Governance Institute of Australia

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Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Committee members

Superannuation Legislation Amendment (Trustee Governance) Bill 2015

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

Our members hold primary responsibility for developing governance policies and supporting the board on all governance matters in public listed entities, unlisted entities and not-for-profit organisations. Governance Institute is a founding member of the ASX Corporate Governance Council and has been deeply involved in the development of all three editions of the *Corporate Governance Principles and Recommendations* .The familiarity of our members with the practical aspects of how to implement best practice governance frameworks, the aims that are being sought when implementing governance frameworks, and how best to ensure sound reporting to members has informed the comments in this submission.

General comments

Governance Institute is of the view that there are potential unintended consequences attached to the proposed definition of independence in the Superannuation Legislation Amendment (Trustee Governance) Bill 2015. We set these out below. Our view is that any strictly prescriptive definition will inevitably lead to difficulties, not least because it is challenging to update legislation in a timely manner to align with changing community values concerning independence.

Given the problems we identify in the revised definition of independence in the Superannuation Legislation Amendment (Trustee Governance) Bill 2015, and the problems we identified in the earlier exposure draft of the definition (Superannuation Legislation Amendment (Governance) Bill 2015), Governance Institute is strongly of the view that now is the time to step back and have a discussion about the governance outcomes for superannuation funds that should be sought, rather than a political discussion as has dominated all consultation on this issue to date. On that basis, it would be best for the bill not to proceed.

Governance Institute is of the view that it would be preferable for the legislation to set out the principle of independence, but not prescribe a definition. A mechanism similar to the ASX Corporate Governance Council could be established — for example, a Superannuation

Governance Council, as recommended by the Cooper Review[1] — which could flesh out how the principle could be assessed and applied in a way that is difficult to achieve in legislation or prescriptive prudential standards. As noted in the Cooper Review, 'APRA could coordinate membership of the council and provide secretariat support'.

Governance Institute continues to advocate for a non-prescriptive approach to independence. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* set out criteria in Box 2.1 against which independence can be assessed, but it cannot be assumed that independence of judgment is lost if only some of those criteria are met. The criteria are examples of interests, positions, associations and relationships that may raise doubts about independence and require consideration, but they do not *prescribe* a loss of independence.

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

A similar approach could be taken by the Superannuation Governance Council.

Governance Institute strongly recommends a non-prescriptive (non-legislative) approach to governance, including assessment of independence.

Governance Institute recommends that a principles-based approach be taken, with the establishment of a Superannuation Governance Council developing a set of guidelines on how the principles of governance, including independence, should be applied.

Governance outcomes that should be sought

While Governance Institute is on record as supporting as a minimum the introduction of a requirement for one-third independent directors and an independent chair on the trustee boards of all APRA-regulated superannuation funds (corporate, industry, public sector, and retail funds, but not self-managed funds), our preference remains for a majority of independent directors.

However, we reiterate that the issue of one-third or majority of independent directors would be more effectively dealt with in guidelines developed by a Superannuation Governance Council than in legislation

Our support for one-third independent directors as set out in the exposure draft of the Superannuation Legislation Amendment (Governance) Bill 2015 and the revised definition in the Superannuation Legislation Amendment (Trustee Governance) Bill 2015 is based on support for independence on the board. We continue to advocate for a majority of independent directors (with appropriate election and accountability requirements), because independent directors need to be able to influence how the board is operating.

In contrast, a 'nominated representative' process is not focused on meeting skills requirements identified by a board skills matrix, but in ensuring representation of particular third parties. The potential pool of director candidates with appropriate skills and experience is substantially increased versus the 'nominated representative' pool candidates when independent directors are sought. In assisting the board to develop a board skills matrix, there is the opportunity for considered reflection and productive discussion on how the board of directors is constituted

[1] *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System*, 2010, p 62, also known as the Cooper Review

currently and also how it believes it should best be constituted in the future to align with the strategic objectives of the entity and the best interests of members.

Moreover, when assessing the skills and competencies needed to align with the strategic objectives of the superannuation fund, the board can also assess the current and desired diversity that it seeks. Improved diversity of thinking has been shown to correlate with high performance.

We are on record as supporting a one-third requirement as a pragmatic, initial step in ensuring board effectiveness, intended to facilitate improvements in board renewal processes, because they will assist the boards to identify the skills, knowledge, experience and capabilities they need.

We could see that the proposed requirement is also intended to provide those funds without any independent directors the opportunity to move in the direction of an independent board more easily than a requirement for a majority. However, a majority of independent directors would be a better governance outcome, given the need for the independent directors to be able to influence the operation of the board.

Research shows majority independence is the most prevalent standard internationally and that retirement schemes in developed countries are moving towards appointing more independent directors. This has arisen from reflection over more than a decade as to how best to provide greater accountability of boards and management to members, be it in corporations or superannuation or pension funds. The primary philosophy driving the modern corporate governance movement law in recent years has been member protection.

There is a great deal of guidance on the governing role of directors positioning them as the agents of their members. Principles-based corporate governance codes in Australia, the UK and various other Commonwealth jurisdictions are focused on what is known as the principal–agent problem, which concerns the difficulties in motivating the agent to act in the best interests of the principal rather than in their own interests. The governance guidelines are addressed to the problem of asymmetric information, where the agent has more information, such that the principal cannot directly ensure that the agent is always acting in the principal’s best interests.

The overarching aim of the governance guidelines in various jurisdictions is to lead the organisation’s decision-makers to focus on the members’ interests and implement governance frameworks that confirm that directors are the delegates of members and accountable to them as the owners of the organisation.

Superannuation funds have played a key role in seeking governance frameworks that reflect this philosophy in the companies in which they invest. A majority of independent directors on the boards of superannuation funds aligns with board composition on their investee companies, which is a good governance outcome.

Equal representation was an important aspect of the governance structure established with the introduction of compulsory superannuation in 1993. As the government noted at that time: ‘One of the most important ways in which members are able to participate in the management and protection of their retirement savings is through representation on the board of trustees’. However, employee representation through third parties such as trade unions is no longer automatically applicable due to the introduction of choice in superannuation — many members of funds are not represented by unions. And unless an employer has a defined benefits scheme, where it bears the risk of underperformance, there is no longer a reason to ensure employer representation on the board of trustees either directly or through third parties such as employer associations.

Appointment of directors by third parties such as trade unions and employer associations entrenches potential conflicts of interest, as the directors may have competing loyalties between the members of the superannuation entity to which they owe a primary duty and the organisations which they represent. Such situations present a risk, real or perceived, that directors may make decisions based on these external influences, rather than the best interests of members.

The central premise of independence in superannuation is that directors should take decisions objectively in the interests of the members. Conflicts of interest (perceived and real) do not provide assurance that such objective decision-making is undertaken.

Moreover, we note that the Superannuation Legislation Amendment (Governance) Bill 2015 requires all RSE licensees to publicly report (on an 'if not, why not' basis) in the annual report of each of their RSEs whether they have a majority of independent directors or not. There is some potential for confusion, given that the legislative requirement is for one-third independent directors, yet the reporting requirement is for a majority. The disjunction between these requirements could create ambiguity as to what superannuation funds should be aiming for. It would be best if the aim of a majority of independent directors was clarified as being the objective both for board composition and reporting.

Any requirement concerning director independence and an independent chair needs also to apply to board committees.

Members should decide independence

A larger governance outcome that is not dealt with in either bill, and which should form part of the discussion on the governance outcomes best suited to the protection of members' interests is the matter of member rights in relation to appointing and removing directors of their funds.

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

Industry and other employer-sponsored funds are a different case. They are not offering a service for a fee in an open market. They are not seeking to generate a profit for an owner. They exist solely for the benefit and to protect the interests of their members. The principal say in the governance of **these funds should be in the hands of the members of the fund, not third parties**, such as trade unions and employer associations**.**

Governance encompasses the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. It encompasses transparency, accountability, stewardship and integrity. As a matter of good governance, therefore, members should be provided directly with the final say in the governance of their superannuation fund.

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

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

Board composition, definitions of independence and management of conflicts of interest are only components of a governance framework. That is, the key governance outcome from which questions of board composition and management of conflicts of interest flow is to aim for greater empowerment to members and greater accountability of directors to members.

Governance Institute recommends that the key good governance outcome is to provide for members of defined contribution schemes to appoint and remove directors of trustees and for those directors to be accountable to members. This provides a governance framework in which other questions of governance structure can be assessed and decided.

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

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

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

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

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

Detailed comments on Superannuation Legislation Amendment (Trustee Governance) Bill 2015

Unintended consequences attached to the proposed definition of independence

If the objective of the proposed definition in the exposure draft of the legislation is to increase the number of independent directors on superannuation trustee boards, the drafting of the current definition has the potential to lead to a greater number of non-independent directors sitting on such boards.

In the Exposure Draft of the Superannuation Legislation Amendment (Governance) Bill 2015, the definition is as follows:

(1) A person is independent from an RSE licensee of a registrable superannuation entity unless the person:

(a) if the RSE licensee is a body corporate that has a share capital—has a shareholding interest in 5% or more of the share capital of the RSE licensee; or

(b) if the RSE licensee is a body corporate—has a shareholding interest in 5% or more of the share capital of a body corporate that is related to the RSE licensee; or

(c) if the RSE licensee is a body corporate—is, or has been at any time during the preceding 3 years:

(i) an executive officer (other than a director) or an employee of the RSE licensee; or

(ii) a director or executive officer of a body corporate that is related to the RSE licensee; or

(d) has, or has had at any time during the preceding 3 years, a business relationship:

(i) with the RSE licensee; or

(ii) if the RSE licensee is a group of individual trustees— with any of the trustees; that is, or was at the time, material to the person or to the RSE licensee (or trustee); or

(e) is, or has been at any time during the preceding 3 years:

(i) a director or executive officer of a person paragraph (d) applies to; or

(ii) a person who, in the capacity of an employee of a person paragraph (d) applies to, is or was involved in the business relationship referred to in that paragraph; or

(f) if the RSE licensee is a trustee of a regulated superannuation fund—is, or has been at any time during the preceding 3 years a director or executive officer of:

(i) an employer-sponsor of the fund who is a large employer in relation to the fund within the meaning of section 29TB; or

(ii) an organisation, representing the interests of one or more employer-sponsors of the fund, that has the right to appoint, or nominate for appointment, directors or trustees of the RSE licensee; or

(iii) an organisation, representing the interests of members of the fund, that has RSE licensee;

(g) is a person to whom circumstances of a kind prescribed by regulations made for the purposes of this paragraph apply

There is an apparent omission in the exceptions to when a person will be considered independent from an RSE licensee. Paragraphs 1(a) and 1(b), rightly in Governance Institute's opinion, exclude from the definition of independence persons who have a shareholding interest of five per cent or more in the share capital of the RSE licensee or a related body corporate of the RSE licensee. However, such shareholdings will often be held through a corporate vehicle, while it is individuals who will be appointed to the board of the RSE licensee.

Governance Institute considers that there should be an equivalent to paragraph 1(e) in relation to paragraphs 1(a) and 1(b). That is, a person who is or has at any time during the preceding three years been a director or executive officer of a person referred to in paragraph 1(a) or 1(b) should not be considered independent. This amendment would assist in giving effect to the spirit of the requirements for independence and avoid those requirements being stepped around by holding substantial shareholdings in RSE licensees through corporate entities.

We refer to our concerns with the definition of independence set out in the earlier exposure draft of the bill (Superannuation Legislation Amendment (Governance) Bill 2015), which introduced different unintended consequences. Under that draft of the proposed definition, it was possible that two-thirds of the directors of a superannuation fund could be nominated by a trade union.

While that issue has been addressed in the definition set out above in the Superannuation Legislation Amendment (Trustee Governance) Bill 2015, there are new unintended consequences — it is possible that two-thirds of the board of a retail fund could be employees of the employing financial institution.

This underpins our conviction that seeking to define independence in legislation is problematic. Governance Institute reiterates that a non-prescriptive (non-legislative) approach to governance, including the assessment of independence is preferable to a legislative one.

Under the revised definition in the bill, a person's independence is not affected by that person's membership of the fund. Governance Institute supports this. If anything, a director is more likely to have a conflict if they are a member of a different fund. By comparison, we note that directors of public listed companies are encouraged to hold shares in the company, as this is seen to align their interests with those of shareholders — directors holding shares in the company on whose board they sit is not seen to affect independence.

Governance Institute is of the view that being a member of a fund should not render a director 'not independent' and welcomes the clarification of this in the revised bill.

We would welcome the opportunity to meet and elaborate on these issues.

Yours sincerely

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Chief Executive