Governance Institute of Australia

1 February 2016

Mr Bernie Fraser
The Fraser Governance Review
c/- Industry Super Australia
Level 39, 2 Lonsdale Street
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Email: submissions@thefraserreview.com

Dear Mr Fraser

Governance arrangements of not-for-profit superannuation funds

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are second to none.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies, as well as not-for-profit organisations (NFPs) and the public sector. They frequently are those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA), the Australian Charities and Not-for-Profits Commission (ACNC) and in listed companies have primary responsibility to deal with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules.

Our members also have primary responsibility for supporting the boards of this range of entities on all governance matters and many also sit on boards. Their familiarity with the practical aspects of how to implement best practice governance frameworks and ensure sound reporting to members has informed the comments in this submission.

General comments

Governance Institute is a founding member of the ASX Corporate Governance Council, which develops and issues the *Corporate Governance Principles and Recommendations* (Principles and Recommendations). We have been involved in the drafting of all three editions as well as the amendments to the second edition (concerning diversity). The Principles and Recommendations have played a vital role in improving corporate governance in Australian listed companies since the release of the first edition in 2003. Their history is one of practical statements on governance which have brought meaningful change to governance practice and behaviour.

The Principles and Recommendations have served Australia well in lifting and maintaining its standing as a country with a high-performing corporate governance environment.

Governance Institute was also a key supporter of the introduction of the ACNC, as our deep knowledge of the differing needs of the NFP sector saw us able to provide expert recommendations to the government as to the legislative framework and governance standards

required. A dedicated regulator recognises that NFPs are established for different purposes than for-profit companies and the governance standards that were introduced for charities also recognise that governance arrangements for charities need to be tailored to the needs of their members.

Given our in-depth knowledge of governance across all sectors, we are concerned that the questions raised by the Governance Review concentrate primarily on the question of the independence of directors and, in doing so, limit consideration of a wider range of governance arrangements. As with the Federal Government's Superannuation Legislation Amendment (Governance) Bill 2015, which also focused on director independence, the Review questions do not fully recognise that board composition, definitions of independence and management of conflicts of interest are only components of a governance framework.

We are on the public record as stating that our preference is for a majority of independent directors on the boards of superannuation funds (with appropriate election and accountability requirements), because independent directors need to be able to influence how the board is operating. Furthermore, research shows majority independence is the most prevalent standard internationally and that retirement schemes in developed countries are moving towards appointing more independent directors. Further, a majority of independent directors on the boards of superannuation funds aligns with board composition on their investee companies, which is a better governance outcome.

Notwithstanding our preference for a majority of independent directors, we are of the view that a one-third requirement is a pragmatic, initial step in ensuring board effectiveness. Moving to a board structure comprising one-third independent directors will assist in improving board renewal, as it will introduce new skills onto boards.

But we are also on the public record as stating that consideration of governance needs to extend beyond the question of independence. Governance encompasses the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. It encompasses transparency, accountability, stewardship and integrity. A central question in governance, which goes to the heart of accountability and stewardship, is: Who are you beholden to? The representative model in superannuation funds — which generally does not provide for direct member representation, but rather third party representation — gives rise to this question, as the third parties are inevitably beholden to their nominating organisation.

Not-for-profit superannuation entity boards are typically comprised of an equal number of directors appointed by either an employee body (a union) or employer body or, in the case of public-sector funds, a state or federal government. A conflict of interest or duty of loyalty or a perceived conflict of interest or duty of loyalty may arise where a director is appointed to the board by such a sponsoring body. For example, a director may have in mind that they have been appointed to a superannuation entity to represent the interests of a particular union or industry body — they may be of the view that their appointment has been made in order to ensure they can control or influence, as well as monitor, the activities of the superannuation entity to which they have been appointed. Alternatively a director appointed to the board by a sponsoring body could be perceived to have been appointed in order to control and influence, even when the director is clear that they have been appointed to represent the best interests of the beneficiaries rather than those of the sponsoring body.

That is, more often than not, conflicts of interest in the superannuation industry arise by reason of the appointed person representing an appointing body the interests of which could differ from those of the trustee, and the beneficiary.

Governance Institute is strongly of the view that the key governance outcome from which questions of board composition and management of conflicts of interest flow is to aim for greater empowerment of members and greater accountability of directors to members.

As a matter of good governance, therefore, members should be provided directly with the final say in the governance of their superannuation fund. The background to the questions posed by the Review notes that NFP superannuation funds exist solely for the benefit of, and to protect the interests of, their members. If the actual governance framework is to match this desired governance framework, then the principal say in the governance of these funds should be in the hands of the members of the fund, not third parties representing them.

The best governance outcome would be to introduce a mechanism which allows members of the fund — both at the contributory/accumulation and pension recipient phase — to appoint and remove directly the directors of the trustee and hold those directors accountable to members. That is, no-one apart from members should have the decision-making power as to the appointment of directors.

If members are granted the right to elect — or not elect or re-elect directors — an independent director is essentially therefore one who has been elected by members, because members are of the view that the director is acting in their best interests.

An example of a similar governance arrangement outside of superannuation is the manner in which members of a corporation (shareholders) have the right to appoint directors of the board and hold those directors accountable for the performance of the corporation, or members of a NFP organisation (non-shareholders) have the right to elect directors and hold them accountable.

It has been argued by many in the superannuation industry that providing for members to appoint directors would lead to 'gaming' of the voting, and third parties controlling voting outcomes. Yet the Cooper Review noted that some large APRA funds already provide for members electing directors and we note that, currently, an example of members electing directors is the Retirement Benefit Fund of the Tasmanian Public Service (a non-APRA-regulated fund), which has two member-elected directors on the trustee board. Representatives of third parties (in this case, a union) were also free to and did stand for election and candidates lobbied members for their votes. The members made the final decision. As in the political process, where lobbying efforts are also made by various parties, the decision ultimately rested in the hands of those whose interests were being represented.

It is incorrect to suggest that providing members with the right to decide who represents their best interests might lead to chaos. All listed companies directors are elected, even companies where, like superannuation funds, most of the members are individuals. For example, listed investment companies, by their very nature, are comprised predominantly of retail shareholders who vote regularly on director elections and re-elections pursuant to the Corporations Act, listing rules and company constitutions. This sector of the market has operated soundly and stably for many decades.

NFP organisations hold director elections, with the members holding the right to appoint their governing body, and with those on the board often being drawn from member ranks. It is also common for independent directors to sit on NFP boards, with members having the right to elect candidates if they are of the view that they will act in the best interests of the organisation.

Managed investment schemes also provide an example of members having genuine influence over the body managing their investment. Members can change the constitution of the scheme and even remove the responsible entity, which is the equivalent of removing a trustee. There is no reason why members of superannuation funds should not have the same rights.

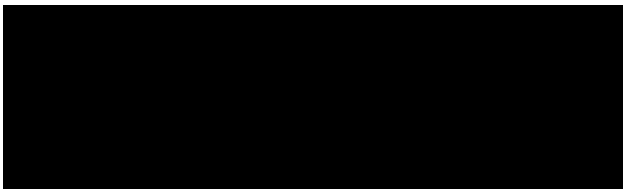
All members should have the right to appoint and remove directors. Currently, in some NFP superannuation funds, only contributing members have the right to elect directors, whereas those in pension mode do not. This results in the inequitable situation where a young member who has just commenced work, with a small amount of, say, $2,000 might have the right to elect directors, whereas an older member with a much larger sum in their retirement savings, say, $200,000, has no such right. Again, like managed investment schemes, all members of a

superannuation scheme, regardless of which class of member they are, should have voting rights proportional to the value of the member's interest in the scheme.

The *Super System Review: Final Report*[1] states that: 'While it is possible under the SIS Act for a trustee to be a natural person, the vast majority of trustees of APRA-regulated funds are companies and it is the board of trustee-directors who are responsible for the trustee's decisions and actions'. Members should have the right to decide who should take those decisions and actions that will bear upon the interests of members.

We provide more detailed comment on the questions posed in the Review paper on the following pages and would welcome the opportunity to discuss these issues at your convenience.

Yours sincerely



Steven Burrell
Chief Executive

[1] On 29 May 2009, the Federal Government commissioned the Super System Review (the Review), chaired by Jeremy Cooper, to make recommendations to ensure the superannuation system has a sharper focus on operating in members' best interests. The Review's final report was handed to the government on 30 June 2010.

Detailed comments

1.1. Can international experiences/studies provide any insights relevant to assessing current Australian practices?

The Australian Institute of Superannuation Trustees (AIST) paper, *Superannuation Governance: International trends and how Australia stacks up*[2] makes reference to a 2008 *OECD Working Paper on Pension Fund Governanc*e, which notes that of the 22 countries reviewed by the OECD, 13 have equal representation and a further six require some form of member representation on the board.[3]

However, it should be noted that the *OECD Guidelines for Pension Fund Governance*, released in June 2009 (after the working paper) explicitly state that accountability can be heightened by member participation on the governing body of the pension fund *and* through the appointment of independent directors.

The OECD Guidelines state:

> Accountability to plan members and beneficiaries can be also enhanced by requiring representation of plan members and beneficiaries on the governing body. When the pension plan is established as part of a collective agreement, the nomination process normally involves the contracting trade unions. In some countries, paritarian representation of employers and employees in the governing body is required by law, ensuring that their respective points of view are represented. In other countries, labour laws governing union-management relations may prescribe when employee representation on pension funds is necessary. The appointment of independent professionals to the governing body is also an effective way to promote good governance.

The AIST paper also states that:

> When examining whether independents 'add value', it is useful to examine why the concept of independent directors was developed. 'Independents' were included on corporate boards as there is a variety of competing interests — shareholders, controlling shareholder interests, various factions of shareholders to balance, and management interests. This is not the case with not-for-profit superannuation funds, which exist solely for the members and other beneficiaries, and which do not have shareholders. The international jury is out on whether 'independent' directors add value.

This is not an accurate statement of why independence was introduced. As stated in the influential Higgs Report (that led to the revision to the UK corporate governance code and also influenced the first edition of the ASX Corporate Governance Council's Principles and Recommendations):

> As the non-executive director does not report to the chief executive and is not involved in the day-to-day running of the business, they can bring fresh perspective and contribute more objectively in supporting, as well as constructively challenging and monitoring, the management team. … Although they need to establish close relationships with the executives and be well-informed, all non-executive directors need to be independent of mind and willing and able to challenge, question and speak up. … At least a proportion of non-executive directors also need to be independent in

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[2] AIST, *Superannuation Governance: International trends and how Australia stacks up* September 2014
[3] Stewart, F and Yermo, Y, *Working Paper on Pension Fund Governance, Challenges and Potential Solutions*, Organisation for Economic Co-operation and Development, 2008, available at http://www.oecd.org/finance/private-pensions/41013956.pdf

> a stricter sense. There is natural potential for conflict between the interests of executive management and shareholders in the case of director remuneration, or audit (where decisions on the financial results can have a direct impact on remuneration), or indeed in a range of other instances. Although there is a legal duty on all directors to act in the best interests of the company, it has long been recognised that in itself this is insufficient to give full assurance that these potential conflicts will not impair objective board decision-making.

Independence was introduced to provide a check and balance on conflicts of interest, not competing interests. Conflicts of interest and competing interests are not the same — all organisations have competing interests (often referred to as stakeholder interests) and managing these is central to any business. Managing conflicts of interest (which can be conflicts of loyalty as well as material personal interests) is a different matter and goes to the heart of good governance outcomes.

The HIH Royal Commission, the trigger that led to the adoption of the corporate governance Principles and Recommendations in Australia, identified a number of governance failures that contributed to the collapse of HIH. One of those was a failure by the company to have a board comprised of a majority of directors who were truly independent. The collapse of HIH saw a loss to the community and the economy that vastly exceeded the loss of value to the HIH shareholders.

In relation to the 'jury being out on whether independent directors add value', many of the articles that are referenced in such claims seek to draw a causal relationship between independence and financial performance. The ASX Corporate Governance Council and other sponsors of governance codes globally have not claimed that independent directors will foster enhanced financial performance. Rather, they have consistently addressed the manner in which independence can mitigate conflicts of interest. This is captured well by the research undertaken by The McKell Institute[4], which states that 'Board independence is not aimed at improved performance in terms of higher returns to shareholders, but rather the prevention of systemic underperformance due to managers optimising their own utility rather than their shareholders'.

The ASX Corporate Governance Council has always been very clear that the recommendation on board independence sits within other recommendations that focus on the knowledge, skills and diversity of directors, as well as their independence. Independence should never be viewed in isolation. Its value lies in focusing the collective mind of the board on independence of thought and decision-making.

1.2. Should not-for-profit funds be viewed any differently from other categories of funds in terms of governance requirements/practices?

When compulsory superannuation was introduced in 1993, employees usually had little or no choice in the superannuation fund of which they were a member. Nor did they usually have any say in the governance of the fund. The SIS Act required that the boards of employer-sponsored funds consist of equal numbers of employer and member representatives. However, the employer representatives were typically, in the words of the Act, 'nominated by a trade union, or other organisation, representing the interests of those members'.

Similarly, when compulsory superannuation was first introduced, most funds involved defined benefit schemes in which the member received a pre-determined pension on retirement (usually calculated by reference to their final salary) and to the extent the assets of the fund were insufficient to fund the pension, the employer was required to make good any shortfall. In the circumstances, employers had a legitimate interest in the performance and good governance of the fund and could oversee this through appointing directors to the trustee.

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[4] The McKell Institute, *The success of representative governance on superannuation boards*, The McKell Institute, Macquarie University, Centre for Workforce Futures, 2014, p 23

Today, most employees are members of accumulation schemes in which the employee, not the employer, bears the risk of under-performance or poor governance in the fund. It was possibly not true in the 1990s and is even less true today that most members of employer-sponsored superannuation funds are members of trade unions. Employee representation through third parties such as trade unions is no longer automatically applicable due to the introduction of choice in superannuation and declining union membership — members of a fund are no longer all represented by the union. And unless an employer has a defined benefits scheme, where it retains responsibility for performance, there is no longer a reason to ensure employer representation on the board of trustees either directly or through third parties such as employer associations.

The governance of employer-sponsored superannuation funds (as opposed to retail or for-profit funds) should be directly in the hands of those with the greatest stake in the performance of the fund — the members.

In the case of retail or for-profit funds, the members are essentially acquiring a service for a fee and, if they are dissatisfied with that service or the performance or governance of the fund, they can transfer their funds to another service provider. Members do not expect a significant say in the governance of retail funds any more than they expect a significant say in the governance of, say, a bank. Rather they rely on strict prudential regulation by APRA to ensure that their interests are properly protected.

There are also self-managed superannuation funds (SMSFs), where the members are the trustees.

2. In considering the general case for requiring super funds to have a number of independents on their boards various issues arise, including:

2.1. How 'independence' is best defined

2.2. The appropriate number of independents for particular funds and how this number should be determined and the timeframe over which it might be implemented

2.3. Current practices among different groups of super funds in Australia and the perceived (and actual) strengths and weaknesses of those practices

2.4. Any findings of overseas studies which might have examined the impact of similar requirements in respect of board composition, and

2.5. Possible implications of 2.3 and 2.4 for the governance of boards of not-for-profit funds in Australia.

2.1 Definition of independence

Governance Institute continues to advocate for a non-prescriptive approach to independence. We note that the review seeks to 'define' independence. This approach was taken by the Federal Government in the Superannuation Legislation Amendment (Governance) Bill 2015, and the challenges inherent in 'defining' independence were apparent in three different drafts of that bill.

Governance Institute is a strong supporter of independence as one of a number of indicators of director capability but we note that it is not the only indicator of director suitability or capacity. Importantly, board composition policy should require companies to have a mix of directors on the board with different skills and robust board evaluation and renewal plans should be in place.

As a founding member of the ASX Corporate Governance Council, we have been closely involved in the development of the indicators of independence set out in Box 2.3 in the Principles and Recommendations. Box 2.1 sets out *criteria* against which independence can be assessed — not a definition — but it cannot be assumed that independence of judgment is lost if only some of those criteria are met. The criteria are examples of interests, positions, associations and relationships that may raise doubts about independence and require consideration, but they do not prescribe a loss of independence.

We note that our recommendation that the governance code include criteria for assessing independence allows for the board to decide that an individual with conflicts of the kind set out in the criteria may still be judged as independent of mind. This approach to governance is reflected in the comment in The McKell Institute report that notes:[5]

> Although independent outcomes may be easier for individuals who do not hold material conflicts of interest, it must be emphasised that this does not mean that individuals who do have such conflicts cannot exercise objective, independent judgement.

Also importantly, under the 'if not, why not' approach taken by the Principles and Recommendations, if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it —- a flexibility tempered by the requirement to explain why to its shareholders.

Each ASX listed company is required under Listing Rule 4.10.3 to include in its annual report either a corporate governance statement that meets the requirements of that rule, or the URL of the page on its website where such a statement is located. The corporate governance statement must disclose the extent to which the company has followed the recommendations set by the ASX Corporate Governance Council during the reporting period.

Importantly, shareholders have the right to not elect or re-elect directors if they are unhappy with the explanation of independence provided in the corporate governance statement (or other governance disclosures). Members of NFP superannuation funds should have the same capacity to exercise their judgment of the board's decision making.

Governance Institute recommends that any code of governance practice take a similar approach and set out criteria for assessing independence, rather than a definition of independence. That is, boards would need to examine interests, positions, associations and relationships that may raise doubts about independence and, should any of those indicators be met, explain to members why the board considers that the director retains independence. The trust of members is sought in such disclosures — it is expected that the board will have given rigorous consideration to whether each director is independent or not. Clearly, the potential for abuse of this trust exists if members do not have the right to elect or re-elect directors.

Governance Institute also recommends that the criteria for assessing independence found in the ASX Corporate Governance Council's Principles and Recommendations be adopted and applied, but that it would also need to be modified to include consideration of where a person is, or has been in the last three years:

- an employee or executive of an employer of members of the fund, or
- an employee or official of a trade union, or other organisation, representing the interests of members of the fund
- an employee of an employer association or body, representing the interests of the employer
- an employee or executive of entities related to the trustee
- an employee or executive of service providers and

[5] The McKell Institute, *The success of representative governance on superannuation boards*, The McKell Institute, Macquarie University, Centre for Workforce Futures, 2014, p 24

- current or former executives of the fund or of a related entity.

The appointment of employer representatives in the case of defined benefit funds would be permitted, but this would need to be reviewed regularly. For example, there are hybrid funds with defined benefit divisions which are a small proportion of the overall fund that will become a still smaller proportion of the fund, as members leave the fund or retire. Permitting employer representatives to be appointed in such cases would not therefore achieve good governance outcomes.

We do not support the *Superannuation Industry Supervision Act 1993* (Cth) (SIS Act) definition of independence, as various issues arise that render this an unsuitable approach. That is, while directors may appear to be independent according to this definition, upon examination, it can be seen that they are likely not to be independent. The issues arising include:

- a director cannot be a member of the fund of which they are a director, but they will be a member of another fund, and may find they have a conflict of duty. By comparison, we note that directors of public listed companies are encouraged to hold shares in the company, as this is seen to align their interests with those of shareholders — directors holding shares in the company on whose board they sit is not seen to affect independence and if the trustee directors are to make decisions in the best interests of the members, being a member of the fund of which they are a director should be encouraged
- directors of a superannuation fund may hold multiple and competing positions on the boards of other funds, and will likely find they have a conflict of duty of loyalty
- the composition of various board committees may not necessarily reflect independence — the board committees could be comprised of the directors of the trustee or they could be comprised of only one director and internal appointees, that is, executive management. Such a committee would not be independent.

Members' rights to determine independence
The background to the Review states that:

> Two distinguishing features of not-for-profit funds stand out. One is their focus on the overriding primacy of members' interests. This is reflected in their governance and operational arrangements, and underpinned by board structures based generally on equal representation from employer and employee organisations. Secondly, they can point to sustained outperformance in the returns they deliver to their members compared with other groups of funds.
>
> This outperformance lends weight to the contention that the mutuality of not-for-profit funds (with all profits to members) and their representative board structures add up to a successful business model and a culture that inspires members' trust in their funds.

While Governance Institute agrees strongly with the overriding primacy of members' interests as a feature of NFP funds, we note again that members in general have no rights to appoint directors to act in their interests. Yet this should be the overriding concern of any governance arrangements for NFP funds.

The representation of members through third parties introduces conflicts of interest, as the directors may have competing loyalties between the members of the superannuation entity to which they owe a primary duty and the organisations which they represent. Such situations present a risk, real or perceived, that directors may make decisions based on these external influences, rather than the best interests of members.

While we recognise that superannuation fund trustees are required to ensure their fund is maintained solely for the provision of benefits to members[6] and must also exercise their powers

[6] s 62 Sole Purpose Test: *Superannuation Industry (Supervision) Act 1993* (SIS Act)

in the best interests of members, it is extraordinary to contemplate that, in 2016, there is a significant body of membership organisations — NFP superannuation funds — where the members have no rights as to who sits on the governing body to represent their interests.

The argument is often made that, in addition to the ordinary duties and responsibilities of trustees and directors, trustee directors of superannuation funds have an overarching duty to the members of the fund and that this additional level of responsibility means that a trustee director's decisions cannot be driven by the trustee entity, their nominating body or another's wishes. The argument is that a representative board model works best, given that a trustee director is required to discharge their overriding duty to the members of the fund even if that duty comes into conflict with their obligations to their nominating body or someone else.

Notwithstanding this, we should not complacently reference trustee duties as a means of avoiding governance arrangements that give members the right to decide who represents their best interests.

2.2 Number of independent directors

The *Super System Review: Final Report* states that:

> The governance standards that apply to major listed entities are a reasonable starting point for the requirements that should apply to trustees and their trustee-directors, given the profound impact the latter have on the retirement incomes of members. This is particularly so in light of the growing influence that super funds have in advocating corporate governance practices for entities forming part of their investment portfolios that are not necessarily matched in their own practices. Turning the governance spotlight on trustees' own operations is, in the Panel's view, critical to the long-term sustainability of the superannuation system.

The ASX Corporate Governance Council's Principles and Recommendations recommend a majority of independent directors on the board, and an independent chair. Similarly, APRA applies to banking and insurance institutions — as a definition which must be followed rather than a recommendation — not only the criteria of independence found in the Principles and Recommendations but also the requirement for a majority of independent directors and an independent chair.

We refer to the extract quoted earlier from the Higgs Report as to how independence addresses conflicts of interest. While the extract speaks to the conflicts of interest that may attend executive director appointments, which is not the matter of concern in superannuation governance, the final sentence speaks to the governance issue that legal duty itself is considered insufficient to protect against conflicts of interest. In the case of superannuation trustee boards, those conflicts arise from third party representation and present a risk, either real or perceived, that directors may make decisions based on the interests of their nominating organisation rather than in the best interests of members.

When considering governance arrangements, it is always useful to step back and recall the four main components of sound governance: accountability; transparency, stewardship and integrity. Less than a majority of independent directors on a board may be seen to be tokenism. Any fewer than a majority may not have the capacity to significantly influence decisions taken by representative directors, given that the central premises of independence are that all directors should take decisions objectively in the interests of the members, and that conflicts of interest do not provide assurance that such objective decision-making is undertaken.

Governance Institute recommends that, ultimately, a majority of independent directors is the appropriate proportion of independent directors for superannuation boards. However, given the considerable commentary on appointing one-third of independent directors to the boards of superannuation funds that has taken place over the past two years, **we recommend** that it would be an appropriate first step to commence with the appointment of one-third of independent directors, preferably directly elected by members.

We note that the current two-thirds majority voting rule may need to be reviewed if a majority of directors are independent.

Timeframe for implementation
Listed entities have been required to make governance disclosures for more than ten years, since the introduction of the ASX Corporate Governance Council's Principles and Recommendations in 2003.

When the Federal Government first consulted on superannuation governance arrangements two years ago, Governance Institute acknowledged that it would likely be an extremely complicated process for most superannuation funds to introduce independent directors and other governance changes. Many would not have considered how to effect such changes to their governance frameworks and it would be unfair to ask superannuation entities to manage such a transition in just one year. We continue to believe that a two-year transition period is reasonable.

We note that, if an 'if not, why not' disclosure framework is also introduced, trustee boards have the flexibility to explain why they have been unable to bring on board independent directors within a two-year period, should this eventuate. It may be that some smaller funds face challenges in securing independent directors within this timeframe. The flexibility of an 'if not, why not' disclosure mechanism encompasses such challenges, subject to the board providing an explanation to members.

2.3 Current practices

We note that a number of NFP superannuation funds have already introduced independent directors to their boards. These entities have been proactive in seeking to foster greater confidence that the board is able to be impartial when making decisions and have frequently also taken the opportunity to assess board skill sets and put board renewal processes in place.

2.4 Overseas studies of board composition

The report from The McKell Institute references academic literature that finds that focusing on independence 'is likely to give investors unwarranted confidence and a false sense of security, increasing the shock when companies continue to fall into disrepute or insolvency'.

However, it does not reference the increased confidence in the market in the transparency and accountability of listed companies that has been evident since the introduction of the ASX Corporate Governance Council's Principles and Recommendations. Referencing theory is important, but so is referencing the very real experiences of Australian investors, including NFP superannuation funds, which invest in Australian listed entities. There has been significant commentary from NFP superannuation funds and their intermediaries of enhanced confidence in the governance of their investee companies over the past decade. Investors will point to independence as one factor in that enhanced confidence.

We also note that a number of reports and submissions reference Professor Peter Swan's research on independence, quoting his findings that the consequences of introducing independence in the ASX Corporate Governance Council's Principles and Recommendations as having resulted in a loss of billions of dollars between 2003 and 2011. Professor Swan's views have not found favour with investor groups, including those represented on the ASX Corporate Governance Council, with concern expressed about his methodology, including:

- the recommendation on board independence is just that — a recommendation and not a requirement (he continually refers to it as a requirement)
- many listed entities, particularly those at the smaller end of the market, do not follow the recommendation and simply give an 'if not, why not' explanation, which they are perfectly entitled to do

- the recommendation on board independence sits within other recommendations that focus on the knowledge, skills and diversity of directors, as well as their independence, and
- the commentary to the recommendation on board independence specifically states that directors having shareholdings may help to align their interests with other shareholders and accordingly is not discouraged (which he consistently maintains it is)
- he provides no discussion of the risks attached to directors with vested interests
- he refers consistently to research on US boards, but US boards operate very differently (the CEO frequently appoints board members and there are many vested interests).

While we do not reference overseas studies here, our comments reflect our stated concern that the terms of reference focus too much on independence, which is only one component of a governance framework.

2.5 Implications for NFP funds

The success of the ASX Corporate Governance Council's Principles and Recommendations in lifting and maintaining Australia's standing as a country with a high-performing corporate governance environment lies in their acceptance that there is no 'one-size-fits-all' governance framework. Different entities may legitimately adopt different governance practices, based on a range of factors, including their size, complexity, history and corporate culture. For that reason, the Principles and Recommendations are not mandatory and do not seek to prescribe the corporate governance practices that a listed entity must adopt. The choice of such practices is fundamentally a matter for the entity's board of directors, the body charged with the legal responsibility for managing its business with due care and diligence and acting in good faith and for a proper purpose.

It is a listed entity's board of directors who are responsible for ensuring that it has appropriate corporate governance practices in place and who must be prepared to explain and justify those practices to shareholders and the broader investment community — the 'if not, why not' approach. It is for the market to decide whether those governance arrangements are sound.

Importantly, the capacity of the board of a listed company to make the decisions as to the appropriate governance framework is dependent on this disclosure model. Disclosure provides transparency and accountability as to the stewardship of the entity and shareholders have the right to vote to elect or re-elect (or not elect) director candidates.

While the importance of not imposing a 'one-size-fits-all' model on superannuation funds also needs to be held in mind, without a disclosure obligation, self-regulation for the superannuation industry is unlikely to provide the transparency and accountability to members that a good governance framework requires. We are of the view that an 'if not, why not' disclosure obligation should be introduced for superannuation entities in relation to the independence of directors and all other governance matters as set out in a code. The use of a compulsory independence rule would not provide members with a true indication of the board's attitude to governance in action, whereas the 'why not' explanation allows members to assess whether the reasons given represent thoughtful and appropriate responses or whether they indicate a low priority given to governance.

Aligned with this should be the provision of the right to members of NFP superannuation funds to appoint directors, so that they can express their views as to the governance of the fund through this mechanism.

Our view is that more and more members of superannuation funds will take a keen interest in the governance of their funds and will wish to assess disclosures from their funds on governance matters. This in turn will inform their voting decisions on director appointments.

While Governance Institute members recognise that there is considerable apathy on the part of members in relation to engagement with their funds at present, we are of the view that the

current apathy will not be permanent. Many members will not only become more interested in their retirement incomes, given the ongoing public policy discussions concerning the limitations of funding retirement through the pension and initiatives (including from primary school) to improve the financial literacy of Australians, but will also be empowered through the capacity to influence board composition to seek further engagement. Making disclosures to APRA alone will not empower members.

The APRA prudential standards could require superannuation funds to make disclosures on governance matters to their members on an 'if not, why not' basis. APRA, as the regulator, would have the power to compel any superannuation entity that did not provide such explanations to make such disclosures. However, it would not be APRA alone that judged the quality of the disclosures, as is currently the case, but also the members.

3. Similar issues arise in relation to any mandatory requirement for not-for-profit funds to have an independent chair, including:

3.1. Current practices among different groups of super funds in Australia and the perceived (and actual) strengths and weaknesses of those practices

3.2. Any findings of overseas studies which might have examined the impact of a similar requirement in respect of an independent chair, and

3.3. In what circumstances would it be appropriate to appoint an independent chair, and what procedures and implementation timeframe would be appropriate, and

3.4. Possible implications of 3.3 for the governance of boards of not-for-profit funds in Australia.

3.1 Current practices

See our earlier comments on 2.3.

3.2 Overseas studies

See our earlier comments on 2.4.

3.3 Independent chair and timeframes

The ASX Corporate Governance Council's Principles and Recommendations recommend that the chair of the board be independent. Separation of the role of chief executive and chair is seen as a central plank in a good governance framework, as it is avoids concentration of authority and power in one individual and differentiates leadership of the board from running of the business. To quote again from the Higgs Review, the following was the rationale for calling for the chair of a public listed company to meet the independence test:

> The chairman needs to foster relationships of trust with both the executive and non-executive directors on the board, whilst at the same time maintaining support for, and partnership with, the chief executive. A degree of detachment from the executive can also be valuable in ensuring objective debate on strategy and other matters.

When viewed through the lens of conflicts of interest, the rationale for having an independent chair is strong. Should the chair be drawn from the representative directors, there is the risk, real or perceived, that they may make decisions based on these external influences, rather than the best interests of members. As Higgs has so eloquently captured, the legal fiduciary duty on all directors to act in the best interests of the members has long been recognised as being insufficient in itself to give full assurance that potential conflicts will not impair objective board decision-making.

Governance Institute recommends that the chair of a board should be independent, but notes that it should be a board decision as to who holds the role of chair, subject to a disclosure requirement as to why a non-independent chair is in the best interests of members.

However, it may take NFP funds longer to install an independent chair with knowledge of the fund than to appoint independent directors. The chair would need to have sat on the board for at least two years to assess its workings, develop a sound understanding of the board dynamics and capacities of all directors, and a heightened understanding of the fund's needs and those of its members. A two-year implementation timeframe would be more appropriate.

Board committees
Governance Institute is of the view that board committees should also reflect independence, given that committees exercise the delegated authority of the board to deal with specific matters. Generally speaking, only members of the board should sit on board committees. Good governance practice is that executive directors should be considered for membership of board committees only where the board considers it necessary to ensure that the requisite skills are represented. Executive director participation can usually be better achieved by inviting executive directors or non-director, external consultants to attend where they have important information or recommendations to provide to the committee. Where executive directors or external consultants sit on the committee, they should be in the minority. Importantly, in determining, and prior to finalising, the composition of committees, any conflict of interest (actual or perceived) that may arise should be considered.

Governance Institute therefore recommends that board committees of superannuation entities should mirror the requirements of the ASX Corporate Governance Council's Principles and Recommendations, and:

- consist of a majority of independent directors — internal appointees (executive management) or external consultants (service providers for example) may sit on these committees but would not comprise the majority
- be chaired by an independent director, and
- comprise at least three members.

3.4 Implications for NFP funds

See our earlier comments about the need to introduce a disclosure mechanism to allow members to assess the governance frameworks of their funds.

4. In the light of the views expressed in comments/submissions from interested parties, and in a proposed round of consultations with major stakeholders, the Review Team will consider the feasibility and nature of a Governance Code for not-for-profit funds which will seek to encapsulate both the positive elements of the existing arrangements and procedures for increased representation of independents where this could be expected to enhance the interests of fund members. The preparation of such a Code would require a careful review of the details of existing governance arrangements, with some modifications here and there. Relevant issues include:

4.1. The nature and status of funds' commitments to such a Code, and procedures for handling any breaches

4.2. An appropriate definition of independence

4.3. The permissible number of independents (which could be set as a maximum), and the timeframes for making appointments (again some flexibility might be appropriate)

4.4. The broad rationale for seeking to appoint independents, and the mechanics of identifying and selecting them
4.5. The kinds of circumstances (and related procedures) leading to the appointment of an independent chair of a not-for-profit fund, and
4.6. Suitable arrangements for handling conflicts of interest; related party transactions; relevant disclosures, including numbers of independents, their backgrounds, genders and salaries; and so on.

4.1 Commitment to governance code

Without a disclosure obligation, self-regulation for the superannuation industry is unlikely to provide the transparency and accountability to members that a good governance framework requires. We are of the view that an 'if not, why not' disclosure obligation should be introduced for superannuation entities in relation to the issues dealt with in the governance code. As noted earlier, we do not believe that making disclosures on governance to APRA alone will empower members.

Disclosures to shareholders about governance practices are mandated through the Listing Rules (please note that the governance recommendations are not mandated, only the disclosure of them). **Governance Institute recommends** that the APRA prudential standards be revised to require superannuation entities to:

- provide a governance statement to members in their annual report disclosing on an 'if not, why not' basis how the board has responded to a series of recommendations in the governance code on governance practice, including:
    - independence of the board
    - independence of the chair
    - independence of board committees
    - whether a board evaluation took place and the process of such an evaluation, and
- these disclosures should be made on the public access sections of the website of the superannuation entity, so that any individual can assess the governance of the fund as part of their decision as to whether to become a member of that fund
- address how the entity will manage related party transactions in its conflicts of interest policy

APRA, as the regulator, would have the power to compel any superannuation entity that did not make such disclosures to make such disclosures. However, it would not be APRA alone that judged the quality of the disclosures, as is currently the case, but also the members.

4.2 and 4.3 Independence issues

We have not responded to 4.2 or 4.3 as we have provided our input on these matters earlier in this submission.

4.4 Selecting and appointing independent directors

Selection

It is good governance for a superannuation fund to create a skills matrix in relation to its board of directors. In effect, *SPS 510 Governance* (para 11) already requires, although it is not made explicit.

A skills matrix identifies the skills, knowledge, experience and capabilities desired of a board to enable it to meet both the current and future challenges of the entity. The creation of a board skills matrix is an opportunity for considered reflection and productive discussion on how the board of directors is constituted currently and also how it believes it should best be constituted in the future to align with the strategic objectives of the fund. It is also an opportunity to review independence.

The board skills matrix should always be tailored to the unique circumstances and requirements of the fund concerned. It identifies:

- the current skills, knowledge, experience and capabilities of the board, and
- any gaps in skills or competencies or independence that can be addressed in future director appointments.

When assessing the skills and competencies desired to align with the strategic objectives of the entity, the board can also assess the current and desired diversity that it seeks in its membership, taking into account all aspects of diversity. A board may also wish to take tenure into account when considering its composition.

It is good governance to review the skills matrix annually, to examine both current and future needs in relation to supervising the fund. The nomination committee could identify the current needs of the board and invite members with those skills who are interested in serving to supply their details to the nomination committee. If a nomination committee is charged with board renewal and the process of reviewing and making recommendations to the board on director appointments and reappointments from independent members and outsiders, it should undertake the annual review of the skills matrix.

Appointment

All funds are owned by members. It is a matter of good governance that those members should have a say in who represents them to act in their best interests. However, we are of the view that the decision-making (voting) should not be connected to a statutory annual general meeting (AGM).

Members could appoint directors and influence board composition via direct voting and on a poll, with a default of online voting.

Direct voting enables members to exercise their voting rights:

- without the need to attend meetings, and
- improves the exercise of voting rights because it removes the intermediary between the member and the entity — members are not required to transfer their right to vote to another party as currently happens with the appointment of a proxy.

Currently superannuation funds provide members with an annual report that is made available to members on the website of the fund. When the report is provided to members, a voting form with the biographies of nominated directors and explanations as to why they are considered independent or not would also be sent to members. The voting form would be provided electronically (with an opt-in to hard copy). There would be a requirement for superannuation funds to keep the polls open for a set period of time (for example, 28 days) and the poll results would be announced as soon as practicable after the polls close (to allow for a proper review to ensure validity of voting). Voting results would be open to public scrutiny.

Voting would be on the basis of the dollar value per vote, in similar fashion to managed investment schemes (MISs). Indeed, given that the regulatory framework is already in place for MISs, and given that there is not a great deal of difference between superannuation funds and other funds management businesses (the difference being that in superannuation members cannot access their funds until retirement), it creates efficiency to apply an existing regulatory framework to the superannuation industry.

We note that voting rights should not differentiate between those in different phases of membership. While members in different phases may have different interests, all members should have the right to appoint the directors they believe will act in their best interests. We note, for example, that members of credit unions may be depositors or borrowers, but there is no differentiation in their right to vote. Equitable voting rights need to be provided, regardless of which phase a member may be in.

A focus on voting will encourage greater engagement on the part of members. While Governance Institute recognises that there is considerable apathy on the part of members in relation to engagement with their funds at present, we are of the view that the current apathy:

- will not be permanent — as members are empowered through the capacity to influence board composition they will seek further engagement, and as financial literacy projects in Australia are furthered, member interest in superannuation is likely to increase
- is not sufficient reason to refuse members the right to elect directors to act in their best interests.

It is not good governance to allow employers, unions or employer organisations, that is, those with conflicts of interests, to have control of the voting process (except to set up the necessary administrative and procedural aspects).

Therefore, employers, unions and employer organisations should not:

- vote
- control or manipulate the voting process
- set the rules without approval by members.

The rules concerning voting should be set out in the constitution of the superannuation fund and made available to members in an easily accessible corporate governance section of the website. Constitutional amendment should be subject to member approval. Elections could be run by the Australian Electoral Commission, which would impose uniformity and potentially reduce costs.

Governance Institute recommends that:

- members of superannuation entities should be provided with the right to elect directors via direct voting, but that the decision-making (voting) should not be connected to a statutory meeting
- employers, unions and employer organisations should not vote, control the voting process or set the rules for voting without approval by members
- the rules concerning voting should be set out in the constitution of the superannuation fund and made available to members in an easily accessible corporate governance section of the website
- constitutional amendment should be subject to member approval.

AGMs

Governance Institute is not of the view that a solution lies in introducing AGMs to provide for greater empowerment to members and greater accountability of directors to members. We note that the Cooper Review canvassed the difficulties of this — the *Super System Review: Final Report* states that:

> In its first Issues Paper on Governance, the Panel canvassed the idea of trustees holding an annual general meeting (AGM) for members of large APRA funds so that members would have a forum to exercise powers in the same way that shareholders can exercise powers with respect to directors at an AGM. While the Panel was initially somewhat attracted to this concept, it has been convinced by the overwhelming weight of submissions that the structural and logistical issues inherent in the superannuation industry make it impractical and undesirable at this time to require superannuation funds to hold AGMs.

Governance Institute is on the record, and has been stating for a number of years, that the AGM requires significant reform. In its current form the AGM as an event is primarily concerned with the engagement of retail shareholders (it does not attract institutional investors), and it fails in this regard. The AGM does not provide a voice for members of corporations in its current regulatory form — Australia is the world's sixth largest country (7,682,300 sq km) and shareholders are dispersed geographically. Physical attendances at AGMs, which has been declining over many years, will never approach a meaningful percentage of the number of

holders a company has, and nor in the case of large companies (some of which now have well over 1,000,000 shareholders) would that be desirable. Given the large membership base of many superannuation funds, similar issues would arise in seeking to engage members through the forum of an AGM.

Our research has shown that shareholders are often more comfortable asking questions of the directors and senior management after the formal AGM than during the meeting. They engage more easily with directors and senior management at non-statutory investor briefings than at the AGM. Anecdotal evidence from companies' experience shows that retail shareholders are more engaged (and more likely to attend) an informal shareholder meeting where they can just hear from the board and executives and ask questions about a company's present condition and performance, rather than sit through a lengthy and highly formal meeting structured around the resolutions that need to be passed.

We are of the view that these findings are useful to consider when assessing how best to provide for superannuation fund member engagement. They are also relevant to our recommendation that direct voting to appoint independent directors be introduced, but not be connected to an AGM. Our recommendations for reform of the AGM are that the meeting and the voting should be delinked (we are happy to speak to the reasons for this, and for how a sound governance outcome is achieved through such delinking).

4.5 Procedures for election of independent chair

The board should elect its own chair. Should the board make a decision not to have an independent chair, it should disclose to members why it is the view of the board that a non-independent chair representing a third party is in the best interests of members.

4.6 Conflicts of interest, related party transactions and relevant disclosures

Related party dealings

APRA now requires that a superannuation entity have in place a conflicts of interest policy. It is good governance for any conflicts of interest policy to convey the message to all responsible persons in the superannuation entity that integrity and effective control cannot be compromised especially in any business dealing when any party is a related party. Related parties, under superannuation law, include members or associates of the superannuation entity, or a standard employer-sponsor, or an associate of a standard employer-sponsor of the superannuation entity. More broadly, it is good practice for a superannuation entity to recognise that there might be other types of related parties with whom conflict may arise, including:

- controlling entities of the superannuation fund, and
- families and relatives of directors or trustees of the superannuation fund, including children, spouses and parents.

APRA Prudential Standard *SPS 521 Conflicts of Interest* addresses related party dealings, and also the disclosure of relevant interests or duties.

Upon being appointed as a director of a trustee, it is good practice for a director to disclose their material or personal interests in a 'standing notice'. The entity should set out the guiding principles for the disclosure of those interests.

The standing notice should provide details of:

- the nature and extent of the interest, including any significant relationships which may create conflicts of interest/loyalty, and
- how the interest relates to the affairs of the superannuation entity.

Directors should give and update notices of their material or personal interests.

The directors of a superannuation fund, at the commencement of a board meeting, ought to be asked to declare any change in the nature and extent of the interest in relation to any of the items on the meeting agenda. If they do, the meeting should then determine the extent to which they may or may not participate in the discussion and vote on that matter. Any declared conflicts of interest and board decisions relating to these should be minuted.

Superannuation entities should ensure that the recording of declared conflicts is consistent with their conflicts of interest policy.

We recognise that many superannuation entities already have implemented such sound governance practices, but any governance code needs to address these matters.

Governance Institute recommends that directors of superannuation entities be required to:

- disclose their material or personal interests in a 'standing notice' upon being appointed as a director of a trustee
- provide update notices of their material or personal interests
- provide for the minutes to show any declared conflicts of interest and board decisions relating to these.

Voting at board meetings

It is good governance for superannuation entities to set out their process for managing conflicts of interests when directors of the superannuation entity are voting on decisions at board meetings where such conflicts arise.

Directors of corporate trustees will have duties under the Corporations Act that prohibit them from being present or voting in such circumstances. However, directors of other superannuation entities are not subject to such prohibitions.

Governance Institute recommends that directors of superannuation entities who have a material or personal interest in a matter being considered at a directors' meeting should:

- not be present while the matter is being considered at the meeting and
- not vote on the matter.

Governance Institute also recommends that a director of a superannuation entity may be present and vote if the directors who do not have such an interest pass a resolution identifying the director; the nature and extent of the director's interest and its relation to the affairs of the superannuation entity; and stating that the directors without a material personal interest are satisfied that the interest does not disqualify the director with the interest from being present at the meeting or voting on the matter. This might occur if the directors had formed a view that allowing the director to be present and vote was in the best interests of the superannuation entity and its beneficiaries. By way of example only, this might occur in circumstances where it is necessary to maintain a quorum, however the 'conflicted director' would be asked to abstain from voting.

Remuneration

Legislation was passed in 2012 that mandates the disclosure of remuneration details of each director or other executive officer if the Registrable Superannuation Entities (RSE) licensee is a body corporate, or each trustee if the RSE licensee is a group of individual trustees from 1 July 2013. Trustees need to disclose all payments, benefits and compensation paid for or provided by the trustee or by related bodies corporate.

ASIC originally exempted superannuation entities from the disclosure until 31 October 2013. On 15 October 2013, ASIC registered Class Order [CO 13/1275] to exempt APRA RSE licensees from the new trustee remuneration disclosure obligations until 1 July 2014. The class order amends Class Order [CO 13/830] which had previously deferred the original start date from 1 July 2013 to 31 October 2013. In deferring the start date again to 1 July 2014, ASIC noted that it had become clear that the superannuation industry needed further time to consider the inherent complexity of the reforms. This is not surprising — listed entities have had years to adjust to

ever-increasing remuneration disclosure requirements, with the first requirements for executive remuneration disclosure effective in 1987. It was not to be expected that superannuation entities could adjust to similar disclosure requirements in one year.

Disclosure is an important aspect of accountability. However, it is equally important to ensure that no conflicts of interest arise in the setting of remuneration for management. A core governance concept is that no individual should be directly involved in deciding their own remuneration.

Our earlier recommendation that board committee requirements for superannuation entities mirror those for listed companies in the Principles and Recommendations would ensure that the remuneration committee be comprised of a majority of independent directors, and that management would not therefore be deciding its own remuneration.

Disclosure of independent directors
Any disclosures concerning directors should not be confined to independent directors. Any disclosure requirements should apply to the board as a whole.

It is good governance to disclose:

- the diversity policy of the board, including requirements for the board to set measurable objectives for achieving gender diversity and to assess annually both the objectives and the fund's progress in achieving them
- the measurable objectives for achieving gender diversity set by the board or relevant committee of the board in accordance with the diversity policy
- the respective proportions of men and women on the board and in senior executive positions
- background of directors, length of tenure on the board and number of board meetings and board committee meetings attended in the reporting period
- remuneration of directors and whether it is paid directly to them or to a nominating organisation.