Governance working group

Issues paper on investment governance

March 2011

PROPOSED REFORM

The Government announced its in principle support for new arrangements for trustees in the investment governance of fund assets as part of its Stronger Super package of reforms.

The reforms would:

- expand the factors to which a trustee must have regard when developing an investment strategy, including costs involved, taxation consequences and the availability of timely and independent valuation information (recommendations 3.1, 3.4 and 3.5); and

- require trustees to publish proxy voting policy and procedures on the fund website (recommendation 3.6).

Recommendations 3.1 and 3.4 were mirrored in recommendations 2.1(b)(v)-(vi).

Other governance measures announced by the Government in the Stronger Super package relating to trustee duties, conflicts of interest and gifts will be canvassed in another issues paper (recommendations 2.1, 2.14 and 2.15). Another paper will address the proposal for a code of trustee governance (recommendations 2.18, 2.19 and 2.20).

In the Stronger Super package the Government also announced that it will give the Australian Prudential Regulation Authority (APRA) the power to issue prudential standards in relation to superannuation.

RATIONALE

The Super System Review found that trustees of superannuation funds in Australia generally delegate investment management to external fund managers, usually on the advice of an asset consultant.

The review also highlighted that it is, in many cases, problematic to ensure that the interests of the external fund managers are properly aligned with the interests of the members of the superannuation funds. There is also the potential for behaviour symptomatic of unresolved agency issues to occur, exemplified by tournament behaviour in adjusting the level of risk based on performance of the fund relative to the benchmark, window dressing of performance around

reporting periods, and herding behaviour where fund managers are reluctant to engage in behaviour materially divergent to competitors.

In recognition of these issues, the review took the view that ultimately the trustees are best placed to understand the needs of members.

The Government agreed with the review that the best way to align the interests of fund managers with those of members is to leverage the fiduciary relationship between trustees and members.

Requiring trustees to publish proxy voting policies and procedures on the fund's website will also promote better transparency and accountability. The review suggested that the absence of accountability has led to suboptimal outcomes for members in relation to areas such as fees, returns and asset valuations.

ISSUES

Issue 1 – Fees and investment management

Recommendation 3.1 of the review was that paragraph 52(2)(f) of the *Superannuation Industry Supervision Act 1993* (SIS Act) be amended to include 'the expected costs of the strategy, including those at different levels of any interposed legal structures and under a variety of market conditions', as one of the factors to which trustees of APRA regulated funds must have regard.

In examining the asset-based fee methodology widely used by the superannuation industry the review noted that, given the increasing economies of scale and consistent flow of SG contributions in superannuation, attaching a fee to the level of assets alone seemed sub-optimal, as it is likely to lead to exponential growth in revenue for fund managers, without necessarily a commensurate increase in underlying value to members.

The review also saw significant costs in the implementation and execution of funds management and investment transactions.

Furthermore, the review argued that performance fees are asymmetric in nature - gains are shared between members and fund managers, whilst the members bear the losses - and thus trustees should consider the expected costs of the strategy under a variety of market conditions.

In responding to recommendation 3.1 in principle, the Government considered that trustees should have regard to the costs of their investment strategies but said that it would consult on design and implementation issues.

The review's approach to place this proposed covenant (and those proposed by recommendation 3.4 and 3.5) under paragraph 52(2)(f) of the SIS Act is significant because:

- firstly, under subsection 55(3), a person suffering loss as a result of conduct of another person that was engaged in the contravention of a covenant in the governing rules of a fund may recover the amount of loss or damage from the person involved in the contravention; and

- secondly, subsection 55(5) provides trustees with a statutory defence to an action for damage or loss as a result of making an investment, so long as the trustee can show the investment was

made in accordance with the deemed covenants listed under paragraph 52(2)(f) (though the burden of proof still lies with the trustee).

As a result, placing the proposed requirement in paragraph 52(2)(f) may better promote compliance certainty, whilst providing any aggrieved persons with a remedy in case of any contravention.

Currently, there is no explicit legislative requirement for trustees to have regard to the expected costs of an investment strategy. However, this requirement can arguably be implied from paragraph 52(2)(f) of the SIS Act, specifically subparagraph 52(2)(f)(i),which requires that an investment strategy take into account 'the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements.'

Further, APRA's *Superannuation Circular No. II.D.1: Managing Investments and Investment Choice* (APRA Circular No. II.D.1) provides that trustees should take into account the costs of managing investments when *implementing* an investment strategy. Therefore, a practical impact of the review's recommendation would be to bring forward the requirement to consider costs when *formulating* the strategy, rather than only during the implementation. A hypothetical situation where this might be significant is where, for example, some strategies may incur higher transaction costs than others and the costs of the strategy could reasonably be considered in the context of the possible return and risk when formulating the proposed investment strategy.

Note that circulars are not legislation, but instead reflect APRA's interpretation of the legislation.

Question 1.1 What transition costs will trustees face in the implementation of this recommendation?

Question 1.2 What ongoing costs will trustees face in the implementation of this recommendation?

Issue 2 – Managing after-tax returns

In recommendation 3.4, the review recommended that paragraph 52(2)(f) of the SIS Act be amended to include 'the taxation consequences of the strategy, in light of the circumstances of the fund,' as one of the factors to which APRA-regulated fund trustees must have regard, and to ensure that trustees consider those taxation consequences when giving instructions in mandates to investment managers.

As with the proposed requirement to consider costs, the requirement for trustees to have regard to the taxation consequences of an investment strategy can also arguably be implied from paragraph 52(2)(f) of the SIS Act.

Tax is the single biggest expense for most superannuation entities. After taxation investment outcomes are already an issue for trustee consideration when appointing investment managers. Therefore, consideration of after tax consequences appears to be widespread. As such the proposed legislative change would have minimal impact on most trustees, but would ensure that all trustees consider taxation in developing an investment strategy.

The Government agreed in principle with recommendation 3.4 and said it would consult with relevant stakeholders as to how it could be implemented.

Question 2.1 What are the benefits to superannuation fund members and the industry if this recommendation is implemented?

Question 2.2 What transition costs will trustees face in the implementation of this recommendation?

Question 2.3 What ongoing costs will trustees face in the implementation of this recommendation?

Issue 3 – Valuation of assets

Recommendation 3.5 of the review was to amend paragraph 52(2)(f) of the SIS Act to include 'the availability of valuation information that is both timely and independent of the fund manager, product provider or security issuer', as one of the factors to which APRA-regulated fund trustees must have regard.

The review found that there is a well established trend by superannuation funds of investment in unlisted assets and that there is a challenge in valuing assets which are not necessarily homogeneous and may contain varying degrees of inherent risk.

The valuation, liquidity and crediting of assets, particularly unlisted assets, need to be carefully managed by any fund. Trustees should not merely rely on the advice of the custodian of the asset to provide accurate valuation, but rather seek additional sources of information. For instance, reporting entities are required under AASB 7 to provide disclosures in their financial report that enable users to evaluate the significance of financial instruments for the entity. This can provide a tangible means of disclosure of unlisted assets and their fair value.

Another issue is that inaccurate valuations, especially where there is an undue lag in revaluation of the underlying assets, can result in inaccurate unit prices and hence cause inequity between members.

In responding to recommendation 3.5, the Government provided its in principle support and considered that trustees should have regard to valuation information, but said it would consult on design and implementation issues.

Currently, APRA Circular No. II.D.1 provides guidance to trustees to consider the ease, or otherwise, of asset valuation in making investment strategy decisions. The circular says that in respect of property and other assets that are not formally traded on a regular basis, the periodic valuations should be independent and updated regularly. APRA's guidance suggests that reliance on internal appraisals on a recurring basis is not sufficient and independent valuations should be obtained no less frequently than every three years. Further, APRA suggests that more frequent valuations should be undertaken for assets that are not traded.

Elevating this guidance into paragraph 52(2)(f) of the SIS Act can address part of or the whole of recommendation 3.5. Its placement in paragraph 52(2)(f) has the advantages previously discussed, that it will provide persons adversely affected by the decisions of trustees a cause of action, whilst providing trustees with a statutory defence.

Question 3.1 What are the benefits to superannuation fund members and the industry if this recommendation is implemented?

Question 3.2 What transition costs will trustees face in implementing this recommendation?

Question 3.3 What ongoing costs will trustees face in implementing this recommendation?

Issue 4 – Voting behaviour

Recommendation 3.6 of the review was for all large APRA-regulated funds to publish their proxy voting policies and procedures and to disclose their voting behaviour to members on their websites.

The Government supported this approach in principle and considered that large APRA-regulated funds should publish proxy voting policies and procedures but said it would consult on design and implementation issues.

Implementing these changes may involve changes to the *Corporations Act 2001* in addition to the SIS Act.

Question 4.1 Are there any circumstances under which votes should not need to be disclosed?

Question 4.2 From the industry's point of view, what are the practical differences between legislating such a requirement and including such a requirement in an APRA prudential standard?

Question 4.3 What transition and implementation issues may industry face?