, lawmakers should be wary of encroaching on traditional rights.

Moreover, APRA's draft amendments to SPS 510 include changes to the regulation of director terms, management of vacancies, how boards assess director independence, the factors to be applied to determine whether a director will be reappointed, who disputes are resolved, and so forth. The draft Standard makes no distinction between the obligations that arise in relation to the appointment of directors who qualify as independent and directors who may not be included in the quota. This aligns with ISA's view that all directors should be held to a high standard and should bring independent judgement to their role.

11. The definition of independent

11.1 Ownership arrangements that impede independence -substantial shareholders

Proposed section 87(1)(a) and (b) would prohibit a person who is a substantial shareholder in an RSE Licensee from being counted towards the quota of independent directors. ISA understands this provision applies to natural persons who hold more than 5 per cent interest in a trustee.

Ownership is not, of itself, an impediment to independence of mind. Indeed, the purpose of this type of provision is more generally directed at ensuring large shareholders do not dominate board decisions to the detriment of small and minority shareholders. That is, it is directed at ensuring that boards represent shareholders with stakes in the corporation.

Such a provision has no work to do in the not-for-profit superannuation sector, and ISA welcomes the carve out contained in proposed section 87(2), which would permit a person who does not derive or expect a profit from holding their interest in the trustee, and whose interest is held as a result of holding the directorship in the trustee, to serve as an independent director. However we submit that the second limb of the carve-out is unnecessary.

11.2 Executives of the RSE, and executives and directors of related bodies corporate of the RSE licensee

Proposed section 87(1)(c)(i) would prohibit, on a three-year look back basis, executives of the RSE from serving as an independent director on the fund board.

Provisions such as this are not uncommon. They protect against management running the corporation in their own interests at the expense of shareholders (or beneficiaries) and ensure that people outside the day-to-day running of the corporation monitor and evaluate the work of management. Subject to the general concerns that we have expressed about prescriptive regulation, and subject to our view that it is generally desirable for the majority of the board to be “outsiders” this is a sensible provision. We again note that not-for-profit super funds do not appoint any executive directors to their boards.

11.3 Related bodies corporate

Proposed section 87(c)(ii) would preclude, on a three-year look back basis, executives and directors of related bodies corporate of the RSE licensee from serving as an independent director on the fund.

ISA is sympathetic to the policy objective that appears to underpin this provision – that is, to manage related-party conflicts that arise where individuals serve as executives and directors of multiple entities within vertically integrated corporate groups. Ideally these would be managed through a trustee’s conflicts policies, which would typically disqualify these individuals on the grounds of an unmanageable conflict rather than their position description.

11.4 Related bodies corporate within vertically integrated for-profit entities

Conflicts within conglomerates are not confined to instances where related parties transact with each other. Conflicts can also arise where the remuneration of an executive or director of the related entity is linked with the success of the common parent. There is a real risk that the introduction of the Bill will divert attention from the need to manage these conflicts.

In ISA's submission, particular attention should be paid to the conflicts that can arise where:

- A director of the RSE is also a director or executive of one or more sibling entities, but is dependent upon the common parent for his or her remuneration;
- A director of the RSE is also a director or executive of a sibling entity, and has some portion of his or her remuneration linked to the financial success of the common parent; or
- A director of the RSE derives a significant proportion of their livelihood from holding multiple directorships within the conglomerate, rendering them financially dependent on, and therefore not independent of, the parent entity.

There is a risk of confusion. The legislation will impose a strict test of independence which precludes any executive of a related body corporate sitting as an independent director. The Prudential Standard will impose a modified test of non-executive director that will permit executives of related bodies corporate to vote alongside independent directors. It will be important if the legislation and regulations proceed, for the Government to ensure absolute clarity about the prohibition on executives and directors within a conglomerate to serve as independent directors.

11.5 Related bodies corporate in a not-for-profit environment

In not-for-profit funds it is common for directors to serve on the boards of wholly or partly owned entities, to ensure that those entities act in the interests of the fund. The Bill would require funds to identify and nominate replacement directors on these subsidiary boards, or to substantially reorganise their operating model.

These subsidiaries operate solely for the benefit of trustee, and ultimately the fund beneficiaries. They provide both material services, such as administration services[31] or investment management services [32] and non-material services [33] such as financial planning services to fund members. [34] Some of the subsidiaries are established to hold assets on behalf of the fund in a separate structure for risk-management, tax, insurance or other reasons.[35]

For efficiency and governance reasons, some or all of the directors of the trustee also serve as directors of the subsidiary.

These entities generally serve no other clients than the RSE Licensee, and ISA understands that any operating profit is reflected in the value carried by the RSE parent and, ultimately, in fund members'

---

[31] For example UniSuper Management Pty Ltd is a wholly owned subsidiary of UniSuper Limited

[32] For example Cbus Property Pty Ltd is wholly owned by Cbus

[33] Energy Super has appointed its wholly owned subsidiary ESI Financial Services Pty Ltd (ESIFS) to provide Energy Super's contact centre operations, financial advisory services and member education services,

[34] First State Super Financial Services Pty Ltd is a wholly owned subsidiary providing financial planning services to First State Super members

[35] For example, HOST-Plus Property Pty Ltd and Host-Plus Investments Pty Ltd

accounts. The interests of the subsidiary and of the parent are completely aligned, and it is hard to see how any conflict of interest arises in these instances, as all duties are ultimately owed to the same beneficiaries.

There is no obvious policy rationale to preclude a director serving concurrently on the board of the RSE and of the subsidiary and retaining his or her standing as an independent director.

Indeed, there are strong governance grounds to permit such dual appointments. It is common for fund directors to be appointed to the board of these subsidiaries to ensure board oversight of the subsidiary entity, and provide a check on management powers. To implement this provision unamended would be to diminish rather than enhance the governance arrangements within the RSE.

11.6 Subsidiaries that provide services to non-fund members

Proposed section 87(c)(ii) would preclude an independent director sitting on the board of a wholly owned subsidiary that provides services to people other than fund members, such as the PSTs. In these instances, a director of the trustee will be unable to sit as an independent director of the PST.

ISA recognises that these structures can give rise to divergent duties between duties to the members of the fund and duties to investors in the PST. However, we submit the rigid application of proposed section 87(c)(ii) would unnecessarily disturb the governance arrangements in place within these RSE licensees, and may discourage otherwise prudent developments aimed at gaining scale, and leveraging this in members' interest.

11.7 Joint ventures/collective vehicles

Industry super funds have collectively established entities to provide services to the funds, leveraging scale, skill and cash to efficiently provide services to fund members. The constitutions of some of these collectively owned entities confer a right on the funds to appoint directors to the board of the collective entities, and this role is traditionally performed by one of the directors of the fund.

In our submission, there are material differences in the governance issues that arise in respect of related bodies corporate in the not-for- profit and for-profit context.

Where a not-for-profit fund establishes a related entity to provide services to it - either alone or as a joint venture – the service provider is akin to a business unit within the fund whose sole purpose is to support the objectives of the fund (or funds). Multiple directorships in this case do not enliven conflicts, as the only purpose of the entity is to deliver value to the funds and their members.

The difference between this and the appointment of a director or executive officer of a related body corporate that is established to deliver a profit could not be starker. In that case, their duty to promote the commercial success of the service provider is in conflict with the interests of the beneficiaries.

Directors appointed to the boards of these entities in the not-for-profit sector provide a crucial link between the funds and the collectively-owned service providers, ensuring control by the trustees over the quality and pricing of the services provided to it by the service provider. These alliances operate as joint ventures serving the collectively agreed needs of their joint owners rather than any external shareholders. We would be concerned if the appointment to the board of a collectively owned entity rendered an otherwise independent director no longer independent.

This is not to argue that these arrangements do not give rise to conflicts, but rather that the conflicts are manageable and that application of a blanket rule may reduce the efficiency of these entities, to the detriment of members. Indeed, APRA research has found that on average not-for-profit funds relying on these related party service providers pay market rates for the services provided. This suggests that not-for-profit boards have managed the conflict effectively, ensuring fund members'' interests are paramount.

This is in contrast to the for-profit sector, where APRA has found retail trustees pay significantly higher fees to related party service providers[36].

Again, ISA would be concerned if the new standard rendered a director no longer independent simply by virtue of being appointed to the board of the service provider.

11.8 Material business relationships

Proposed section 87(1)(d) would exclude, on a three-year look basis, people that have material business relationships with the RSE trustee from serving as an independent director.

Proposed section 87(1)(e)(i) would extend this to executives and directors of entities with a material business relationship with the RSE Licensee, and section 87(1)(e)(ii) would extend to employees of the entity involved in the business relationship.

These provisions have been significantly re-drafted since the Exposure Draft Bill, and avoid many of the pitfalls identified in that draft. Nonetheless, there are circumstances where it will be in the best interest of the fund for a person who has an association with a service provider to serve on a board, and trustees should be free to make this decision in light of all the circumstances.

11.9 Employer-sponsors

Proposed section 87(1)(f)(i) would exclude, on a three-year look back basis, executives and directors of employer-sponsors who employ (directly or through related entities) 500 or more contributing members of the fund, on the grounds that it is desirable to ensure directors are independent of sponsoring employers.

This exclusion is problematic.

First the relationship between employer sponsors and funds rarely gives rise to any interest or duty that would compromise independence.

Second, if it were sensible to exclude certain employer sponsors, then a relative rather than absolute threshold would be preferable.

Third, an employer sponsor may have no control or line of sight to the number of fund members at their workplace. There are a range of factors that affect the number of contributing members from day to day – including seasonal variations in employment at the employer sponsor and individual member choice of fund. Indeed, a director's status as an independent director could vary from week to week as members join the fund or cease contributions.

11.10 Employer organisations, unions and member representatives

Proposed section 87(1)(f)(ii) and (iii) provides that executives and directors of organisations that nominate or appoint directors cannot serve as independent directors, on the grounds that it is desirable that directors be independent of bodies with nominating rights.

---

[36] APRA, Working Paper - *Australian superannuation outsourcing – fees, related parties and concentrated markets*, Kevin Liu and Bruce R Arnold, 2010 & APRA, Working Paper - *Superannuation and insurance: Related parties and member cost*, Kevin Liu and Bruce R Arnold, 2012

It is difficult to identify a sound public policy rationale for this provision. The mere existence of the right to nominate directors to the board does not create a conflict of interest or duty. This is particularly true in light of the proposed abolition of the equal representation provisions.

Put simply, if the law no longer confers any special rights or privileges that will encourage the appointment of member or employer nominated directors, there is no rationale for imposing barriers to the appointment of member and employer nominated directors.

12. APRA's powers

The Bill gives APRA power to:

- Make Prudential Standards in relation to appointment and removal processes;
- Determine, on application of the trustee, whether an individual is likely;
- Determine, on its own motion, whether an individual is unlikely to be able to exercise independent judgement in performing their role; and
- Issue directions to comply, and to suspend or terminate the licensee's ability to receive contributions.

Industry super funds have generally supported the role that APRA performs in developing and administering its standards and guidance.

12.1 APRA's powers to determine an individual can or cannot exercise independent judgement

The Bill would confer upon APRA, power to determine that an individual is or is not independent for the purpose of compliance with the Act.

The test that APRA applies is not whether the person meets the statutory definition, but whether the person is capable of exercising independent judgement.

The Explanatory Memorandum suggests APRA will be afforded these powers to cater for "*situations where a person's capacity to exercise independent judgement is clear but for reasons such as timing, restructures, and mergers and acquisitions.*" It goes on to claim these powers would be used "*where a person's circumstances means they do not meet the independence requirements, but they are considered to be capable of exercising independent judgement*."

That is, it allows APRA to consider all of the circumstances, and ignore the statutory test where it makes sense to do so. The existence of these provisions highlights the inherent problem with the rigid statutory definition of independence. They provide a "workaround" to the problem that could be readily avoided through non-prescriptive, principles based regulation.

These powers are far in excess of the powers that APRA enjoys in respect to ADIs and insurers, where boards self-assess whether directors meet the test of independence, and APRA's capacity to determine independence is enlivened only where the board is in doubt and refers the matter to APRA. [37] No reason is offered for the differential treatment.

[37] APRA, Prudential Standard CPS 510 (paragraph 25 & 26)

It is hard to understand the grounds on which APRA – who is unlikely to be in possession of all of the facts – could override the trustee's judgement about an individual's capacity to perform their role with independence. We note that the legislation does not provide for the trustee to be notified that APRA intends to make a determination, nor provide for a right to be heard.

A trustee may apply to APRA for a determination that a person who does not meet the statutory test is nonetheless independent. Proposed section 89(6) provides that where APRA fails to determine an application by a trustee within the prescribed time, the person is presumed to be not independent. This provision could discourage funds from seeking certainty, and should be removed.

ISA is particularly concerned about APRAs powers to determine, on its own motion, that that a person is not independent. The Explanatory Memorandum suggests APRA will rarely be called upon to exercise these powers, because the definition in section 87(1) provides sufficient certainty to trustees to have confidence that the director they have appointed meets the independent test. Frankly, this is disingenuous. First, APRA's powers are not limited to consideration of whether a person meets the test, and second, as noted above, on the Government's own admission there will be circumstances where there is a need for a more flexible application of the notion of independence.

12.2 APRA's new compliance powers

Finally, the proposed powers for APRA to issue a notice to comply or to direct an RSE Licensee to not accept contributions proposed will apply to non-compliance with the prudential standard relating to director appointment and removal.

APRA's powers to suspend or remove a trustee are generally linked to the financial stability of an entity, and it is incongruous that this standard would have a stand-alone compliance regime. Put simply, it is hard to see how a well-functioning, highly competent but non-compliant board poses such a different prudential risk than other standards as to warrant new a compliance regime.

13. Transition period

The Bill provides for a very short transition period, with trustees required to comply in full within three years of the date of Royal Assent, with APRA empowered to extend the period on a case-by-case basis.

The transition period is too short, and raises the risk that boards will have to prioritise compliance with the new law over other competing demands related to board renewal and continuity. Meeting the new obligations is certain to disrupt existing renewal and succession plans. Plans to fill gaps in skills or experience may be abandoned in favour of meeting the demands of the legislation.

14. Other matters

14.1 Voting requirements

A key to the effective workings of representative boards is the requirement that decisions of the boards of representative trustees be made by a two-thirds majority vote. This requirement has provided the basis for consensus based decision-making in representative trustees, assisting in guarding against inappropriate risk taking, and ensuring that diverse not-for-profit boards come together in the interests of members.

The Government has also indicated that, if the Bill is enacted, Regulations would follow that would remove the current requirement that decisions of the boards of representative trustees must generally be made by a two-thirds majority vote. Along with the requirement for one-third independents, this would completely undermine the not-for-profit model.

14.2 Independent directors on committees

The draft APRA Standards signal an intention to require independent directors to comprise one third of the audit and remuneration committees.

ISA opposes this as an unwarranted intrusion into the workings of the fund that would undermine the ability of boards to allocate work according to the skills of the particular directors and their availability to take on a particular workload. It would be counter-productive if, for example, an independent director recruited because of his or her investment expertise was unable for workload reasons to serve on an investment committee, as they were required to serve on audit and remuneration committees.

14.3 "If Not, Why Not" a majority of independent directors

A foreshadowed Regulation under the Corporations Act would require all funds to report publicly each year on whether they have a majority of independent directors, and if not why not. This appears to be supported by a mistaken assumption that "best practice" governance of super funds involves having a majority of [non-associated] directors.

In contrast, "best practice" governance for pension funds is an equal representation model where all directors are non-associated. The avoidance of misconduct and quality of performance in funds governed by representative boards in Australia is confirmation of this, but it is also the case that across the OECD, pension funds are commonly governed by representative trustees as a result of private ordering: the natural stakeholders of pension funds have repeatedly decided to govern funds in this way.

The proposed requirement would make bad law. It would require funds to report against a standard that is not required of them, and may create a perception that a trustee who has complied with proposed section 86(1) is nonetheless avoiding its legal obligations.

Conclusion

The proposed legislation is a significant departure from the flexible, principles-based approach to corporate governance that has served Australia well. The legislation removes the successful representative trustee model, while failing to address the real governance shortcomings that arise in the delivery of superannuation within in vertically integrated for-profit financial institutions.

The proposed changes are not supported by any evidence, will not achieve their stated policy objectives, and suffer from a number of unworkable provisions.

The Government should not proceed with the Bill.

REFERENCES

APRA, Superannuation Fund-level Profiles and Financial Performance - interim edition 2014, 20 May 2015

Australian Institute of Company Directors, Submission of the Australian Institute of Company Directors to the Financial System Inquiry, dated 31 March 2014

Australian Prudential Regulatory Authority, Response to Submissions - Fund level disclosure from the APRA superannuation statistics collection, APRA, 2009

Banks 'deserve what they get', says regulator, Financial Times, June 21, 2015 2:17 pm, https://next.ft.com/44b666a0-16a1-11e5-b07f-00144feabdc0

Byres, Wayne, 'The post-crisis reform agenda – a stocktake', APRA Chairman address to the Symposium on Asian Banking and Finance, Singapore, May 2015

Coleman, A., Esho, N. and Wong, M., 'The investment performance of Australian superannuation funds', APRA Working Paper, APRA, 2003

Dr Sally Wheeler, Do we really need 'Independent' directors on super boards?, Queens University Belfast, September 2013 http://www.clmr.unsw.edu.au/article/accountability/corporate-governance/do-we-really-need-independent-directors-super-boards

Ellis, K., Tobin, A. and Tracey, B. 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', APRA Working Paper, APRA, October 2008

Fischer Marc-Oliver and Swan Peter L, 'Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment', Australian School of Business, University of NSW 18 November 2013

Grattan Institute, Super Savings, April 2015

Harper, Joel T., 'Board of Trustee Composition and Investment Performance of US Public Pension Plans', Rotman International Centre for Pension Management, February 2008

Industry Super Australia, In members' best interests: ISA submission to Government discussion paper, February 2014, http://www.industrysuperaustralia.com/assets/Submission/120214-ISA-Submission-Governance.pdf

Koerniadi, Hardjo and Tourani-Rad, Alireza, 'Does Board Independence Matter? Evidence from New Zealand', Australasian Accounting, Business and Finance Journal, 6(2), 2012, 3-18

Lawrence, Jeffrey, and Stapledon, Geof, 'Do Independent Directors Add Value?', Centre for Corporate Law and Securities Regulation Faculty of Law The University of Melbourne 1999

Leibler, Jeremy, 'Let's drop independence obsession', The Australian October 16, 2013

Liu, Kevin , Governance and Performance of Private Pension Funds: Australian evidence, School of Risk and Actuarial Studies, University of New South Wales, Australia, 2014 http://papers.ssrn.com.ezlibproxy.unisa.edu.au/sol3/papers.cfm?abstract_id=2484380

Liu, Kevin, and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', APRA Working Paper, 12 July 2010

McKell Institute, The Success of Representative Governance on Superannuation Boards, 2014

Mercer, Governance of Superannuation Funds A report on independence requirements for trustee boards, May 2015 http://www.mercer.com.au/content/dam/mercer/attachments/asia-pacific/australia/Governance/Governance-Independent-Report-0515.pdf

Productivity Commission, Default Superannuation Funds in Modern Awards Inquiry Report, No. 60, 5 October 2012

Super System Review, Final Report, 2010

Sy, Wilson, 'Superannuation fund governance: An interpretation', APRA Working Paper, August 2008

Sy, Wilson. & Liu, K., 'Investment performance ranking of superannuation' APRA Working Paper, APRA 2009

Tung, Frederick, 'The Puzzle of Independent Directors: New Learning', Boston University Law Review, Vol. 91, No. 3, pages 1175-1190, May 2011

ATTACHMENT A – CRITIQUE OF FSI EVIDENCE

The research relied upon by the Financial System Inquiry does not support the thesis that replacing representative trustees with "independent" trustees improves governance or fund performance. In particular, the Final Report cited the research by Ambatchtsheer in 2007 which links good governance and pension fund returns.[38] However, in the updated research in 2008, it is clear that Ambatchtsheer and his co-authors have not included the proportion of independent directors as a measurement of quality governance. Instead, a board's quality is measured by CEO views on trustee skills, experience, appropriate behaviours and the right motivations.[39]

Indeed, it should not be assumed that the imposition of independent directors or chairs will add value in all instances.

Most recently, a study by the McKell Institute examined the relationship between governance structures in the superannuation sector and fund performance. The research found a strong relationship between the existing representative structure of industry funds and the higher levels of returns delivered by the not-for-profit sector. [40]

The research found that the evidence does not support the view that mandating independent directors on not-for-profit superannuation funds would improve fund performance. Instead, research and empirical data suggests strongly that the representative trustee governance structure of industry and other not-for-profit funds is actually the model that most closely satisfies the objectives of meeting the best interests of members and maximising retirement incomes for Australians.

As well as generating higher net returns for fund members, the representative governance model has promoted higher levels of diversity among trustees, and more effectively minimises conflicts.

Further, the research concluded that the most serious structural issues in governance are found in the retail sector. These issues include:

- Greater prevalence of multiple directorships on the boards of retail funds
- Retail fund directors spend much less time of fund matters
- Retail fund directors are commonly employed by the fund or employed by service providers to the fund, creating a conflict of interest
- Service providers to retail funds are much more likely to be related entities to the fund

In addition, a separate study looking at the governance and performance of APRA-regulated funds found no evidence that board independence and chairman independence affect funds' performance.[41]

Research on US public pension plans indicates that board composition has an effect on asset allocation and funding levels of US pension plans. Specifically the research suggests independent directors possess different investment beliefs and risk appetites than representative trustees. Significantly the research

---

[38] Ambachtsheer, K, 2007, Pension Revolution: A Solution to the Pensions Crisis, John Wiley & Sons, Hoboken

[39] Ambachtsheer, K, Capelle, R. and Lum, H., 2008, The Pension Governance Deficit: Still with Us. Rotman International Journal of Pension Management

[40] McKell Institute, The Success of Representative Governance on Superannuation Boards (2014)

[41] Liu, K., 2014, Governance and Performance of Private Pension Funds: Australian evidence, School of Risk and Actuarial Studies, University of New South Wales, Australia

found a higher proportion of representative trustees (and by implication a lower proportion of outside independent trustees) had "a positive effect on funding levels of the pension plans and are more focused on a stable, sustainable plan to provide future benefits". [42]

Moreover, empirical research on US public pension funds indicates that the proportion of "outside" trustees on the board has no significant relationship with funds' excess outperformance. [43] Other research studies undertaken by international and Australian academics also show that the introduction of majority independent arrangements on boards either adds limited or negative value to boards.[44]

[42] Harper, J., 2008, Board of Trustee Composition and Investment Performance of US Public Pension Plans. International Centre for Pension Management

[43] Harper, J., 2008, Board of Trustee Composition and Investment Performance of US Public Pension Plans. International Centre for Pension Management

[44] Frederick Tung of the Boston University School of Law (2011) suggested that there was no solid empirical evidence to suggest that independent directors add value

Fischer and Swan (2013) concluded that the introduction of independent directors resulted in large and statistically significant falls in performance indicators. The study compared the performance of 969 Australian companies over the nine years to 2011, including 561 that changed their board structure following the introduction of the ASX's "if not why not" guidance. The work found that the application of the five per cent rule that determines a board member not to be independent if they hold more than five per cent of the companies wealth combined with the adoption of ASX guidelines for majority independent directors has "destroyed considerable shareholder wealth in the order of $69 billion or more."

Wheeler (2013) questions the value of board independence. She suggested that structural rules on board independence "fail on all account" since board tends to choose "people with the same professional training and experience base as themselves. […]So you don't get the cognitive diversity that comes from different perspectives and experience, you just get more of the same. It doesn't address relationship conflict."

ATTACHMENT B – REGULATORY IMPACT ANALYSIS

Contents

Table of Tables

1. Executive Summary

The proposed *Superannuation Legislation Amendment (Governance) Bill* requires a number of changes to fund governance. In meeting these changes funds will incur a number of costs that for not-for-profit funds, will be ultimately born by their members.

These costs relate to higher director fees for both replacement and additional directors who meet the proposed definition of independence, additional recruitment and training costs, and administrative and legal costs.

The total implementation cost over the first five years of reform is estimated to be between $89 and $168 million.

The reform will impact an estimated 101 not-for-profit funds (corporate, industry and public sector funds), with secondary costs impacting 147 retail funds.

The most significant and costly change is an estimated increase in the number of non-chair independent directors of 57 per cent, and an estimated increase in number of independent chairs of 35 per cent across all superannuation sectors, including retail.

This estimate of implementation cost does not include the very likely consequence that the proposed changes will result in lower net returns given that the funds impacted most significantly (corporate, industry and public sector funds) have achieved consistently higher net returns for their members over the last 17 years, as compared to the funds less impacted by the proposed changes.

Against this estimate of direct compliance costs associated with these proposed changes, absolutely no evidence has been presented in the explanatory material released so far to demonstrate that the proposed changes will result in benefits to members.

2. Introduction

Australia's superannuation system manages the retirement savings of over 13 million people. The pool of savings is currently just over $2 trillion in total assets.

The majority of these savings, $1.2 trillion, are in funds regulated by the Australian Prudential Regulatory Authority (APRA). The majority of these assets, $715 million, are in turn managed by funds that are governed by representative trustees.

Representative trustee funds are defined by their governance structure in which employer and employee representatives are equally represented on the trustee board. These funds include corporate funds, industry funds and public sector funds.[45] In legislation they are referred to as standard employer-sponsored superannuation funds.

Over the last 10 years, funds governed by representative trustees have outperformed funds governed under the alternative governance structure (retail funds) by on average two per cent per annum.[46] Retail funds are governed by trustees that reflect the governance models of the major banks (often their parent companies) and other publicly listed companies.

Under current legislation funds operating under the representative model are able to appoint one director who is neither an employer or employee representative, i.e. an "independent director" under current

[45] Some public sector superannuation schemes are not regulated by APRA but rather under their own specific legislation.

[46] APRA, *Superannuation Fund-level Profiles and Financial Performance*, 2014 and ISA analysis

definitions.[47] In reality, however, funds may appoint independent directors through an application to APRA or if such an appointment is permitted under the individual fund's governing rules and requested by the employer or employee representatives on the board. Boards of Registrable Superannuation Entity (RSE) licensees acting as trustees of APRA regulated superannuation must regularly review their governance arrangements. This has been a requirement since the introduction of APRA licensing regime s in 2006, with further enhancements to prudential oversight and governance standards introduced in 2013 as part of the Stronger Super reforms.

Representative trustee boards have evolved over the past twenty years. This evolution has included an increased use of independent directors and independent chairs where the trustee has formed the view that this would improve the skills matrix of the board and or improve board dynamics whilst maintaining the positives flowing from the representative character of the board.

In 2014, approximately half of all representative trustees had at least one independent director.[48] Just over one third of representative trustees had an independent chair.

3. Proposed Change

3.1 The *Superannuation Legislation Amendment (Governance) Bill*

The proposed *Superannuation Legislation Amendment (Governance) Bill* provides that all boards of RSE licensees acting as trustees of APRA regulated superannuation funds, including standard employer-sponsored superannuation funds, are required to have a minimum of one-third independent directors and an independent chair. Where the licensee is a group of individual trustees, one-third of these individuals must be independent. The definition of "independence" is the proposed Bill is far broader than the both the current definition in the SIS Act (independent of stakeholders i.e. employer and employee associations), and the definition used in the FSC Code for the retail sector (independent of management, parent companies and material service providers).

The definition of "independence" in the proposed *Bill* excludes anyone is employed by an entity with a material relationship with the fund. These entities would include management, service providers and a number of others including sponsoring organisations. The determination of "material" is made by ARPA in prudential standards. It is proposed that APRA will also have the power to make a determination regarding whether an individual trustee satisfies APRA that they can exercise independent judgement, at their own motion. Due to the breadth and discretionary element in the proposed definition/process, it is impossible to determine for every case whether a trustee director currently classified as independent (under SIS or the retail definition) would be classified as independent under the proposed definition.

---

[47] As noted by the Explanatory Guide of the proposed Bill 'the current definition of "independent director" under the SIS Act is designed to achieve independence from stakeholders (i.e. employers and members and their representative organisations) rather than independence from management, service providers and advisers.' In the retail sector, which has not stakeholder representation, "independence" currently means independent of management, service providers and advisers

[48] This is based upon the sample of 45 funds used in this analysis. APRA has previously reported that at June 2013, 34 per cent (35 out of 103) of RSE licensees with an equal representation board had an independent director. See APRA, *Annual Superannuation Bulletin June 2013* (revised 5 February 2014). Note that the definition of independent trustee used in this calculation is narrower than the definition contained in the exposure draft Superannuation Legislation Amendment (Governance) Bill 2015 and associated material.

3.2 Impact analysis and the *Australian Government Guide to Regulation*

Regulatory impact analysis is a crucial element in policy development, as it tests the evidence base for reform and ensures a degree of rigour in the reform process. Regulatory impact analyses are the key feature of the 2014 *Australian Government Guide to Regulation* and are required of all reform proposals by government regulatory agencies.

The 2013 discussion paper *Better regulation and governance, enhanced transparency and improved competition in superannuation* which informs the current Bill specifically requested estimates of the costs incurred in complying with reform proposals for superannuation governance. Moreover, it committed the Government to "ensuring all regulatory measures undergo a Regulatory Impact Assessment, to establish the precise impact of regulation".[49]

However, the draft legislation, draft regulation and explanatory guide do not include any assessment of associated costs and benefits of the proposed reforms. This analysis provides a regulatory impact assessment for the proposed reforms.

4. Methodology

4.1 Categories of costs

In implementing the proposed governance reforms, affected funds will incur two kinds of costs: (i) transitional costs, particularly the costs to search for, recruit, and train a greater number of new chairs and trustee directors than would otherwise be the case, and (ii) ongoing costs, particularly assumed higher average salary costs of independent chairs and trustee directors.

There also are potential costs that relate to the substance of the proposal. Representative trustees are associated with superior long-term net performance relative to funds with non-representative governance models, including those with a majority of independent directors. Long term performance data provides an unequivocal basis for this fact. We have not included the costs of reduced performance in this analysis but have focused solely on the costs associated with the need to recruit additional trustee directors, pay their salaries and meet the requirements of the reform in respect to legal and administrative processes.

4.2 Population of Affected Funds

This regulatory impact assessment considers the processes which funds must undertake to comply with the proposed law within the transition period. For each of the processes, the costs incurred by the superannuation funds, and ultimately their members in the case of not-for-profit funds are estimated. As many of the processes do occur within funds in a business as usual scenario, the cost estimates are for costs in excess of a business as usual scenario.

The explanatory statement accompanying the Bill indicates the intended target of the reforms is the representative trustee sectors. While some retail funds will incur costs associated with these reforms, this analysis takes a conservative scope in only considering the intended target of not-for-profit representative funds. Hence, the for-profit retail sector funds are not included in the affected population in this analysis,

[49] *Better regulation and governance, enhanced transparency and improved competition in superannuation*, Discussion Paper, 28 November 2013, Treasury, p 7

although changes in the demand for independent directors may impact fees they charge across all sectors of the superannuation industry, including retail. This factor is included as a sensitivity analysis.

The population of affected funds is anticipated to be 101 funds in the following sectors:

- 44 industry funds
- 38 corporate funds
- 19 public sector funds

A survey of 45 funds, representative of the three different APRA regulated sectors (corporate, industry and public sector) which use equal representation trustees was used to inform the estimates under the reform scenarios. The sample includes 26 industry funds, 13 corporate funds and 6 public sector funds. The parameters determined by the survey are included in Table 1 below.

Under the draft Bill, APRA is given power to determine which relationships will fall within and outside the definition of independent. Hence, there is a level of uncertainty regarding whether trustee directors who are currently considered independent under the SIS Act and the constitutions of particular RSEs will meet the new definition of independence, or whether current directors not currently considered independent will meet the definition following reform. However, the current analysis assumes no change in the number of directors who are currently classed as independent/not independent under the reform scenario.

Table 1 – Summary statistics of fund and trustee parameters

Summary Stats	Industry	Corporate	Public Sector	Overall
Population of affected funds	44	38	19	101
Number of funds in sample	26	13	6	45
Average trustee size - current	9.62	7.00	8.17	8.36
Number of funds with at least one independent trustees	17	3	3	51%
Average number of independent directors per trustee	0.96	0.54	0.83	
Average proportion of independent trustees	9.68%	6.22%	10.19%	
Proportion of funds with an independent chair	42.31%	23.08%	50.00%	37%
Average number of independent trustees (excl chair)	0.54	0.31	0.33	
Average proportion of independent trustees (excl chair)	5.10%	2.37%	4.17%	
Average trustee size - reform scenario	10.27	9.62	9.00	

Source: APRA, RSE Disclosures and ISA analysis

4.3 Reform Scenario

Affected funds may meet the requirement to have a minimum of one-third independent directors and an independent chair on their boards in two ways:

1. They may maintain their existing trustee size and substitute existing trustee directors and/or chair for new directors who meet the new definition of independent trustee directors
2. They may increase the size of their trustee board through adding additional trustee directors.

In practice, the implementation across the population of affected funds will likely involve a combination of these approaches. Trustees of relatively small size may increase in size, whereas larger trustees may exclusively substitute.[50]

[50] APRA are also likely to weight against large increases in trustee size or the emergence of very trustees in response to this reform.

The reform scenario used in this analysis takes into account the combined response of substitution and addition of trustee directors. Funds with fewer than nine trustee directors will comply by both adding trustee directors up to a trustee size of nine, and substituting trustee directors. Funds with nine or more trustee directors will exclusively substitute trustee directors.

The reform scenario will result in:

- The appointment of 64 replacement independent chairs
- The appointment of 247 replacement independent trustee directors, and 48 new additional trustees.

Table 2 shows these appointments broken down by sector.

Table 2 – Number of new appointments under reform scenario

Reform Scenario	Industry	Corporate	Public Sector	Overall
Number of Replacement Chairs	25	29	10	64
Number of Replacement Independent non-chair Trustees	119	82	46	247
Additional New Independent non-chair Trustees	10	33	5	48

Source: APRA, RSE Disclosures and ISA analysis

The increase in the number of both independent chairs and independent non-chair trustee directors is significant. It is estimated that that there is currently 520 trustee directors serving as independent directors under current definitions: 79 on the trustees of the affected funds population specified above and 441 on the trustees of retail funds. For trustees serving as independent chairs, under current definitions, there is estimated to be 184: 37 on affected funds and 147 on retail funds.[51] Hence, the increase in non-chair independent directors under the reform scenario is estimated to be 57 per cent, while for independent chairs the increase is estimated to be 35 per cent.

4.4 Implementation Costs

The full parameters and assumptions underlying cost estimates is provided in Table 5.

4.4.1 Recruitment

The additional cost of recruiting new independent trustees would be equal to the difference between the recruitment costs under normal trustee director renewal processes and the recruitment costs incurred appointing the required independent trustees within the transition period.

Typical board renewal policies state a maximum tenure of between 9 and 12 years.[52] For a trustee with between 8 and 9 trustee directors, an average constant appointment rate for directors is between 0.75 and 0.90 per year. Due to the significant and rapid increase in demand for independent directors, prudent funds are anticipated to recruit (and train) new independent directors within the first two years of the three year transition period. Therefore, under a business as usual scenario, between 1.5 and 1.8 trustee directors would be appointed during the transition period. To take this into account, the number of new

[51] The estimates for the retail sector are based upon APRA statistics at June 2014 and an assumption of one independent chair per fund and three independent non-chair trustee director per fund (this equates for four independent directors per fund in the retail sector where the average trustee size is estimated to be 7 based upon the survey of 11 major retail funds.

[52] Typical renewal polices are nine years (three three-year terms), 10 years (two five-year terms), or 12 years (three four-year terms) after which the board can continue to extend tenure under specified circumstances.

independent directors required has been reduced by 1.75 for each fund for estimating recruitment and training costs.

The current industry benchmark for recruitment is a one-time cost of between $20,000 and $30,000.[53] This cost is the same regardless of whether the recruitment is done in-house or using a recruitment agency.

4.4.2 Training

The additional cost of training the required independent directors is estimated in the same way as recruitment costs.

The current industry benchmark for training is between $10,000 and $15,000.[54]

4.4.3 Termination Costs

Under the assumptions detailed in section 4.4.1 Recruitment, 48 independent trustees must be appointed in addition to those that replace existing positions under business as usual. These 48 appointments may require a corresponding 48 terminations. Termination fees have not been a feature of the governance practices of industry super funds, however in other sectors terminations may incur costs depending on the contractual arrangements.

ISA has been unable to source cost estimates for terminations and therefore have not included these in the analysis.

4.4.4 Trustee Director Fees

The reform is predicted to lead an increase in director fees. This is due to differences in fee rates between representative chairs and independent chairs and non-chair representative directors and non-chair independent directors.

The following fee rates (Table 3) have been determined by a survey of 45 funds, representative of the population of funds governed by representative trustees, and 11 trustees of major retail funds.

Table 3 – Average Current Chair and Independent Director Fees

Trustee Position	Corporate	Industry	Public Sector
Average Chair annual fee (representative sectors)	$14,911	$87,940	$85,572
Average non-Chair annual fee (representative sectors)	$14,053	$50,959	$51,662
Average Independent Chair annual fee (excluding corporate)		$120,029	
Average Independent non-Chair annual fee (excluding corporate)		$79,440	

Source: RSE Disclosures and ISA analysis

Note: Corporate Funds have been excluded from the Independent Chair and Independent non-chair fee averages because the sample size is small and disclosed fees are atypical compared to the two other representative sectors (industry and public sector) and the retail sector within which independent chairs are more common. These fee estimates do not take into account additional fees for committees of the board which are likely to increase under APRA's proposed changes to SPS 510 to require that a majority (including the chair) of both the Board Audit Committee and Board Remuneration Committee be independent directors. All figures are in 2013/14 dollars.

---

[53] Industry Super Australia has surveyed funds and industry consultants to determine this range.

[54] Industry Super Australia has surveyed funds and industry consultants to determine this range.

The average independent chair fee and independent non-chair fee are used for the reform scenario. The cost for each sector will be the difference in the current fee and the fee under the reform scenario, multiplied by the number of new independent chairs and new independent directors under the reform scenario.

In addition to the direct costs of increasing the number of independent directors on equal representation trustees, on a broader scale this rapid demand for independent superannuation trustee directors is likely to bid up independent director remuneration and flow through to all independent directors. This is due to two factors.

First, the required increase in independent directors is significant. Across the affected funds and retail funds, the estimated increase in the number of non-chair independent directors industry wide under the reform scenario is estimated to be 57 per cent, while for independent chairs the increase is estimated to be 35 per cent.

Second, the supplier response to wages is highly inelastic for specialised services, such as being a superannuation trustee director. That is, general speaking, there are relatively few people with the appropriate skill level and background, and therefore larger movements in fees are required to attract greater work effort. This is a standard result in labour economics.[55] The supply of appropriate candidates will ultimately depend on the definition of excluded persons.

There appears to be few directly relevant Australian studies that address the link between independent directors, work effort and remuneration. Linck et al 2008 uses United States public company data on 8000 firms to find that regulatory reforms imposing greater independence significantly drive up the cost of corporate boards.[56]

In the absence of a precise estimate of the regulatory impacts on Australian super fund boards, we have assumed that independent director fees increase from current average fees to the 80th percentile fees of retail fund non-chair independent directors. Chair fees increase to $125,000.[57] The immediate fee impact is assumed to take immediate effect.

4.4.5 Legal and Administrative Costs

RSE licensees acting as trustees of APRA regulated superannuation funds will need to amend trust deeds and articles of association under the reform scenario. In addition, they must update publications including Product Disclosure Statements and websites. The additional cost of implementing these changes is assumed to be $14,000 per fund based upon stakeholder feedback.

4.4.6 Transition plan

The proposed Bill requires funds to comply with transition requirements to be prescribed by APRA under SPS 512. These requirements will include submitting a Transition Plan by July 1 2016. The Transition Plan must include assessment of the status of each current director, what changes are needed to meet new requirements, steps that the board will take by the end of the transition period to ensure compliance. The additional cost of meeting the requirements under SPS 512 are assumed to be $20,000 per fund based upon stakeholder feedback.

---

[55] Richardson, S, 2007, *What is a skill shortage?,* National Centre for Vocational Education Research (NCVER), 2007

[56] Linck, J, Netter, J & Yang, T, *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand of Directors, Oxford University Press on behalf of The Society for Financial Studies, 2008, p 3298*

[57] There is insufficient data from which to calculate a meaningful estimate for the chair uplift, either using the 80th percentile for independent chairs or premium rates for chairs across all sectors. Such metrics produce figures between $150,000 and $200,000.

5. Estimates

Table 4 shows the cost estimates, expressed as a range, for each item under the reform scenario.

The five year cost for the reform is estimated to be between $89 million and $168 million.

Table 4 – Aggregate Cost Estimates

Item	Minimum Cost	Maximum Cost
Transition Costs		
Recruitment	$7,183,985	$10,775,978
Training	$3,591,993	$5,387,989
Legal and Admin Cost	$3,472,000	$3,472,000
Transition Plan	$4,960,000	$4,960,000
Ongoing Costs		
Chair Fees	$4,214,570	$4,533,285
Director Fees (non-chair)	$13,858,107	$23,061,884
Fee Response (retail funds)	$0	$8,835,226
Total Costs		
Total - Transitional Years	$45,620,532	$84,570,590
Total - Subsequent Years	$14,259,920	$31,120,633
Five Year Cost	**$89,390,401**	**$168,050,904**

Source: ISA analysis

Note: All estimates are in 2013/14 dollars.

The minimum and maximum cost of Director Fees (non-chair) is determined using the reform fee rate as the average independent director fee for the minimum and the 80th percentile fee for retail funds for the maximum.

For the total cost in the reform scenario, the anticipated remuneration response to the spike in demand for independent superannuation trustee directors (discussed in section 4.4.4) is only included in the maximum cost estimate. It is judged this outcome is more likely than no change in independent director remuneration assumed in the minimum cost estimate.

The five year cost is determined as the sum of the transition costs (which are one-off) and an appropriate weighting of the ongoing costs over the three year transition period. The chair fee increase is weighted at 1.5 on the assumption that the new chair is appointed half way through the transition period. The director fee are weighted at two, assuming all new independent directors are appointed after the first two years (a weighting of half for the first two years and one for the third year). The fee response is weighted at two, assuming the price impact is swift and comes into full effect within the first year.

6. Parameters and Assumptions

Table 5 – Parameters and Assumptions

Item	Corporate	Industry	Public Sector	Retail
Cost Estimates by Sector				
Increase in chair fees Min is current average / Max is $125,000	$3,072,671 to $3,217,976	$814,559 to $940,745	$327,340 to $374,564	-
Increase in non-chair independent. directors fees Min is current average / Max is current 80th percentile	$5,385,951 to $7,955,127	$3,402,289 to $7,128,304	$1,257,110 to $2,668,691	-
Fees for additional non-chair independent Min is current average / Max is current 80th percentile	$2,631,689 to $3,664,970	$761,805 to $1,060,912	$419,264 to $583,880	-
Recruitment cost per director	$2,894,595 to $4,341,893	$3,088,695 to $4,633,042	$1,200,694 to $1,801,041	-
Training cost per director	$1,447,297 to $2,170,946	$1,544,347 to $2,316,521	$600,347 to $900,520	-
Legal and admin cost per fund	$532,000	$616,000	$266,000	$2,058,000
Transition plan	$760,000	$880,000	$380,000	$2,940,000
Assumptions / Inputs				
	Corporate	Industry	Public Sector	
Current chair fee	$14,911	$87,940	$85,572	-
Current non-chair fee	$14,053	$50,959	$51,662	-
New independent chair fee	$120,029 to $125,000			-
New independent non-chair fee (average)	$79,440 to $110,630			-
Recruitment cost per director	$20,000 to $30,000			-
Training cost per director	$10,000 to $15,000			-
Legal and Admin Cost per Fund	$14,000			
Transition plan	$20,000			

Source: RSE Disclosures and ISA analysis – new fees adjusted for wage inflation since relevant reporting periods.

Note: All estimates are in 2013/14 dollars.

ATTACHMENT C – FUND MERGER ANALYSIS BY SECTOR

Will appointing more independent directors lead to mergers of not for profit super funds?

Introduction

The Financial Services Council (FSC) – which represents bank-owned super funds and other wealth management companies – has been lobbying Parliamentarians to change the structure and character of not-for-profit super funds which compete with FSC members.

The FSC submission to the Senate Economics Inquiry into the Superannuation Legislation Amendment (Trustee Governance) Bill 2015 suggests that independent directors on the board of not for profit super funds would lead to more mergers and through scale, better outcomes for fund members.

These assertions are contrary to all available evidence. In summary:

- Increased scale can deliver superior returns to members – but only not–for-profit super funds have achieved economies of scale and passed them on to members. While profit orientation does determine whether economies of scale are passed on to members, there is no link to board composition. According to APRA data the largest bank-owned and retail super funds ($25bn or larger) delivered on average lower returns than the smallest funds (less than $2 billion).
- In fact, where retail and bank-owned funds do have a majority of 'independent' directors, the number of super funds has increased.
- There is a comparable precedent. Since 2006 credit unions were required to change their board composition to increase the number of independent directors. No increase in merger activity has been evident since that point.

The proposition that disrupting the governance structures of the best performing sectors of the superannuation industry will improve outcomes for fund members is a sideshow from the main debate on the governance of the super industry.

The most obvious governance challenge facing the super industry is the drag on returns to members created by the profit orientation and conflicts of interest of the bank-owned and retail super funds.

The evidence suggests that these funds prioritise profits to the parent bank or insurer over member returns.

According to IBISWorld, *Industry Report K6330: Superannuation Funds in Australia*, June 2014:

> *"It is only retail funds that generate profit to distribute to shareholders. Importantly, the operators of the retail funds (i.e. the major financial institutions) earn most of their profit through super fund support services such as funds management, financial advice and asset investment. Essentially, the fund is just a means to attract savings to earn money from."*

Alternatively

According to the latest APRA data, industry super funds outperformed bank-owned super funds on average by 2.0% over the eleven years to June, 2014.

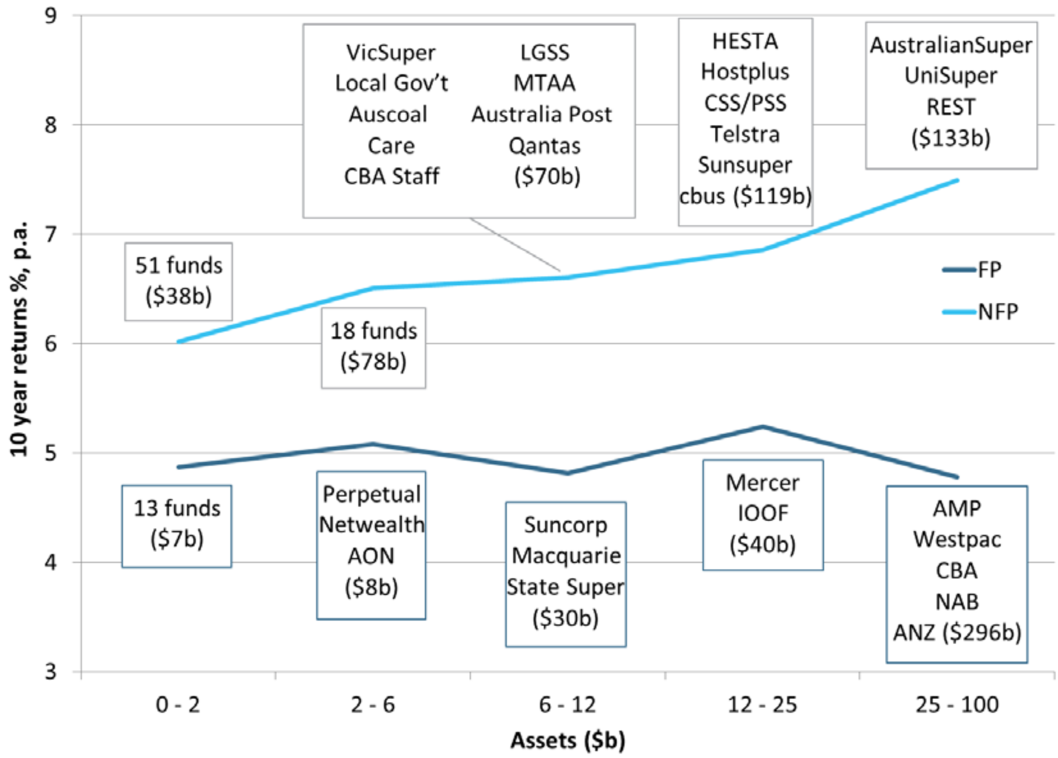
Scale can deliver greater benefits to members – but only for not for profit funds

Not–for-profit funds have demonstrated that as efficiencies such as economies of scale are achieved, these are passed on to beneficiaries.

Figure 1 displays average rates of return (drawn from APRA data) for the ten financial years from 2004 to 2013 for superannuation funds grouped by profit orientation and size in assets.[58] Average performance improves with scale for not-for-profit funds but does not for retail funds. Average outperformance by not-for-profit funds increases from 1.1 per cent among smaller funds to 2.8 per cent for the largest funds (with assets over $25 billion).

Either economies of scale are not available to bank-owned and retail funds, or the benefits of scale economies are not passed on to members. Recent research by APRA suggests that it is the latter.[59] In particular, retail funds do exhibit economies of scale, at least in relation to administration costs. Evidently, “the structure of retail funds… is less conducive to capturing the benefits of scale” for their members.[60]

Figure 2 – Average fund level rate of return by profit orientation, 2004-2013



Source: APRA (2013) Fund level performance data and profiles, ISA analysis.

In short, as not-for-profit funds get larger, economies of scale are passed on, resulting in higher net returns.

For retail funds, the opposite occurs. At all points, not-for-profit funds deliver superior returns to members than bank-owned and retail super funds.

---

[58] Funds are grouped as fund families, with asset-weighted average returns calculated for all retail funds within the same conglomerate

[59] Cummings, James Richard, *Effect of fund size on the performance of Australian superannuation funds*, APRA Working Paper, March 2012

[60] Id.

The economies of scale identified on the administration side (for funds of both profit-orientation) are only evident for not-for-profit funds when it comes to investment management.

APRA research concludes that large not-for-profit funds are able to use greater bargaining power to get more attractive prices for investment management.[61]

To explain the lack of such economies on the retail fund side, other APRA research found that retail funds on average pay substantially above market rate to service providers *if they are related parties*.[62] The funds management of large retail funds is generally provided by related parties.

APRA research has found that across a range of outsourced services, retail funds paid 81 bps more than market rates (133 bps instead of 52 bps) to related parties compared to non-related party service providers.[63]

Of particular note was the differential on administration costs. Payments to non-related party providers were $64.39 per member per year for a median cost fund, compared to $358.17 per member per year to related party providers. This represents a more than five-fold mark-up of cost.

This phenomenon also was found in respect of insurance providers.[64]

Case study: the evidence of credit unions

In October 2006, APRA implemented prudential standard APS 510 which requires all ADIs, including Credit Unions, to have a majority of independent directors, where 'independence' was assessed following the ASX principles.[65]

Merger activity among credit unions (using the annual change in number of credit unions as a proxy), does not show a meaningful change from historical trends following the implementation of APS510 (See Figure 2, years before and after APS510 in orange).

The *Financial Services Reform Act* (administered by ASIC) introduced in 2000 implemented licensing and training requirements for providers of financial services including credit unions did not cause merger activity to move away from the historical trend.

[61] Id.

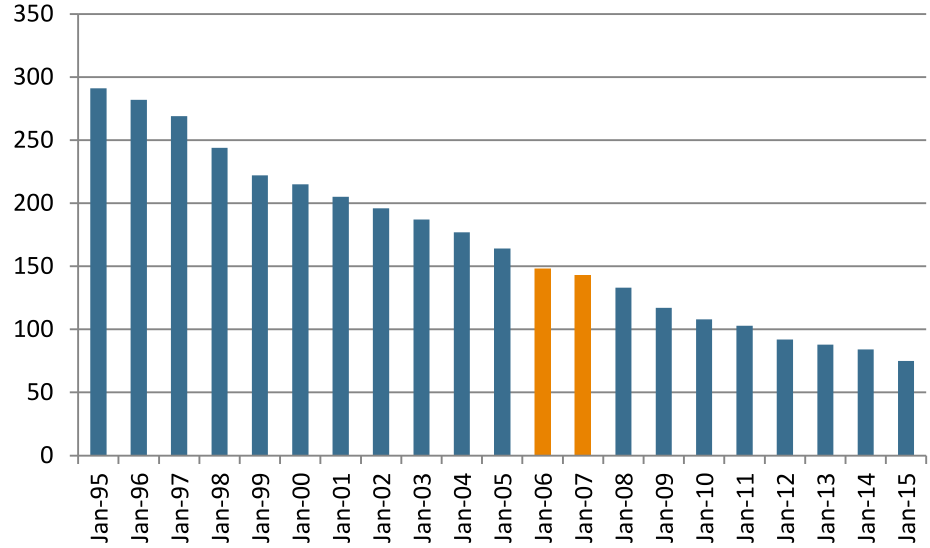
[62] Liu, Kevin; Arnold, Bruce; *Australian superannuation outsourcing: fees, related parties and concentrated markets*, APRA Working Paper, November 2010

[63] Liu, Kevin; Arnold, Bruce; *Australian superannuation outsourcing: fees, related parties and concentrated markets*, APRA Working Paper, November 2010

[64] Liu, Kevin; Arnold, Bruce; *Superannuation and insurance: Related parties and member cost*, APRA Working Paper, November 2012

[65] APS510 was seen as a significant regulatory change for credit unions, however not as significant as being brought under the Corporations Act in 1999 which imposed additional reporting and compliance requirements on credit unions. The most significant merger activity since 1995 coincided with credit unions coming under the Corporations Act in 1999. The trend growth in the number of credit unions has been -7 per cent in the two decades to 2015.

Figure 3 – Number of Credit Unions, 1995 - 2015



Source: APRA

Rather than merge, retail super funds have proliferated since the advent of MySuper

Between 2004 and 2013, the trend growth in the number of super fund RSE licensees (a proxy for merger activity) has been -7 per cent, the same as the historical trend for credit unions (see Figure 2).

In 2013, the number of RSEs jumped from 212 in June 2013 to 269 in June 2014 (an increase of 57 RSEs or 27 per cent). This was driven by the response of the retail funds to the introduction of the MySuper regime, which restricted each RSE to one MySuper product, and the desire of some sectors to provide multiple MySuper products. The overall increase of 57 RSEs was due to an additional 46 retail RSEs, 12 corporate RSEs and 2 public sector RSEs, while the number of industry super fund RSEs continued reducing in line with historical trends.

At June 2014, the four major banks operated 27 RSEs, three more than in June 2004. Half of these funds have assets of $2 billion or less, while the average size is $10 billion.

Conclusions

There is evidence that scale can lead to better returns to members, but only for members of not for profit funds.

There is no evidence that more independent directors will lead to increased mergers of super funds. The inclusion of more independent directors on the boards of credit unions did not lead to an increase in merger activity. The presence of independent directors on bank-owned super funds has coincided to an increase in the number of bank-owned funds. Indeed an independent director whose livelihood may solely depend on the number of board positions they hold may face an even more difficult decision than a representative trustee director who has an alternate main form of employment.

In any event, APRA has the relevant powers – through the “scale test” to assess whether a fund has the scale to meet the interests of its members. APRA should be encouraged to vigorously apply this test.

The primary governance problem in Australia’s super sector is the divided loyalty of directors of bank-owned super funds and the way in which they have appeared to prioritise the objective of securing a profit for the parent bank or insurer ahead of the interests of fund members.

ATTACHMENT D – LEGAL ADVICE

(SEE NEXT PAGE)

Superannuation Trustee Governance - the proposed 'independence rules'

In this paper, we make some comments from a legal perspective regarding the proposed 'independence rules' as set out in the Exposure Draft of the *Superannuation Legislation Amendment (Governance) Bill* 2015. (Please note that this paper is not intended to constitute a comprehensive analysis of the proposals.)

What is the objective of the proposed independence rules?

The Explanatory Guide issued with the Exposure Draft states that

> '… an objective of setting a minimum standard in terms of the number of independent directors on all superannuation trustee boards is to promote good governance by broadening each board's pool of experience and expertise. In addition, independent directors allow for an increased accountability of decisions made by other directors who may have conflicting interests.'

The Explanatory Guide refers to the *Super System Review* (commonly known as the Cooper Review) and the *Financial System Inquiry Final Report*, each of which addressed the issue of independent directors on the boards of superannuation funds.

In brief, it appears that the Government intends by implementation of the proposals to:

- promote good governance
- establish a structure that is consistent with international best practice on corporate governance
- broaden the experience and expertise reflected on boards
- increase accountability for the conduct of other directors, particularly as regards conflicts of interest.

What are the proposed independence rules?

In summary, the key elements of the proposals would:

- remove the equal representation requirements from the *Superannuation Industry (Supervision) Act 1993* and Regulations (**SIS**)
- remove the two-thirds voting rule
- require one-third of the directors of an RSE licensee of a regulated superannuation fund to be independent from the RSE licensee and require the chair to be independent
- introduce certain criteria for independence, and allow APRA to determine Prudential Standards relating to such criteria, with such standards able to specify the circumstances in which a person will be taken to be 'directly associated' with another person, and what constitutes a 'material relationship'
- allow APRA to determine that a person is independent or not independent, regardless of whether they meet or do not meet the criteria set out in SIS and the Prudential Standards
- require an RSE licensee to report to members each year as to whether a majority of directors are independent, and, if not, explain the reasons why not.

What are the legal implications of the key proposals?

Removal of the equal representation requirements

- This will remove the requirement for members and employers to have a 'voice' in relation to the operation of their fund (this is currently secured in relation to standard employer-sponsored funds through the equal representation rules, and for public offer funds through the requirement to establish policy committees in certain circumstances).

- It will also leave open the possibility of funds having boards comprising one-third independent directors and all remaining directors being associated with, say, a single employer-representative organisation or a single member-representative organisation, or with a shareholder or associated entity in the case of a retail fund. It is not clear whether this is intended.

Removal of the two-thirds voting rule

- This will take away the 'checks and balances' imposed by that rule, which currently (in the case of an equal representation fund) prevents a resolution from being passed without support from both member and employer-representatives - under the proposal, resolutions could be passed (subject to the terms of the relevant corporate constitution) by a bare majority (which will not be required to include any of the independent directors).

Requiring one-third of the directors (including the chair) to be independent

- This will limit the 'pool' of directors from which the chair can be drawn and may prevent the board from choosing the candidate it considers best qualified for the role.

- It will also add a 'filter' that will exclude certain persons from appointment (where such appointment would not allow the independent director quota to be met), in addition to a number of filters and rules that already apply in relation to directors of RSE licensees.

Introduction of the proposed independence criteria

- This will require RSE licensees to focus on the direct associations and material relationships of board candidates rather than the relevance of such associations and relationships to their likely ability to exercise independent judgment.

- It will also bring a focus on substantial shareholdings in the RSE licensee that is of little relevance in the context of not-for-profit funds.

- APRA will be given the power to define the terms 'directly associated' and 'material relationship' through the making of Prudential Standards. A Prudential Standard is a legislative instrument that has the force of law. It is not however made by Parliament, but is delegated legislation that is tabled before both Houses of Parliament and is effective unless it is disallowed. While hundreds of pieces of delegated legislation are presented each year, very few are ever formally considered, let alone disallowed, by either House. This means that a fundamental element of the rules is effectively to be left to the regulator to establish, rather than to the elected Government.

Allowing APRA to determine whether a person is independent or not independent

- This will place the ultimate decision as to whether or not an individual is 'independent' in the hands of the regulator rather than in the hands of the relevant board, or to be measured against clear, objectively ascertainable criteria.

- It will require APRA to decide if it is reasonably satisfied whether or not an individual 'is likely to be able to exercise independent judgment'. There is no guidance in the legislation as to the matters to be taken into account.

The annual report on whether a fund has a majority of independent directors and 'if not why not'

- This will require RSE licensees to report against a standard different to that required by the law.
- Such reports might potentially create confusion for members, who might be led to believe that a fund without a majority of independent directors is in some way deficient.

How are board composition issues addressed at present in SIS and the Prudential Standards?

It is a condition imposed on all RSE licensees that they must comply with the RSE licensee law, which includes the Prudential Standards.

APRA Prudential Standards *SPS 220 Risk Management*, *SPS 510 Governance*, *SPS 520 Fit and Proper* and *SPS 521 Conflicts of Interest* all include provisions aimed at ensuring that governance matters, including board composition, are properly addressed.

These Prudential Standards include requirements that each RSE licensee:

- has a risk management framework that covers governance risk
- ensures that directors, collectively, have the necessary skills, knowledge and experience
- ensures that annual assessments are undertaken of board performance and of the performance of individual directors
- has a formal board renewal policy
- clearly defines and documents the competencies required of the director role
- has a policy relating to the fitness and propriety of its directors (and other responsible persons), and takes all reasonable steps to make sure that directors know and understand the provisions of the Fit and Proper Policy
- applies criteria for determining whether a person is fit and proper to be a director that include a consideration of competence, character, diligence, experience, honesty, integrity, judgment, education or technical qualifications, knowledge and skills, as well as whether the person has a conflict in performing director duties, or, if they do have a conflict, whether it would be prudent to conclude that this conflict will not create a material risk that the person will fail to perform their director duties properly
- conducts annual fit and proper assessments in relation to each director, including the making of reasonable enquiries to obtain relevant information
- takes reasonable steps to ensure that a person who is not assessed as fit and proper is not appointed as a director, or does not continue as a director if they already hold that role
- takes reasonable steps to assist APRA to conduct its own fit and proper assessment of directors
- establishes a robust conflicts management framework that:
    - includes a conflicts management policy with controls and processes for identifying, monitoring, avoiding, managing and recording conflicts
    - incorporates clearly defined roles, responsibilities and resources for the oversight of conflicts management within the RSE licensee's business operations
    - requires the keeping of up-to-date registers of relevant duties and interests
    - requires annual reviews of the framework with comprehensive reviews by operationally independent, appropriately trained and competent persons every 3 years.

Importantly, APRA can apply to the Federal Court to disqualify a person from being a director of a trustee of a superannuation entity where the Court is satisfied the person has engaged in serious contraventions, or is satisfied a person is not otherwise fit and proper.

Mapping the Government's stated objectives in relation to the proposed independence rules against the detailed requirements under SIS and the Prudential Standards, 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.

In particular, the focus on accountability around conflicting interests is curious in light of the extensive attention to conflict issues in *SPS 521 Conflicts of Interest* and the very clear obligations of directors in relation to conflicts under the SIS covenants.

At the date of preparing this paper, Treasury was considering a number of submissions made in respect of the Exposure Draft.

Paper prepared for AIST as at 13 August 2015

Contact:

Heather Gray | Superannuation Partner