AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

Level 30
20 Bond Street
Sydney NSW 2000
companydirectors.com.au
ABN 11 008 484 197

T: +61 2 8248 6600
F: +61 2 8248 6633
E: contact@companydirectors.com.au

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Manager
Superannuation Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: superannuationconsultation@treasury.gov.au

Dear Sir/Madam,

Discussion Paper: Better regulation and governance, enhanced transparency and improved competition in superannuation

The Australian Institute of Company Directors welcomes the opportunity to comment on the Government's Discussion Paper, "Better regulation and governance, enhanced transparency and improved competition in superannuation" dated 28 November 2013 (Discussion Paper).

The Australian Institute of Company Directors (Company Directors) is the second largest member-based director association worldwide, with individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, charities, and government and semi-government bodies. As the principal professional body representing a diverse membership of over 34,000 directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

Company Directors applauds the Government's commitment to ensuring the superannuation industry remains stable and efficient and to working closely with the sector to ensure that this is done in a way that does not impose excessive, black-letter regulation.

Our submission only comments on the governance-related measures proposed under the Discussion Paper. Broadly speaking, Company Directors considers that these proposed measures will generally lead to a marked improvement in the governance practices of superannuation funds.

1. Executive summary

- The regulatory framework that is adopted for the governance of superannuation funds needs to recognise and address a number of key differences that exist between the corporate structures of superannuation funds and listed entities and also between superannuation funds and other financial institutions. One way of addressing these differences would be to require superannuation funds to provide greater disclosure of their governance arrangements.
- It would be most logical for governance standards to be introduced through amendments to the current Australian Prudential Regulation Authority (APRA) Prudential Standard that applies to superannuation funds relating to governance (ie SPS 510). To achieve this, it would be appropriate to aligning the requirements of SPS 510 with the governance requirements that apply under APRA's cross-industry Prudential Standard CPS 510.

- Independent directors can make a valuable contribution to the boards of superannuation funds. There should be enough independent directors appointed to the board to genuinely influence and affect the decisions of the board. It is widely accepted that at least a majority of the directors on a board should be independent. The Company Directors also considers that the Chair of a superannuation fund's board should be independent.
- The processes for appointing directors, board and director assessment and board renewal are already adequately addressed under the current Prudential Standard that applies to superannuation funds (ie SPS 510).

2. Implementation issues

We agree with the Government that strong governance arrangements are needed to ensure the interests of the members of superannuation funds are paramount. Given the size and significance of the industry, it is imperative that superannuation funds implement and maintain "best practice" governance structures. As the Discussion Paper has rightly recognised, there must also be a balance between the need to create a regulatory environment that fosters good governance and avoiding the imposition of unreasonable cost and time burdens on superannuation funds.

In our view, generally the regulation of governance arrangements is best achieved through the application of guiding principles, similar to the ASX Corporate Governance Council's (ASX CGC) Corporate Governance Principles and Recommendations[1] (Principles and Recommendations) that apply to ASX listed companies. The ASX Corporate Governance Council comprises a broad range of stakeholder groups, including representative bodies from the superannuation industry.

We note the strong and widespread support for the Principles and Recommendations, which establish a robust governance framework for listed entities without mandating the corporate governance practices that a listed company must adopt. If a board determines that is not appropriate for it to adopt one of the particular practices recommended by the Principles and Recommendations, it may chose not to follow that practice - but where it does so, it must provide an explanation as to why this was appropriate. This "if not, why not" approach recognises that there is no one model of good governance and provides boards with the flexibility to adopt alternative practices where they are of the view that such practices are more suitable to its particular circumstances[2]. Most of the governance arrangements that have been set out in the Principles and Recommendations could be easily adapted for superannuation entities. In our view, Treasury should, to the extent possible, ensure that the regulation of the governance arrangements of superannuation funds is consistent with these, including requirements for the boards of superannuation entities to report and disclose governance arrangements to stakeholders, such as members of the superannuation fund and market participants, for example in their annual report or on their website.

While our preference is generally to take a principles-based approach to corporate governance arrangements, we also acknowledge that there are important differences between the corporate structures of superannuation funds and listed entities (and also between superannuation funds and other financial institutions). In particular:

- Fund members (ie policyholders) have limited ability to control and/or engage with the superannuation fund. They are reliant on a representative body (for

[1] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations 2nd edition with 2010 Amendments,
http://www.asx.com.au/documents/about/cg_principles_recommendations_with_2010_amendments.pdf
We note that these are currently being revised and that a 3rd edition is expected to be released in early 2014.

[2] Note 1 at page 3.

example, in the case of industry superannuation funds, the relevant trade union) to represent their interests at both a shareholder and board level and to apply pressure to improve corporate governance standards where they are not in line with good corporate practice.

- Directors are often not subject to re-election by rotation. Instead, their appointment and removal is usually at the behest of their nominating shareholder.

In developing the regulatory framework for the governance of superannuation funds, it will therefore be necessary to address these differences – the same "if not, why not" regime that applies to listed companies may not be appropriate as superannuation funds do not have the same level of accountability that listed entities have through their shareholder base. The regulatory framework that is adopted for superannuation governance will need to have built-in mechanisms that ensure accountability and encourage the adoption of appropriate governance practices. In our view, one way that this could be achieved would be to require that superannuation funds disclose their corporate governance arrangements publicly (for example on their website) and for there to be greater regulatory oversight to ensure the adequacy of these disclosures.

Given that the APRA already has supervisory powers with respect to superannuation funds, it would be most logical for it to continue to have regulatory oversight of superannuation funds and for any new governance standards to be introduced through amendments to the current Prudential Standard applying to superannuation funds regarding governance (ie SPS 510). Currently, SPS 510 does not address all of the governance issues that we believe should appropriately be dealt with. For example, it does not deal with issues relating to board composition and board representation. We note, however, that these issues have been dealt with in the cross-industry Prudential Standard that applies to other financial institutions, for example in the authorized deposit-taking institutions (ADIs), general insurance and life insurance industries (ie CPS 510). We do not see any compelling reason why superannuation funds should not be held to the same governance standards that apply to other financial institutions. As such, we would recommend amending SPS 510 so that it is aligned with the requirements of CPS 510.

Compliance costs

As superannuation funds already come under the purview of APRA, introducing stronger governance standards for superannuation funds through APRA Prudential Standards (for example, by expanding the existing SPS 510) should not carry significant administrative compliance costs. Introducing new governance standards for superannuation funds in this way will also minimise duplication or inconsistency of regulation and avoids the introduction of further excessive, black-letter regulation.

To ensure a smooth transition to any new governance model, its introduction should allow for a sufficiently period of transition. To remove some of the compliance burden that comes with moving to a new or enhanced regulatory framework, the transition should also be coupled with education for superannuation funds as well as the directors of superannuation entities, in relation to the proposed regulatory changes and governance issues more broadly.

It should be acknowledged, however, that there will inevitably be unavoidable "substantive compliance costs", many of which will be one-off costs, involved in moving to a new framework. However, as these changes are aimed at strengthening governance practices, they are critical to ensuring that the superannuation industry remains stable and efficient.

3. Independence of directors

3.1 Inclusion of independent directors on boards

It is widely accepted that independent directors play an important role in achieving good governance. We note, for example, that:

- the Organisation for Economic Co-operation and Development (OECD) recommends that boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest[3];
- the ASX CGC recommends that a majority of the board should be independent directors[4];
- the Australian Council of Super Investors (ACSI) considers that a board should be comprised of a majority of independent non-executive directors who are sufficiently motivated and equipped to fulfill the function of independent scrutiny of the company's activities[5]; and
- the Financial Services Council (FSC) considers that the board of directors of a listed company should be constituted with a majority of individuals who qualify as independent directors[6].

Additionally, APRA has demonstrated support for the inclusion of independent directors on the boards of organisations in other industries. Paragraph 19 of Prudential Standard CPS 510 provides that the boards of ADIs, general insurers and life companies must (ie not on an "if not, why not" basis) have a majority of independent directors at all times[7].

Company Directors considers that independent directors can make a valuable contribution to the boards of superannuation funds. There are a variety of reasons, with broad relevance, why independent directors are considered important for good governance. By way of example, independent directors may be expected to:

- exercise objective independent judgement in order to make decisions in the best interests of an entity;
- bring external experience and specialist knowledge;
- assist in areas where there is potential for conflict of interest, or where the interests of management, the entity and its shareholders/members may diverge (such as executive remuneration, succession planning, changes of corporate control and the audit function);
- help ensure legal and ethical behavior;
- monitor the activities of an entity and its officers, including decision making and regulatory compliance;

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[3] OECD Principles of Corporate Governance, 2004, Principle VI.E(1), http://www.oecd.org/dataoecd/32/18/31557724.pdf

[4] Note 1, Recommendation 2.1

[5] ACSI Governance Guidelines: A guide for superannuation trustees to monitor listed Australian companies, July 2011, principle 5(d), http://www.acsi.org.au/images/stories/ACSIDocuments/cg_guidelines_2011_final_version_22.06.11.pdf

[6] IFSA (Investment and Financial Services Association Limited) (now FSC) Guidance Note No. 2.00: Corporate Governance: A Guide for Fund Managers and Corporations, June 2009, para 8.2.3, www.ifsa.com.au/downloads/file/IFSAGuidanceNotes/2GN_2_Corporate_Governance_2009.pdf

[7] APRA, Prudential Standard CPS 510: Governance, July 2012, http://www.apra.gov.au/CrossIndustry/Documents/Prudential%20Standard%20CPS%20510%20Governance.pdf

- bring an objective perspective in evaluating the performance of an entity and management;
- bring an objective perspective in identifying and managing risk; and
- assist in balancing competing demands on an entity.

We note that the significance of any particular reason may vary depending on the type of superannuation entity. The Super System Review of the governance, efficiency, structure and operation of the superannuation system (Super System Review)[8] recognised, for example, that independence from management is important for retail funds, while an "outside perspective" is important for industry funds[9].

Company Directors also considers that there are other important reasons for including independent directors on the boards of superannuation funds that are currently subject to the equal representation requirements in Part 9 of the SIS Act (or where a board otherwise comprises only employer and member representatives). These reasons include:

- independent directors can represent and protect the interests of significant groups that are unrepresented under the equal representation model. The Super System Review found that employer and employee representatives are often nominated by third party organisations, such as employer associations and trade unions, which do not necessarily represent the interests of all employers or employees[10]. Similarly, there are other key groups, which are growing in size and are unrepresented under the equal representation model, that include retirees, ex-employees and members who have joined funds by exercising fund choice;
- independent directors can assist employer and member representatives by providing a fresh perspective, as well as bringing different skills and knowledge, particularly where member representatives and employer representatives may have had similar backgrounds, experiences or training;
- independent directors can bring specialist investment, finance, director or trustee experience, which employer and member representatives may lack;
- independent directors may be able to reduce the risk of industrial instability, which is inherent in the equal representation model; and
- unlike many company directors who have long involvement with a company and substantial company-specific knowledge, employer and member representatives may have no real understanding of the superannuation fund, the superannuation entity or the superannuation industry generally. Where this is the case, a failure to appoint independent directors with specialist skills and knowledge may be particularly problematic.

In terms of how many independent directors should be present on the board of a superannuation entity, Company Directors considers that there should be enough independent directors to genuinely influence and affect the decisions of the board. It is widely accepted that at least a majority of the directors on a board should be independent. The Company Directors also considers that the Chair of a superannuation entity's board should be independent[11].

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[8] Super System Review chaired by Jeremy Cooper, Final Report, http://www.supersystemreview.gov.au

[9] Super System Review, *op. cit.,* s.4.3

[10] Super System Review, *op. cit.,* s.4.2

[11] See also: APRA Prudential Standard CPS 510: Governance, para 20; ASX Corporate Governance Principles, *op. cit.*, Recommendation 2.2; IFSA Guidance Note No. 2.00, *op. cit.*, para 8.2.5

While Company Directors supports the inclusion of independent directors on the boards of superannuation entities, we do not believe that this practice should be mandatory. Superannuation entity boards should be free to determine their own composition and structure rather than needing to comply with a "one-size-fits all" approach. Boards should generally be able to adopt governance practices that are appropriate for the type of superannuation entity and its situation, size, structure and industry associations. This flexibility is particularly important in view of the ongoing and rapid changes to the environment that superannuation funds operate in.

That said, we do not believe that provisions regarding independent directors can be left to purely non-mandatory guidance for a number of reasons, including:

- this may signify that the practice of including independent directors on boards is relatively unimportant;
- superannuation funds may be unwilling to go to the time and expense of changing their current practices (particularly if members are satisfied with the recent financial performance of the superannuation fund);
- superannuation funds may focus on short-term performance instead of implementing changes to governance practices that are necessary for sustainable long-term growth;
- superannuation funds that receive little industry and media attention may be unwilling to change their current practices; and
- many superannuation funds with good governance practices already have independent directors on their boards, while those with poor practices are less likely to voluntarily to adopt a new practice.

As noted above, our preferred approach to the governance regulation of superannuation entities is to apply an approach consistent with the "if not, why not" reporting practice adopted by the ASX CGC in its Principles and Recommendations. This approach has proved to be an effective mechanism for encouraging the inclusion of independent directors on boards of listed companies while avoiding a "one-size-fits all" approach to corporate governance. It follows that taking this same approach would also be effective in encouraging greater representation of independent directors on the boards of superannuation entities. This would need to be coupled with appropriate disclosure of the arrangements that have been adopted by an entity, together with an explanation of why this is appropriate for its particular circumstances.

However, given the director independence requirements that apply to other APRA-regulated entities do not apply on an "if not, why not" basis, in order to align the governance standards of superannuation funds with those of other financial institutions and in light of the key differences between superannuation funds and listed entities (as set out in section 2 above), in our view it will be appropriate for the same requirements to apply to the boards of superannuation funds.

3.2 Definition of "independent director"

In defining the term "independent director", it is important to recognise that the determination of a director's independence involves an assessment of whether the director is, as a matter of practice, in a position to exercise independent judgment as a director. This assessment needs to be able to take into account a number of factors that may impact on the director's ability to exercise independent judgement.

While we do agree that there are certain relationships that are likely to be relevant to the board's consideration of a director's independence, Company Directors opposes the use of indicative factors based on the director's relationship with the company[12]. It is our view that, by listing these relationships for the purposes of defining when a director will be "independent", this can create an unofficial "independence criteria". A director's independence cannot be assessed strictly against set criteria, nor can it be based on any one factor. There are a number of factors that may impact on a director's independence, and many of these are captured in Box 2.1 of the ASX CGC's Corporate Governance Principles and Recommendations (Principles and Recommendations); however, a director's independence is ultimately a function of attitude, diligence and mindset. A board can be expected to take into account all relevant interests, positions, associations and relationships that could impact on a director's ability to exercise independent judgement – but the board's assessment should ultimately be made based on whether the director is in fact independent of mind and in practice exercises their judgement in an unfettered and independent manner.

Accordingly, we would recommend that a broad description of "independent" be adopted for directors of superannuation funds, similar to the one that is used for the purposes of Principle 2 under the Principles and Recommendations, namely:

> *An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with - or could reasonably be perceived to materially interfere with – the independent exercise of their judgement.*

If any examples are to be provided of the types of relationships that might be considered to materially interfere with the independent exercise of their judgement (along the lines of Box 2.1 of the Principles and Recommendations and as adapted for Annexure A of the APRA Prudential Standard CPS 510), it should be made clear that the existence of any such relationship is just one consideration to be taken into account. Ultimately, independence is a matter for determination by the board based on whether the director is in fact independent of mind and in practice exercises their judgement in an unfettered and independent manner. Such factors should <u>not</u> be considered as factors that preclude a director from being independent. Contrary to what has been stated in the Discussion Paper[13], the existence of one of the relationships set out in Box 2.1 of the Principles and Recommendations does not automatically preclude a director of a listed company from being considered independent – although if a director is considered by the board to be independent notwithstanding the existence of one of these relationships, the company must disclose the reasons why. A similar approach should be taken for directors of superannuation funds.

Again, however, we acknowledge that this has not been the approach taken by APRA. In its Prudential Standard CPS 510, APRA has listed a number of relationships that, if they exist, mean that a director will not be independent for the purposes of the standard. While we do not agree with this approach, if SPS 510 is to be aligned with the requirements of CPS 510 to bring superannuation funds in line with other financial institutions, this more prescriptive definition will also need to apply to superannuation funds.

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[12] See AICD submission to the ASX Corporate Governance Council dated 14 November 2013 in response to the Review of the Principles of Good Corporate Governance and Best Practice Recommendations < http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Submissions/2013/Submission-on-revised-Corporate-Governance-Principles-and-Recommendations> and also on 9 February 2007 in response to an earlier Review of the Principles of Good Corporate Governance and Best Practice Recommendations <http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Submissions/2007/~/media/Resources/Director%20Resource%20Centre/Policy%20on%20director%20issues/2007/SUBM200701_ReviewASXPrinciples.ashx>.

[13] See page 1 1

4. Process for appointing directors

As is the case for ASX listed companies, there should be a formal and transparent procedure for the election, appointment and re-appointment of directors to the boards of superannuation funds. This transparency will help promote investor understanding and confidence in that process.

We do not, however, believe that it is appropriate for any particular director appointment process for superannuation entities to be mandated in any way – whether for the appointment of independent directors or otherwise. Instead, we recommend that superannuation funds be required to disclose the processes that the board has adopted for the purposes of searching for and selecting new directors to the board. Again, we believe that this disclosure should be along the same lines as is expected of ASX listed companies under the Principles and Recommendations[14] and should include information on:

- whether the superannuation entity develops a board skills matrix and uses this matrix to identify any 'gaps' in the skills and experience of the directors on the board;
- the process by which candidates are identified and selected including whether professional intermediaries are used to identify and/or assess candidates. Where different processes have been adopted for the appointment of directors who are not independent, for example member directors and employer representatives, details of these processes should also be disclosed;
- the steps taken to ensure that a diverse range of candidates is considered for director election; and
- the factors taken into account in the selection process.

Currently, Prudential Standard SPS 510 already states that the board of a superannuation entity must have a "formal policy on Board renewal" detailing "the process for appointing and removing directors, including the factors that will determine when an existing director will be re-appointed"[15]. This is consistent with the Prudential Standard that applies to other financial institutions. In our view, this sufficiently deals with the issue and no changes are required. However, as noted earlier, to enhance transparency and to reflect the differences between superannuation funds and other corporate entities, superannuation funds should also be required to disclose the policies and arrangements that they have adopted in compliance with the requirements of SPS 510.

5. Ongoing effectiveness of superannuation trustee boards

In order to be able to discharge its mandate effectively, the board (or a committee of the board) should have in place a process for evaluating the performance of the board, its committees and individual directors. Such an evaluation enables identification of the particular skills that will best increase board effectiveness and of any changes in the needs of the board over time. It should also have a plan for identifying, assessing and enhancing director competencies.

Board performance assessment is already dealt with under SPS 510 which requires that boards have "procedures for assessing, at least annually, the Board's performance relative to its objectives" and that it "also have in place a procedure for assessing, at least

[14] Note 1, Recommendation 2.6. Any amendments made to this Recommendation under the 3rd edition should also be incorporated under the Prudential Standards to ensure that they remain aligned.
[15] APRA Prudential Standard SPS 510: Governance, para 20

annually, the performance of individual directors"[16]. In our view, this adequately deals with the issue and note that it is consistent with the requirements of CPS 510.

As noted in the Principles and Recommendations, Board renewal is also critical to performance, and directors should be conscious of the duration of each director's tenure in succession planning. However, rather than mandating a maximum appointment term or any other restrictions on director tenure, the boards of superannuation funds should be expected to consider issues of tenure and how they will deal with succession planning to maintain an appropriate mix of skills, experience, expertise and diversity on the board.

This is consistent with the requirements of SPS 510 which notes that the board's formal policy on board renewal should detail "how the board will renew itself in order to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise" and that the policy give consideration to "whether directors have served on the Board for a period that could, or could reasonably be perceived to, materially interfere with their ability to act in the best interests of beneficiaries"[17]. Again, in our view, this adequately deals with the issue and is consistent with the requirements applying to other financial institutions under CPS 510. However, as noted earlier, to enhance transparency and to reflect the differences between superannuation funds and other corporate entities, superannuation funds should also be required to disclose the policies and arrangements that they have adopted in compliance with the requirements of SPS 510.

We hope that our comments will be of assistance to Treasury. Please do not hesitate to contact Senior Policy Advisor, Gemma Morgan on (02) 8248 2724 if you would like to discuss.

Yours sincerely

John Colvin
CEO & Managing Director

[16] Note 15, para 19
[17] Note 15, para 20