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Subject: Exposure Draft Superannuation Legislation Amendment (Governance) Bill 2015, Regulations and Proposed changes to the relevant Prudential Standard

To whom it may concern

The Financial Services Council (FSC) supports the Government's proposed reforms to raise standards of governance in the superannuation industry set out in the Exposure draft *Superannuation Legislation Amendment (Governance) Bill 2005: Governance arrangements for APRA regulated superannuation funds* (Draft Bill*) and the corresponding regulations (*Draft Regulations*)*.

A requirement to have independent directors and an independent chair on the boards of superannuation trustees is consistent with international best practice for corporate governance and is in the best interest of consumers. It is consistent with recommendations from the Super System Review and the Financial System Inquiry.

The FSC welcomes the opportunity to address technical issues in relation to the Draft Bill, Draft Regulations and APRA's proposed amendments to its prudential standard. Due to the overlapping nature of the issues, the FSC uses this submission to address issues that arise in relation to all three documents.

This submission focuses on the following topics:

- Potential gaps in the definition of independence that may undermine the reforms;
- A recommendation that the Government consider legislating an obligation on trustee boards to consider whether each board committee have an independent chair, and if an independent chair is not appointed, an explanation of why this is not the case;
- Amendments to the transitional arrangements, to be applied on a case by case basis, to prevent disturbance in the market and allow for a smooth transition; and
- A proposed ban on individuals from acting as independent directors on the boards of competing trustees.

Please contact me on 02 8235 2566 if you have any further questions in relation to this submission.

Yours sincerely

BLAKE BRIGGS
SENIOR POLICY MANAGER

Definition of independent

The purpose of the reforms is to improve governance standards by reducing the scope for potential conflicts amongst one-third of the directors. A robust definition of 'independent' is critical to achieving this outcome.

The FSC is concerned that there are potential 'gaps' in the proposed definition of independence and the related APRA letter to ALL RSE Licensees dated 26 June 2015 (APRA's Letter). These gaps arise as a result of the Draft Bill concerning itself with the relationship between the individual director and RSE licensee, and not also considering the individual director and the nominating body or sponsoring organisation.

The FSC submits that the current drafting would allow an individual who has a material relationship with a sponsoring organisation or body with nomination or appointment rights to satisfy the definition of independent, even though this may give rise to a conflict of interest that could undermine their capacity to act independently of the sponsoring or nominating organisation.

The Draft Bill proposes a person is independent if they do not have a substantial holding in the trustee or its related bodies corporate, they are not directly associated with a person who has such a holding, they do not have a material relationship (or not employed by such a person) with the trustee and are not an executive officer or director of a body corporate that has in the past 3 years had a material relationship with the RSE.

The Draft Bill grants APRA the power to amend the *Superannuation Industry (Supervision) Act 1993* (SIS Act) to determine what is a material relationship for these purposes. APRA's letter of 26 June 2015 suggests that it will include in the definition; relationships with material professional advisers, consultants and suppliers, as well as standard employer sponsors, parent companies and bodies with the right to nominate directors.

An important aspect of the Bill is that it provides that independence is lost if the person has a 'material relationship' with the trustee. This test includes persons who do not have or have not had within the last three years a material relationship with the trustee, including through their employer and a sponsoring or nominating organisation. As such, independence will only be lost if a director is employed by the sponsoring organisation or body with nomination rights. It is not lost if the director has another relationship with the sponsoring organisation or body with nomination rights eg. he or she is also a director of the sponsoring organisation or nominating body, or is a material service provider the sponsoring organisation or nominating body or otherwise receives monies from the sponsoring organisation or nomination body.

The FSC recommends that the prohibition against material relationships be retained in the Draft Bill as a 'catch all' clause, but that the Government consider prohibiting certain types of relationships where a conflict may arise, if it is not clear if the definition of independent captures those relationships.

To the extent that the following relationships are not included in the currently drafted definition of independence, the FSC recommends that the Government consider specifically prohibiting these relationships under s 87 of the SIS Act:

- Being, or having been in the last three years, an employee, principal or director of a professional adviser, consultant or supplier that provides goods or services to the RSE licensee or any of its related bodies corporate and the RSE licensee or related body corporate is a material client of the professional adviser, consultant or supplier; [1]
- Being, or having been in the last three years, an executive employee or director of a parent company;

[1] All service providers performing a material business activity have to be appointed by contract under the SIS Act

- Being, or having been in the last three years, an executive employee or director of a standard employer sponsor[2];
- Being, or having been in the last three years, an employee, principal or director of an entity or person, other than the RSE licensee[3], entitled to nominate or appoint persons to the Board of the RSE licensee or any of its related bodies corporate;
- Being, or having been in the last three years, an employee, principal or director of a material professional adviser, consultant or supplier that provides goods or services to an entity or person, other than the RSE licensee, entitled to nominate or appoint persons to the board of the RSE licensee or any of its related bodies corporate;
- Being a person who receives fees or other remuneration from an entity or person, other than the RSE licensee, entitled to nominate or appoint persons to the Board of the RSE licensee or any of its related bodies corporate; and
- Being, or having been in the last three years, associated with any of the above.

This framework targets the types of relationships and associations present in the superannuation industry.

The FSC does not propose that these exclusions would prohibit a non-executive director appointed or remunerated by a parent company from serving as an independent director on an RSE Licensee Board. This framework does, however, specifically prohibit an independent director on a parent company within a corporate group from also serving as an independent director on the trustee board to whom the parent company and its related body corporates are material service providers. A director of a non-parent related entity, where there is no conflict of interest arising, may be treated as independent on a trustee board.

The draft Bill provides that substantial shareholders are not independent, but this rule ceases to apply immediately when the shareholding ends. The FSC also considers that there should be a gap of 3 years after the shareholding ends before the person should be considered to be independent.

The FSC also supports the proposed power for APRA to determine a director is not independent from the RSE licensee, even where the legislated test is met.

Recommendation: The legislation provide a specific test for independence, in addition to the catch all concept of 'material relationship', to clarify which individuals would not be independent.

The FSC is concerned that the current drafting may delegate power to APRA to 'write the law' in relation to the definition of independence. In effect, APRA is to be given power to determine the policy in relation to this area. APRA's role, however, is to regulate bodies in the financial sector and develop practices and procedures[4]. The ability to determine policy in this manner may not be consistent with APRA's mandate.

Further, the separation of powers within the Commonwealth Constitution restricts the extent to which parliament can delegate the power to make laws to other bodies.

[2] The FSC notes that large superannuation funds may provide superannuation services to large numbers of employer sponsors, potentially blocking a significant portion of the pool of directors. The FSC does not propose that this provision should prohibit a non-executive director of a corporate sponsor from serving as an independent director on an RSE board.
[3] Some trustee boards may establish nomination sub-committees to select their independent directors. This should be encouraged as it promote the directors' independence and this provision allows this structure to be established.
[4] Section 8 of the *Australian Prudential Regulation Authority Act 1998* (Cth).

These two limits of the delegation of powers to APRA create a risk that a court may decide the powers delegated under this draft Bill are ultra vires. This would remove a significant limb from the test of independence that would 'widen' the gaps in the definition.

A comprehensive, legislated definition of independence as proposed by the FSC would restrict APRA's role to issues within its legislated powers and reduces the risk that the legislation is overturned in the courts. It also provides additional clarity to RSE licensees seeking to comply with the law.

Recommendation: The legislation comprehensively define independent to ensure that a power is not delegated to APRA that is inconsistent with APRA's legislated mandate and beyond the parliament's capacity to delegate.

The FSC notes that there is an unintended, technical issue arising from the power of an organisation to nominate or appoint a director to the trustee board and the definition of independence.

The legislation may result in a director no longer being independent solely as a result of a material relationship being established when they were nominated or appointed by an organisation or shareholder other than the trustee. This is clearly not intended and the legislation should make this clear.

Recommendation: The very fact that a director was nominated, appointed or remunerated by a nominating third party organisation that has a material relationship should not, of itself, result in the director not being independent.

Multiple directorships of RSE Licensees

Directors on an RSE have a fiduciary duty to the members of the fund, as well as their legal duty. Where a person holds directorships in more than one RSE licensee and those RSE Licensees operate in the same market this may give rise to a conflict of duty as those RSE Licensees compete to attract the same membership.

The FSC is concerned that a director would have access to confidential and commercial information in relation to both entities that may result in the interests of the membership of one fund being advanced, deliberately or otherwise, ahead of the members of another fund. At very least the conflict inherent in such a scenario would be very difficult to manage.

Although conflicts may be addressed by disclosure and nonparticipation in decisions, conflicts of duty are difficult, and sometimes impossible, for a fiduciary to resolve. This is because a fiduciary in such a conflict, by acting in the interests of one is not complying with duties owed to the other. If the fiduciary fails to act at all, there will be a failure to conform to duties owed to each principal without "absolution" from each principal. In these circumstances, good governance requires that it is better to avoid conflicts of this kind entirely.

The FSC notes that the requirements of the duty of priority go some way to managing these conflicts, but that the requirement may be inadequate where a director has conflicting fiduciary responsibilities. The Government should develop a suitable definition of 'competition' in this context.

The FSC would support a prohibition against serving as an independent director on multiple RSE licensees where those RSEs licensees compete, giving rise to a material conflict as a result of serving as an independent director on the two RSE licensees. The FSC submits a prohibition is consistent with the governance principles underlying the Draft Bill.

Recommendation: The legislation prohibits directors serving as an independent director on multiple RSE boards where those licensees compete and a material conflict arises as a result of the multiple directorships.

Independent directors on board committees

In APRA's letter to RSE licensees on 26 June 2015 (APRA's Letter), APRA discusses proposed amendments to SPS510 that would bring the standard into line with the draft legislative amendments to the SIS Act and the regulations under that Act. One of those proposed amendments is in relation to the composition of the Board Audit and the Board Remuneration Committees (together, "A&R Committees").

SPS510 currently requires three independent, non-executive directors for A&R Committees. The philosophy behind this requirement was to promote independent decision-making by these committees, in the absence of an overarching independence requirement for RSE licensees.

In light of the draft legislative amendments to the SIS Act and the key reform measure of independence at a board level for RSE licensees, APRA proposes to amend SPS510 to wind back the requirement for wholly independent A&R Committees. APRA proposes to replace this with a requirement for a majority of independent directors and an independent chair.

The FSC support's APRA proposed approach to A&R Committees. The FSC also supports the RSE licensee continuing to have access to the group remuneration committee for the purpose of setting remuneration of directors of the trustee board. The FSC agrees that the new independence requirement for RSE Licensee Boards obviates the need for more stringent composition requirements at the committee level.

Recommendation: APRA proceed with its proposed changes to A&R Committees and continue to allow RSE Licensees to use a group remuneration committee for determining remuneration policy for the RSE Board.

The FSC notes, however, that APRA's Letter is silent on the composition of other board committees, other than A&R Committees. SPS510 provides that, where an RSE licensee establishes a board committee and that committee has responsibility for activities that could materially impact the interest of members, a director of the RSE must hold the positon of chairperson on that committee. There is currently no requirement for an independent chair or for independent directors to be members of these committees.

The FSC is concerned that the policy objectives of the package may be undermined if there is no obligation on trustee boards to consider whether each board committee should be chaired by an independent director. The charters for committees often delegate extensive decision-making powers that allow committees to make decisions with reduced board oversight. These decisions are often substantive in nature and may have a direct and material impact on the consumer. The FSC agrees that the quality of decision-making can be improved by having independent directors and submits that the same principle applies to decisions delegated by the board to a board committee.

The package of reforms is also intended to provide an opportunity for RSE licensees to recruit independent directors with specific skills or experience that the board may currently not possess. If trustees are obligated to consider whether the chair of each board committee should be an independent director the proposed reforms would have the practical effect of prompting boards to consider recruiting independent directors that have the expertise that matches the area of responsibility of the particular committee they may be required to chair.

The FSC submits that Treasury and APRA note the current absence of any independence composition requirement for board committees other than A&R Committees, and consider whether trustee boards should be obligated to consider whether committees should have an independent chair, chosen from the independent directors on the board. If the trustee board decides that any committee should not have an independent chair, the reasons for this decision should be set out in the annual report.

The FSC submits this is necessary to support the governance regime set out in the draft legislation. It may also potentially result in a material benefit to consumers where this results in new expertise or experience being brought to a board committee with a specific responsibility.

Recommendation: The Government and APRA decide that trustee boards be obligated to consider whether all board committees have an independent chair, chosen from the independent directors on the board. If the trustee decides that any individual committee should not have an independent chair, the reasons for this decision should be set out in the annual report.

Transitional arrangements

The Draft Bill provides for a three-year transition period for a superannuation trustee to locate, identify and appoint sufficient numbers of independent directors to the RSE Licensee board. However, many trustees will be sourcing candidates for independent directors at the same time, and conflict issues may prevent directors being appointed to multiple boards. It is possible some superannuation trustees will not satisfy the one-third independent director requirements by 1 July 2019.

The FSC recommends that APRA be given the ability to agree an extension of the transitional period in circumstances where reasonable efforts are being made by the relevant RSE Licensee to comply with the new rules by 1 July 2019 but this deadline cannot be met because of difficulties in locating suitable independent directors with the requisite skills.

APRA should also have the power to provide relief where a corporate group restructures their governance arrangements, including as a result of a merger between funds or acquisition of a business, that causes a director to cease being 'independent' for a limited period of time as a result of the restructure.

Recommendation: APRA have the power to extend the transitional period in appropriate circumstances or provide relief from the legislation where a fund merger or restructure causes the RSE licensee to be non-compliant.

The transitional rules contained in the Draft Bill operate as follows:

- RSE licensees established on or after 1 July 2016 must comply with the one-third independent director rules from the date of establishment; and
- RSE licensees established before 1 July 2016 must comply with the one-third independent director rules from 1 July 2019.

There is some ambiguity in relation to how trustees can transition between these dates. One interpretation is that RSE licensees established before 1 July 2016 will be required by the SIS Act to comply with the equal representation rules (that includes the current independent trustee rules) at all times until 1 July 2019. After this date, however, compliance would require all new independent directors to commence on 1 July 2019 and those existing directors who will be leaving the board must do so on the same date (and not beforehand).

If the director changes are not managed in accordance with the process outlined above, the FSC understands that the RSE licensee may breach the requirements of the SIS Act. If this is correct, the RSE licensee would need to record the breach on its breach register and determine whether to report the breach to APRA and ASIC.

The draft Bill and regulations, suggest this interpretation may be incorrect. Part 3 of the exposure draft proposes that, as long as an RSE licensee complies with any prudential standards it only has to meet the equal representation requirements to the extent not covered by the standards. APRA's letter then advises

that RSE licensees will be permitted to breach the equal representation requirements and the independence obligations during the transition period as long as the board remains effective.

The FSC would welcome further guidance to clarify the interaction between these two legislative instruments.

Further, the Draft Bill does not specifically permit an RSE licensee to comply with the one-third independent director rules early. It is possible that an RSE licensee who complied with the one-third independent director rules before 1 July 2019 would also breach the SIS Act because it did not satisfy the current equal representation rules in the SIS Act.

Accordingly, the FSC is concerned that the Draft Bill does not enable independent directors to be appointed over time as means of progressively moving towards a one-third independent board. We are also concerned that there is no ability for existing RSE licensees to comply with the rules contained in the Draft Bill prior to 1 July 2019. In our view, there should be no breach of legislation where RSE licensees move towards the one-third independent model or comply with the one-third independent model prior to 1 July 2019.

Finally, the FSC would welcome clarification that directors of the Board who satisfy the definition of independence prior to 1 July 2016 do not cease to satisfy the requirements of independence because of their prior relationship with the corporate group as an independent director before this date.

Recommendation: The transition rules in Part 3 of the Draft Bill be amended to facilitate the progressive compliance with the one-third independent director rules over time, and to enable RSE licensees to comply with the new rules prior to 1 July 2019.

Other legal issues

The ability to attract independent directors to boards may require changes to both company constitutions and trust deeds – for example, to ensure there is power to appoint and pay independent directors.

Limits on powers of amendment and restrictions on accrued benefits can make it problematic from a legal perspective to amend trust deeds to facilitate the one-third independent director regime.

Section 95 of the Draft Bill seeks to provide flexibility in this regard, however the FSC is of the view that the section is inadequate to address the necessary changes to trust deeds.

Recommendation: The legislation be amended to grant RSE licensees the power to change constitutions and trust deeds to facilitate compliance with the one-third independent director regime.