Reforms to Superannuation Governance

23 July 2015

AIST Submission

AIST

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

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

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

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1 Executive summary

AIST does not support the proposed governance changes outlined in the exposure draft legislation circulated for consultation on 26 June 2015.

The reform package comes in two parts – the exposure draft legislation and a letter from APRA also dated 26 June 2015. APRA's letter outlines its intentions for prudential reforms to support the implementation of the proposed changes.

The details of APRA's proposed amendments to the Governance Prudential Standard (SPS 510) and the new Transition Prudential Standard (SPS 512) have not been released and accordingly the full package of reforms cannot be considered side-by-side to provide a comprehensive understanding of the likely impact of the proposals. This makes informed comment on these changes within the timeframe specified by the Government impossible.

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

Funds that return all-profits-to members have not been at the centre of the recent financial planning scandals that have plagued the banks. There have been no prudential failures or losses suffered by members in our sector, yet these proposed changes will have a bigger impact on equal representation boards that the for-profit retail sector.

AIST submits that these changes will impose significant costs and introduce risks to the industry for no good reason. The changes also take Australia in the opposite direction to the rest of the world by removing member representation from boards of occupational-based retirement savings funds.

The proposed changes do nothing to address the real and demonstrated conflicts associated with board structures in the retail superannuation sector where it will still be possible for the staff of a bank (dedicated to the profitability of their employer) to form the majority of the bank superannuation fund board, and for the 'independent' directors to be the same 'independent' directors that sit on other boards of the same banking institution, where again they are responsible for maximising profits for the bank's shareholders.

AIST disputes the need for change in light of the existing prudential framework and the powers available to the regulators to rectify or address any issues that arise. With the changes, APRA is granted powers that should only lie with the legislature in the proposed package of reforms, as well as powers that are

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significantly broader than those available to the in the regulation of other APRA-regulated industries.

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

Whilst the whole package is unclear and subject to the determination of the regulator (which is a serious matter, given that this aspect breaches the rule of law), there is sufficient detail to demonstrate that there will be unintended consequences to these proposals, as well as a range of unreasonable risks that will naturally flow.

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

- The single governance model proposed to sit across all regulated superannuation funds is not fit-for-purpose as it dismantles the successful equal representation model and does not address the most significant and fundamental conflict inherent in banks and other for-profit (or 'retail') institutions managing compulsory superannuation savings.
- The exposure draft legislation cannot be reviewed in isolation, as too much of the detail set out in the legislative proposals needs to be clarified by APRA in its Prudential Standards and guidance. Accordingly any legislation should not be progressed until it can be further analysed with the complementary APRA proposals. AIST supports a principles-based approach that should be set out in the legislation.
- Leaving the further definition and interpretation of key terms in the proposed changes, as well as the ability to approve and supervise outcomes to the regulator is contrary to the proper operation of the rule of law, and should not be pursued.
- The equal representation governance model, with flexibility for up to one-third independent directors satisfies a principles-based framework of good governance. AIST opposes changes to the equal representation system outlined in the exposure draft legislation.
- Both a member and an employer voice in a mandatory savings system is vital and that it should be preserved in all sectors of the APRA-regulated superannuation industry. The representative model ensures a deep knowledge of the membership, representation of their respective interests in a mandatory system, and a balancing of considerations between in the pursuit of the best possible outcomes for members.
- The choice of Chair should be a decision for the superannuation fund board, and should not be subject to legislative intervention. The Chair should be the best person for the role.
- The proposed one-size-fits-all definition for not-for-profit and retail for-profit sector funds is unworkable. AIST supports a principles-based approach for any new governance-related definition,

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with inherent flexibility and adaptability for the specific differences that exist in the two sectors. AIST opposes APRA being granted powers that should be exercised by the legislature.

- There should be no power for APRA to make determinations on a person's independence; only the capacity to give guidance, such as exists in CPS 510.
- The transition period for implementing the proposed changes is inadequate and inherently dangerous to the stability of the financial sector and the operation of each super fund.
- The regulator should be allowed to consider special circumstances for a failure to transition where the intention is to cease operation before 1 July 2019.
- The transition plan due date should be reviewed in the event that the final APRA Prudential Standards SPS 510 and SPS 512 are not available before the end of 2015.
- The proposed majority independent director reporting requirement should be abandoned. Funds should not be required to report against a benchmark that is not a legal obligation as this will only confuse members.
- The two-thirds voting rule for board decision-making should be maintained.
- Boards should retain their power to seek regulator approval for alterations of the right to claim and/or change the amount of an accrued benefit that have been approved by the board.

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2 Introduction

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

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

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

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

2.1 Reform package considerations

The Government has proposed significant changes to the composition of super fund boards in the exposure draft legislation, released for consultation on 26 June 2015. At the same time, APRA has set out in a letter of the same day its intentions on supporting the implementation of the legislation. However, the detail of the proposed prudential framework reforms is not available for comment at this time. It is therefore difficult to respond to the exposure draft legislation without being able to review the reform package as a whole.

AIST submits that the exposure draft legislation cannot be reviewed in isolation, as too much of the detail set out in the legislative proposals needs to be clarified by APRA in its Prudential Standards and guidance and that accordingly any legislation should not be progressed until it can be further analysed with the complementary APRA proposals. Even though such details are as yet unavailable, **AIST submits** that a principles-based framework should be adopted in the legislation as opposed to the model proposed.

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

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Furthermore, **AIST submits** that leaving the further definition and interpretation of key terms in the proposed changes, as well as the ability to approve and supervise outcomes to the regulator is contrary to the proper operation of the rule of law, and should not be pursued.

Meanwhile, AIST makes its best endeavours in this submission to address the exposure draft proposals that have been released for consultation.

2.2 Evidence-based reform

In a listed company context, independent directors are there to protect minority shareholders and to ensure independence from management. In the not-for-profit superannuation sector these protections are neither relevant nor necessary - minority shareholders don't exist and superannuation funds must act in the best interests of all beneficiaries. A trustee is not a listed company in function or in form, and these changes fail to recognise that fundamental difference.

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

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

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

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

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

The costs will include legal costs for the amendment of constitutions, potential legal costs for RSE licensee ownership model restructuring, plus recruitment costs and new director training. Legal costs for constitutional changes are estimated at around $25,000 per RSE licensee (depending on the complexity of changes required), individual director recruitment costs estimated at $60,000 per new director (more for Chairs, some sources indicate $100,000 per Chair), advertising costs at an estimated $8,500 for a national newspaper, and director training a further minimum of $8,500 per director. We estimate the total, pure transitional cost to AIST member funds (based on 60 funds) to be $20 million in the first year. Director fees, and in particular the fees of Chairs, will increase and this greater expense will be ongoing.

AIST supports a principles-based regulatory framework for superannuation fund governance where the law allows superannuation funds to make decisions in the best interests of their members, taking into consideration the unique nature of their fund's size, business mix and complexity of their operations. AIST supports a framework that preserves accountability to members, a voice for both members and employers and a board of trustee directors drawn from a wide pool of appropriately skilled individuals with no material conflicts of interest or duty.

Professor Donald C Clarke notes that:

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

AIST does not dispute that independent directors can add value to a board, however the significance of their contribution depends on the individual needs of that board and an alignment with the skills and competencies of the independent director. A structural reorganisation of boards by the legislature to

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

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

Corporate scandals and failures in Australia have similarly arisen as a result of structural and systemic conflicts of interest arising in for-profit structures where the inclusion of independent directors on boards has failed to avoid these crises. The demise of OneTel, for example, resulted from poor corporate governance practices, in particular a situation where the independent directors failed to exercise adequate monitoring and oversight of management, as a result of the strong executive representation on the OneTel board.[4]

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

SuperRatings' data to 30 June 2015 on the performance of Australia's superannuation funds shows industry not-for-profit super funds as having outperformed retail super funds by 2 per cent for the year. On a rolling 10-year basis the outperformance is 1.94 per cent.[5] This trend has persisted since the introduction of compulsory superannuation.

Research conducted by APRA in 2008 also highlighted that the time commitment of the trustee directors of not-for-profit funds far outweighed that of directors on retail fund boards (1,364 director hours compared with 559 director hours for retail funds).[6]

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

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

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

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

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

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

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

2.3 Broader pool of experience and expertise already exists

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

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

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

In considering governance in financial institutions post-Global Financial Crisis, the European Commission in 2010 said: "Empirical evidence highlights the benefits of diversity for corporate governance both in terms of efficiency and better monitoring. Diversity, not just of gender but also of race and social background,

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and the presence of employee representatives, broadens the debate within boards and helps, as some say to avoid the danger of narrow group think."[7]

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

2.4 Director skills and training

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

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

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

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

2.5 Independents and other directors with conflicting interests

According to the Explanatory Guide, the proposed changes to superannuation governance 'allow for an increased accountability of decisions made by other directors who may have conflicting interests'. This principle stems from corporate boards where the independence sought is primarily from the executives of

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

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the company who might act in their own interests and not those of the shareholders. Yet on not-for-profit superannuation fund boards all of the directors are independent of the management.

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

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

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

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

APRA's 2010 report[9] into related party transactions in the superannuation industry highlights the fact that retail funds have significant financial conflicts at play in their related party transactions, and that these conflicts have resulted in significant additional costs to the super fund members. In the case of administration fees, for example, APRA revealed that the fees paid by members of some retail funds were more than twice that of not-for-profit funds. It is these conflicts that the introduction of independent directors seeks to address. It is these considerations that should be central to what is meant by 'independence' – overcoming the impact of relationships and associations that due to the potential

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

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

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personal benefit to the director, could influence their decision-making in a way that does not prioritise the best interests of members.

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

> *History tells us that independence neither guarantees good financial performance nor freedom from scandal … Structural rules around independence fails on all counts … The injection of new blood is forced. … Policies that assume that structural independence is a panacea capable of addressing failures in group decision making are simply a recipe for disappointment.*[10]

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

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3 Government proposals

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

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

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

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

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

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

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

The explanatory guide states that the proposals seek 'to promote good governance by broadening each board's pool of experience and expertise' as well as 'allow for an increased accountability of decisions made by other directors who may have conflicting interests'. Both these principles are valid and important governance objectives and are supported by AIST. However, we disagree that the proposed reforms achieve those aims.

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The proposed changes do nothing to address the real and demonstrated conflicts associated with board structures in the retail superannuation sector where it will still be possible for the staff of a bank (dedicated to the profitability of their employer) to form the majority of the bank superannuation fund board, and for the 'independent' directors to be the same 'independent' directors that sit on other boards of the same banking institution, where again they are responsible for maximising profits for the bank's shareholders.

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

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

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

AIST does not support further government intervention in board composition of equal representation boards when a strong regulatory framework already exists, and the regulators have sufficient powers to ensure the fitness and propriety of directors, as well as how the management of conflicts is handled.

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

The intention that these independent directors would then also be required to sit on - and potentially Chair - board audit and board remuneration committees, as suggested in APRA's letter, is also problematic. This suggestion potentially narrows the qualifications and experience of the new directors to those suitable for the mandated committee commitments, excluding other expertise, such as investment for example.

AIST therefore supports the retention of equal representation.

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

The exposure draft legislation seeks to introduce a minimum one-third independent directors onto regulated superannuation fund boards, including an independent Chair. We understand that the intention in the legislation is to allow an independent Chair to count towards the minimum one-third independent director requirement (Explanatory Guide, p. 3).

Clause 86(1) of the exposure draft Bill however, after paragraph (a) and before the paragraph (b) adds the word 'and', allowing for the interpretation that the 'at least one third' referred to in paragraph (a) to mean one-third and a Chair who is independent. The intention as identified in the explanatory guide should

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therefore be more clearly defined in the legislation, and provide certainty that the independent Chair is included within the one-third requirement.

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

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

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

3.4 Meaning of independent is unclear, unworkable, and breaches the rule of law

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

The exposure draft legislation provides a definition of independent at clause 87. The true meaning of the definition is uncertain, however, as APRA will have the power to give meaning to key terms in the definition. Clearly, the meaning that is given to the terms 'directly associated' and 'material relationship' will have a substantial impact on the effect and operation of the legislation. Without seeing the full reform package on the definition it is therefore difficult to assess and comment conclusively.

In any event, AIST strongly contends that it is highly inappropriate that APRA will be placed in the role of being law-maker (eg. defining terms in the legislation), judge (eg. if a person is 'independent') as well as jury (regulator and supervisor of the trustee board) as a consequence of the proposed reforms. The rule of law requires that Australians are governed by laws made by their elected representatives, and requires a

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separation between the legislature, the executive and the judiciary. Here, it is proposed that the executive (APRA) be given powers that should properly be exercised by the legislature.

AIST strongly submits that the proposed one-size-fits-all definition for not-for-profit and retail sector funds is unworkable. AIST supports a principles-based approach for any new governance-related definition, with inherent flexibility and adaptability for the specific differences that exist in the two sectors. AIST opposes APRA being granted powers that should be exercised by the legislature.

However, AIST provides the following comments on the basis of the information on the definition that is currently available to us:

There are essentially three circumstances whereby a person will not qualify as independent. Each of these issues renders the definition as unclear, unworkable, and in breach of the rule of law:

1. **The person having a substantial holding in the RSE licensee or being directly associated with a person who has a substantial holding.** This part of the definition appears to assume that RSE licensees have a particular corporate structure. However, structures within the not-for-profit superannuation sector vary widely. An RSE licensee that is a public company limited by guarantee, for example, does not have substantial holdings vested in any person/s. Further, some funds have shares held by the directors from time-to-time, or under trust arrangements. This part of the proposed legislation would therefore require some RSE licensees to restructure. For example, it seems that it would no longer be permissible for shares to be held by the directors of an RSE licensee from time-to-time. AIST queries whether it is appropriate that restructuring should be required of RSE licensees by an indirect method such as this, and further queries whether there is evidence to suggest that structures of this nature are problematic.
2. **The person not having a material relationship or an employment relationship with someone who has such a material relationship, with the RSE licensee.** 'Material relationship' is not defined in the exposure draft legislation and is intended to be clarified by APRA. The as yet undefined limitations on material relationships (including, it would appear based on statements made by APRA, employees of professional advisers, suppliers, consultants, nominating bodies and employer sponsors) can be expected to reduce significantly the pool from which to draw appropriate trustee director candidates. This principle could unreasonably exclude non-conflicted and highly skilled potential trustee director candidates.

   The extent of the employment relationship proposed poses unintended consequences. For example, Australian Super has 210,000 contributing employers of which 70,000 employers contribute as a result purely of member choice. This leaves 140,000 standard employer sponsors. Excluding anyone that has worked for one of these employers, regardless of their individual connection to the RSE licensee, excludes a substantial number of people from the pool. The operation of the provision, as drafted, applies regardless of the number of employees enrolled as

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members with the RSE licensee (it could be 3 out of 1,000), or whether the potential director candidate has any influence over, or knowledge of the employer's default super fund selection.

Also, AIST does not believe that excluding specific industry knowledge of the sector that a super fund services is in the best interests of members. For example, a director candidate with direct health industry knowledge, for an industry fund such as HESTA (which services health and care workers) should not be excluded because their employer contributes to HESTA. AIST submits that the alignment of interest and the industry understanding helps the HESTA board to make better decisions as a result.

Similarly, not all employees of material service providers are potentially conflicted insiders. Many service providers to the superannuation industry are multi-national companies, with thousands of employees. A board candidate might be ruled out because of their employment by such a company, even if they have had no involvement with services provided to the particular superannuation fund.

AIST submits that consideration of material relationships should correlate with the potential of those relationships to materially interfere with the exercise of independent judgement. It is not the relationship itself, but rather the nature of the relationship that should be considered. This approach will also more closely align with the CPS 510 requirements.

3. **Executive or director roles held within the previous three years in an organisation that has a material relationship with the RSE licensee.** Again, 'material relationship' is not defined in the exposure draft legislation and AIST submits that this must be dealt with in legislation, not by the regulator. As outlined above, not all employees of material service providers, for example, are potentially conflicted insiders. Similarly, the mere act of being nominated by a nominating organisation for a board position should not impact on the nominee's independence. AIST is aware of many instances where the nominating body has used their nominating rights to put forward qualified candidates who do not have an association or affiliation with the nominating organisation. These individuals should not be disqualified as independent directors only a result of their nomination.

AIST opposes the introduction of clause 87(2) whereby APRA in its Prudential Standards can overlay the legislative definition with further requirements relating to a person's independence. In effect, this places APRA in the position of making the law. This is the role of the legislature. The law should be defined in a parliamentary instrument and the regulator should provide oversight.

AIST submits that only a principles-based approach for a whole-of industry definition is appropriate, with inherent flexibility and adaptability for the specific differences that exist in the two sectors. Clause 87(2) should be removed from the proposed legislation.

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3.5 APRA's powers to determine independence breaches the rule of law

AIST is concerned that the exposure draft legislation allows for the prudential regulator to supplement the proposed SIS Act definition of independent through its Prudential Standards making powers and then also determine whether a person is or isn't independent.

Clause 88 states that APRA may determine if a person is independent, based on APRA's assessment that the person is likely to be able to exercise independent judgement in performing their role as a director. Clause 90 states that APRA may determine that a person is not independent if it is satisfied that the person is unlikely to be able to exercise independent judgement in performing their role as a director.

It is unclear how APRA could be expected to undertake assessments of this type. Ultimately, this is an issue to do with conflict management, and that issue is dealt with already in the legislation and in the Prudential Standards. While APRA can consider what other interests and duties a proposed director may have, it cannot know whether the individual concerned is likely or unlikely to exercise independent judgment. A determination on that matter would require an assessment of the individual's character, past behaviour and the like, and this would be beyond APRA's capacity to undertake.

CPS 510's definition of independent director also refers to a director's ability to exercise independent judgement, but only in the context of any of the person's associations or shareholdings materially interfering with that capacity. Entities regulated under CPS 510 are able to seek guidance from APRA on the question of independence and there are no determination powers such as those proposed in clauses 88 and 90 of the exposure draft legislation. The exposure draft legislation provides no frame of reference within which APRA is required to make their determination, making the law uncertain. **AIST submits** that the power is too broad and unreasonable.

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

AIST submits that there should be no power for APRA to make determinations; only the capacity to give guidance such as exists in CPS 510.

Clause 93 of the exposure draft legislation proposes that non-compliance with the provisions of the proposed new Part 9 of the SIS Act may result in a direction to not receive employer-sponsor contributions. This is a serious consequence for non-compliance and AIST submits that as so much is reliant on proposed powers vested in APRA, outside of the SIS Act, that the proposals be reassessed giving proper consideration for the role of the legislature and the executive.

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3.6 Transition to the new arrangements

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

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

With regard to the impact on RSE licensees intending to cease operations before 1 July 2019, we submit that those RSE licensees attempting to merge during the transition period, who make all reasonable efforts, and act in good faith, should be exempted from the full consequences of non-compliance in the event that the merger fails just prior to the transition cut-off date. Such breaches should be judged on a case-by-case basis, and APRA should provide relief in genuine cases of best efforts made.

AST submits that the regulator be allowed to consider special circumstances for a failure to transition where the intention is to cease operation before 1 July 2019.

As we do not have the complete reform proposal package available for comment, RSE licensees cannot begin to work on their transition plans until the full details are available. Whether existing directors or Chairs meet the criteria for example, will not be clear until 'material relationship' is defined. This may mean that a deadline of 1 July 2016 for a transition plan to be delivered to APRA may not be realistic. APRA's letter of intent indicates that it will require an assessment and plan for each individual director on the existing board. It is unreasonable to expect that this can be achieved within the timeframe, and AIST proposes that a transition plan containing details of the process to be undertaken should be sufficient.

AIST submits that the transition plan due date be reviewed in the event that the full package of reforms is not available before the end of 2015.

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

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3.7 Reporting on majority independents

AIST opposes the proposed changes to paragraph 7.9.37(1)(c) of the Corporations Regulations. The Government's proposed governance changes require a minimum one-third independent directors on superannuation fund boards, yet the reporting requirement relates to an unrelated stipulation of a majority of independent directors.

If a reporting requirement is deemed necessary, the appropriate reporting requirement should relate to the legal obligation that, under the proposals, is a minimum one-third. A reporting requirement related to a majority is not in any way linked to the duties and obligations of the trustee and would potentially confuse members or other stakeholders by creating an impression that funds that do not have a majority of independent directors are in some way deficient.

AIST submits that the proposed paragraphs 7.9.37(1)(c) - (cb) of the Corporations Regulations be abandoned.

3.8 Two-thirds rule

AIST opposes the repeal of the two-thirds voting rule in regulation 4.08. The two-thirds voting rule has effectively lent itself to the development of consensus decision-making in the majority of board decisions. AIST supports a governance model whereby consensus decision-making is encouraged ensuring that risks are appropriately considered and debated.

Good governance practices will be diluted without the need for substantial majority support in board decisions. Only well-considered proposals should be passed by the board, and with a two-thirds majority requirement, this robustness of process is more likely to be maintained than with a simple majority. The risks of decisions being made without substantial majority board support fractures good governance, exposes the members of the fund to greater risks and less due diligence in decision-making. Removal of the voting rule may lead to poor governance practices and board procedures and this is of great concern to AIST.

Furthermore, with a short transition period coupled with a high board turnover, AIST submits that removing the two-thirds rule poses a real risk to sound decision-making as the experience and corporate memory will have suffered as a result of the transition to the new arrangements.

AIST submits that the two-thirds voting rule be maintained.

3.9 Accrued benefits

Given its opposition to the abolition of the equal representation principles, AIST opposes thF20e repeal of SIS Regulations 13.16(2)(a)(ii) and 13.16(5) which seek to remove one of the ways in which a member's right or claim to accrued benefits (and the amount of those benefits) can be altered adversely. The proposed Regulation doesn't provide an option for the regulator to approve alteration of the right to

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claim/change the amount of an accrued benefit other than where at least two-thirds of the affected beneficiaries have approved the change.

It is important that boards retain the power to seek the regulator's consent, having approved such alterations. Engaging a substantial majority of members on any issue is impossible. However, circumstances may arise where the trustee believes it is in the best interests of members that a change be made, such as where this is necessary to secure the ongoing viability of a defined benefit fund. AIST queries whether it is intended to remove the power of boards to approach the regulator for consent in these circumstances? This is a substantive change going well beyond the mere adjustment for the removal of equal representation.

AIST submits that boards should retain their power to seek the approval of the Regulator for alterations of the right to claim and/or change the amount of an accrued benefit.

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4 Conclusion

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

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

The introduction of APRA's 12 new prudential standards in 2013 including new fit and proper processes – together with key amendments to the SIS Act – have significantly raised the bar on the level of skill, duty of care and due diligence required of directors. Even before these standards came into play, Australia was ranked third out of 18 countries[11] in relation to governance – this ranking has now improved to second following the Stronger Super reforms.

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

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

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

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

APRA's already enhanced powers in superannuation are sufficient to deal with governance issues that might arise and the proposed extension of those powers as proposed is contrary to the rule of law.

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

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There is no evidence to support the need for changes to board composition and AIST opposes the disruption, unnecessary cost and potential harm that the government's proposed governance changes may have on the best interests of super fund members.

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