

Dear Committee Secretary

Thank you for your email dated 24 September 2015 inviting Mercer Consulting to make a submission on the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015*.

In May 2015, Mercer Consulting published our research on the extent to which overseas pension funds require structural independence on the boards of their governing bodies. We then looked at the range of decisions made by these governing bodies, as compared with the range of decisions required to be made by the board of directors of an Australian superannuation fund trustee.

We concluded that, having regard to the trend for overseas pension funds to either:

- introduce a requirement for a minimum number of independent directors; and/or
- prescribe professional qualifications and skills that would indirectly drive an increase in independent directors,

It would be equally appropriate for the boards of Australian superannuation trustees to include a number of independent directors.

A copy of our research report – *Governance of Superannuation Funds, a Report on Independence Requirements for Trustee Boards* - is attached for the information of the Committee and as our submission to the Committee's inquiry.

My postal address and contact details are below. Please do not hesitate to contact me if you require any further information.

Regards

Pam McAlister, Partner
Mercer | Mercer Consulting (Australia)

HEALTH WEALTH CAREER

GOVERNANCE OF SUPERANNUATION FUNDS

A REPORT ON INDEPENDENCE
REQUIREMENTS FOR
TRUSTEE BOARDS

MAY 2015



MAKE TOMORROW, TODAY

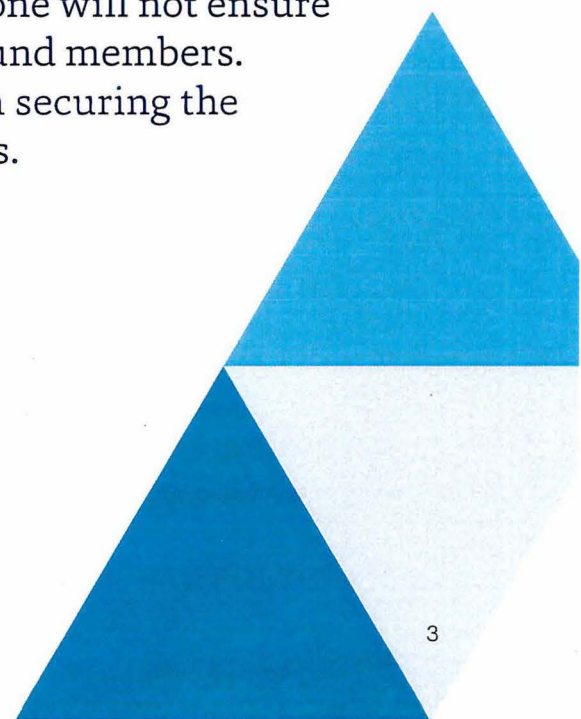
 MERCER

CONTENTS

1. Introduction and Executive Summary	4
• Executive Summary	4
2. Background	6
• Governance reviews	6
• Corporate Governance	7
• Pension Funds	7
• Importance of Member Representatives	8
3. Australian Practice	10
• Legal requirements for non-superannuation boards	10
• Concept of independence	11
• Industry Codes and Best Practice Recommendations	12
4. What's happening around the world?	14
• Listed Companies	14
• Concept of independence	15
• Equal representation for pension funds in OECD countries	16
• United Kingdom Reforms	18
• Hong Kong	20
• The Netherlands	20
• The EU Directive	21
5. Our thoughts on the Australian governance model	22
• Responsibilities of Australian superannuation trustees	22
• Mandating independent directors	23
• A principles-based definition	24
• Member representation	24
• Conclusion	24
Appendix A. Independence requirements for non-superannuation entities	26
Appendix B. Industry bodies – definitions of independence	34
Appendix C. APRA Guidance SPG 510 – factors taken into account in determining whether a director is “non-affiliated”	40

KEY FINDINGS

- In overseas jurisdictions, both independence and member representation are recognised as important features for pension fund boards. There is also a trend for increased professional qualifications.
- Australian superannuation trustees are held to a professional standard of care and are responsible for all significant decisions affecting the fund, when compared with the restrictions imposed on some of their OECD counterparts.
- Australian superannuation funds have become complex financial businesses, requiring a diverse range of skills and experience on the trustee board.
- We therefore believe that Australian superannuation trustee boards should include a number of independent directors (but not to the exclusion of member representation).
- We propose a ‘principles-based’ definition of independent director designed to enhance objectivity and impartiality, but which would allow an independent director to be a fund member.
- Structural independence requirements alone will not ensure good decision-making in the interests of fund members. Therefore funds should remain focused on securing the right competencies for their trustee boards.



1

INTRODUCTION AND EXECUTIVE SUMMARY

‘Independence’ is often equated with good decision-making, because it connotes objectivity and impartiality.

In light of the recommendation from the Financial Systems Inquiry for a majority of independent directors on superannuation trustee boards, Mercer decided to research the extent to which overseas pension funds require structural independence on their boards.¹ In conducting this research, we considered the range of decisions that might be made by these governing bodies and how they compared with the range of decisions required to be made by the board of directors of an Australian superannuation trustee.

We also examined the definition of “independence” that applies in some jurisdictions and, in particular, how well a definition encapsulates concepts of professionalism, objectivity and the absence of conflicting interests and duties, all of which contribute to an optimal decision-making environment.

This report contains the results of our research, together with our thoughts on how our findings might translate to the Australian superannuation system.

EXECUTIVE SUMMARY

The aim in mandating a governance structure for superannuation trustee boards is to optimise the quality of decision-making in the interests of fund members. The trust model for regulated superannuation funds is an inherent governance control since it imposes an obligation to act in members’ interests on trustees, and now directors. Equally a competent and diverse board is vitally important.

Our research demonstrates that many overseas jurisdictions are either mandating independent directors² or considering elevating competency levels to a professional standard (with the result that boards may well need to consider the appointment of independent directors in order to meet the standard).³ Member representation is also recognised by overseas jurisdictions as an important feature for occupational superannuation.⁴

¹ Our research is confined to pension funds in the private sector.

² As in the United Kingdom and Hong Kong

³ As in the Netherlands and some OECD countries – see also the EU Directive

⁴ In nearly all OECD countries, pension fund boards include member representatives. In some countries (the Netherlands, for example) pension members are also represented.

In Australia, the sole responsibility for management of a regulated superannuation fund is with the trustee (and its directors), who are required to exercise a professional standard of care, skill and diligence. In addition, the range of decisions required to be made by a superannuation trustee and its directors is very extensive, involving broad discretions as to the investment of fund assets, the provision of insured benefits and the management of risk when compared with the restrictions imposed on many of their counterparts in OECD countries. Hence the range of skills and experience required to heighten good decision-making by Australian superannuation trustees is broader. In addition to enhancing the overall competencies of a board, independent directors can bring objectivity by virtue of their detachment from stakeholders.

We therefore consider that the boards of Australian superannuation trustees should include a number of independent directors, since many superannuation funds are now very significant and complex financial businesses. It is also hard to argue that superannuation funds should be held to a lesser standard of governance than the standards applicable to other major financial institutions or those expected of their investee companies.⁵ However, we do not believe that independent directors should be required to the exclusion of member representation in the fund's governance structure. The challenge will be to include independent directors as a complement to existing boards, without growing them to an unwieldy size. We therefore favour flexibility rather than fixed quotas.

In mandating a number of independent directors, the definition of "independent director" should enhance objectivity and impartiality. We propose a principles-based concept such as:

a non-executive director who is free from any business or other association that could materially interfere with the exercise of independent judgment, including those arising out of the director or a close relative of the director having:

- *a personal shareholding in the trustee company or its related bodies corporate;⁶*
- *involvement in an employer, employee or member organisation; or*
- *significant involvement in the management of the fund or as a service provider, auditor, actuary or adviser to the fund, whether currently or within the past three years*

but who may be a member of the fund.

In view of the value of having member and pensioner perspectives on the board, the concept of independence should not, in our view, preclude an independent director from being a member of the fund.

Ultimately, we believe that the Australian superannuation industry should remain focused on achieving the right composition of skills and experience for each fund, since, in our experience, the collective skill set, objective judgment and dynamics of a trustee board are critical to effective decision-making. Mandatory appointment of independent directors is therefore an opportunity for funds to consider the optimal skills, experience and attributes they wish to have as a collective and to build better trustee boards as a result.

⁵ See Australian Council of Superannuation Investors Governance Guidelines

⁶ In some 'not for profit' funds each director holds a nominal number of shares, but the shares are required to be transferred when the director's term expires. In these situations, the shareholding does not generate any personal profit, but merely attaches to the office of director. We would not consider this kind of nominal holding to be a personal shareholding.

2

BACKGROUND

GOVERNANCE REVIEWS

The structure of trustee boards first came under the spotlight by the Super Systems Review in 2010. The Panel felt that changes in the industry over time meant that the governance structure established by the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* was no longer ‘fit for purpose’. Accordingly, the Panel recommended that trustee boards follow corporate governance best practice by introducing a minimum number of “non-affiliated trustee directors” for all boards.⁷

The recommended proportion of “non-affiliated” directors would vary as follows:

- a majority of “non-affiliated” directors for boards that did not have equal representation; and
- for boards with equal representation, a third of the directors should be “non-affiliated”.

The Panel believed that introducing “non-affiliated” trustee directors could help provide an objective assessment of issues. The Panel also made a strong recommendation to establish a Code of Conduct similar to the ASX Corporate Governance Principles and Recommendations (**ASX Principles**) used for listed companies. These recommendations were not implemented, although many of the other governance reforms recommended by the Panel were subsequently adopted.

The next time trustee board composition was subject to review was in November 2013 as part of the Government’s discussion paper “*Better regulation and governance, enhanced transparency and improved competition in superannuation*” (**Governance Discussion Paper**). The Government sought feedback on a number of proposals relating to the governance practices of superannuation boards, including its proposal to introduce independent directors on all trustee boards. The rationale for this change was explained in the following terms:

*Independent directors provide an external, dispassionate perspective, enabling boards to benefit from a diversity of views and provide a check on management recommendations. By being free from relationships that could materially interfere with their judgment they can provide an objective assessment of issues.*⁸

⁷ The phrase “non-affiliated” director has been subsequently adopted by the Australian Prudential Regulation Authority (APRA) in its *Superannuation Prudential Guidance (SPG) 510 – Governance*.

⁸ Governance Discussion Paper p 10

The Government postponed formulating its final position pending the release of the report from the Financial System Inquiry (FSI).

The FSI issued its final report in December 2014 and the structure of trustee boards was again under review. The FSI recommended the introduction of a majority of independent directors on trustee boards for all 'public offer' funds. Like previous reviews, the rationale for this recommendation was also linked to a perceived need to increase the objectivity of board deliberations. The inquiry also recommended that the chairman of a trustee board should be an independent director.⁹

CORPORATE GOVERNANCE

The concept of independent directors on trustee boards is based on corporate governance best practice. Independent directors were introduced to the corporate governance framework in the 1970s following a series of corporate scandals. Over the decades, requirements relating to independent directors have been enhanced and refined, so that now most OECD jurisdictions around the world recommend or require independent directors on the boards of public companies.¹⁰ While there is conflicting research regarding the extent to which the presence of independent directors correlates with improved performance,¹¹ it is generally believed that individuals who do not have material conflicts of interest or duty are more likely to be able to exercise independent and objective judgment.¹²

PENSION FUNDS

While the promotion of independent directors has been a settled position in corporate governance for some time, it has not been a common practice for occupational pension funds. This can be attributed to a number of reasons, including the fact that, until relatively recently,¹³ pension funds have been structured as 'defined benefit arrangements', linked to a single employer and having a single diversified investment strategy. Accordingly, it was considered appropriate for the board to be comprised of key stakeholders – being the employer who had the financial obligation to fund the liabilities of the fund and the employees who were entitled to the benefits.

However the pension landscape around the world is changing by virtue of the increasing trend towards defined contribution or 'accumulation' arrangements, multi-employer funds and, in some jurisdictions, more sophisticated investment arrangements, including member investment choice. In Australia, introduction of 'Choice of Fund' has also had an impact on the superannuation industry by allowing greater portability of superannuation benefits and enabling members to 'vote with their feet' if they are not happy with their fund's performance. In addition, the economic influence of pension and superannuation funds has grown significantly. Given these developments, Australia is not alone in reviewing the composition of the governing body of the fund. In Chapter 4 we look specifically at the recent developments in the United Kingdom (UK), the Netherlands and the European Union (EU).

⁹ Financial Systems Inquiry – Recommendation 13

¹⁰ OECD *Corporate Governance Factbook* (2014)

¹¹ No link between board independence and performance: see, e.g. S Ferris and S Yan "Do independent directors and chairmen matter? The role of boards of directors in mutual fund governance" (2007) 13 *Journal of Corporate Finance* 392 (mutual funds); S Bhagot and B Black "The uncertain relationship between Board Composition and Board Performance" (1999) 54 *Business Lawyer* 921-963 Available at SSRN: <http://ssrn.com/abstract=11417> (companies).

Positive link between board independence and performance: see, e.g. B Ding and R Wermers "Mutual Fund Performance and Governance Structure: The Role of Portfolio Managers and Boards of Directors" (June 15, 2012) <http://dx.doi.org/10.2139/ssrn.2207229> (mutual funds); O Kowalewski "Corporate Governance and Pension Fund Performance" (December 1, 2010) CAREFIN Research Paper No. 26/2010. Available at SSRN: <http://ssrn.com/abstract=1799962> (pension funds); ET Nisbet "Influence of Board Structure on the Performance and Governance Framework of Australia's Superannuation Funds" (December 2013) (superannuation funds).

¹² OECD *Principles of Corporate Governance* (2004)

¹³ In Australia, until the introduction of award and superannuation guarantee requirements

IMPORTANCE OF MEMBER REPRESENTATIVES

In pension governance, the role of a member representative is considered to be different to that of an independent director. An independent director is appointed to bring to the board an independent view on issues such as strategy and performance, whereas a member representative serves as a voice for fund members on the board.¹⁴ For that reason, it is generally believed that accountability to fund members and beneficiaries can be enhanced by requiring representation of fund members and beneficiaries on the governing body.¹⁵

The shift to defined contribution plans further supports the need to have members represented at board level since it is the members, rather than the fund sponsors, who bear the risk of poor investment performance. Accordingly, from a governance perspective, it is considered appropriate for this group to be involved in making decisions because they have a financial interest in the outcome and therefore a strong incentive to exercise greater vigilance.¹⁶ The main challenge is that some member

representatives may not have the range of expertise that many academics have argued is necessary to effectively scrutinise and monitor the increasingly complex administration and investment arrangements of pension funds.¹⁷ Independent directors have sometimes been added to supplement skills in these areas. Going forward, pension members may also be a ready source of skills, since many retirees could be willing to contribute relevant experience amassed over their working lives.

However, it must also be remembered that the entire board of a corporate trustee is ultimately accountable to ensure that the trustee acts in the interests of fund members.¹⁸ In this respect, the trust itself acts as a governance control by aligning the obligations of the governing body with the interests of the ultimate beneficial 'owners'.

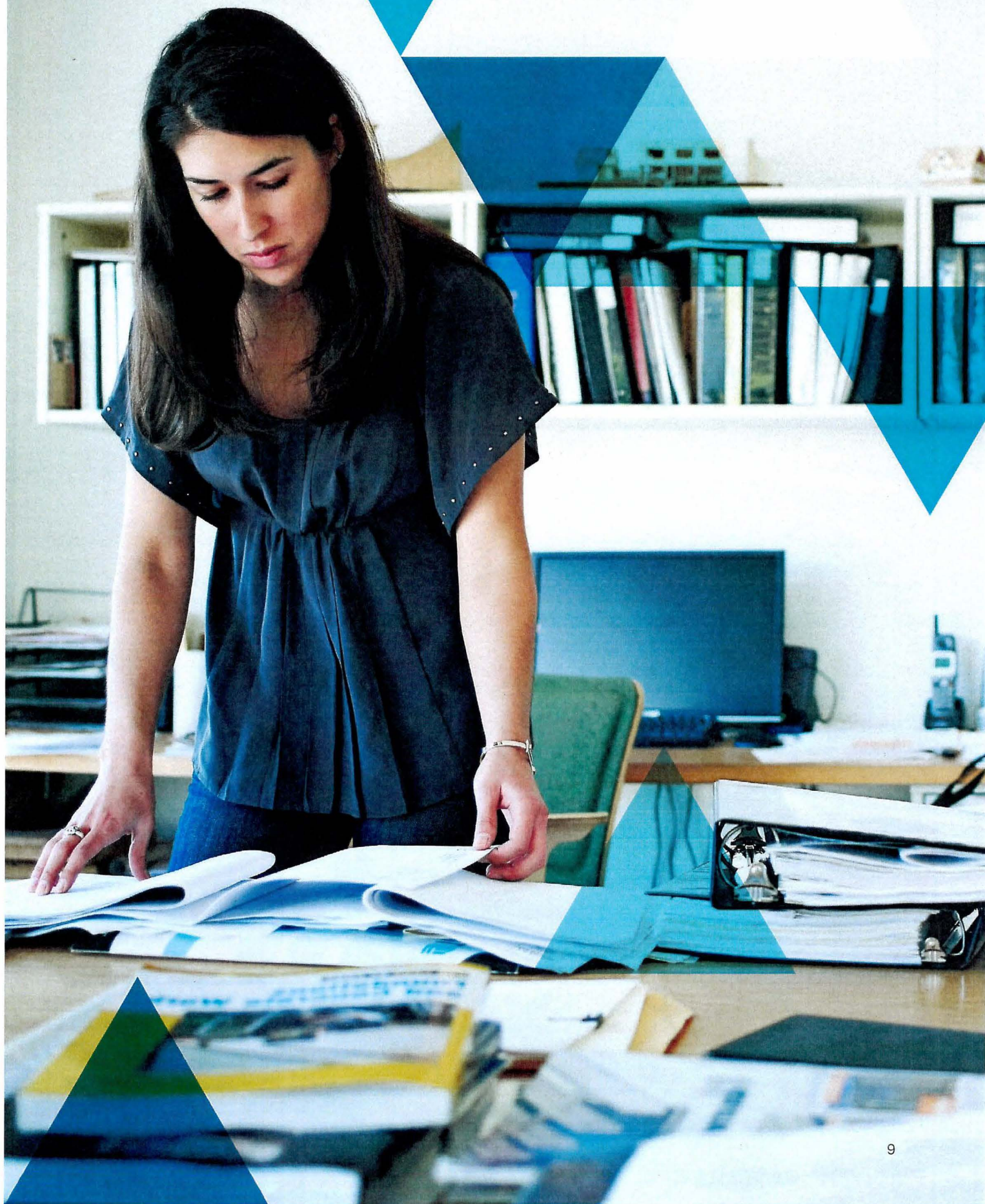
¹⁴ IOPS *Supervisory Oversight of Pension Fund Governance* (2008)

¹⁵ OECD *OECD Guidelines for Pension Fund Governance* (2009)

¹⁶ D Hess and G Impavido "Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence", *World Bank Research Paper 3110*, August 2003

¹⁷ GL Clark "Pension fund governance: Expertise and organisational form" (2004); GL Clark "Expertise and representation in financial institutions: UK legislation on pension fund governance and US regulation of the mutual fund industry" (2007); K Ambachtsheer, R Capelle and H Lum "The pension governance deficit: Still with us" *Rotman International Journal of Pension Management* (2008).

¹⁸ In Australia, these equitable obligations are reinforced by the covenants in the SIS Act.



3

AUSTRALIAN PRACTICE

LEGAL REQUIREMENTS FOR NON-SUPERANNUATION BOARDS

The boards of managed investment schemes, banks, life and general insurance companies and private health insurers all require a majority of independent directors,¹⁹ although there are some exceptions to this general principle:

- Managed investment schemes can have less than a majority of independent directors on the board of a responsible entity (referred to as “external directors”) provided the scheme has a compliance committee with a majority of external members.
- Banks and life and general insurance companies that are subsidiaries of another APRA regulated body do not need to have a majority of independent directors, but instead must have a majority of non-executive directors,²⁰ not all of whom must be independent directors. The minimum number of independent directors for such boards is either two independent directors (where the Board has up to 7 members) or at least 3 independent directors (where the Board has more than 7 directors), plus an independent chair.²¹ The independent directors may include persons who are independent directors on the parent company or on another subsidiary company.²²
- Banks and life and general insurance companies that are subsidiaries of a parent company which is *not* prudentially regulated by APRA must have a majority of independent non-executive directors; again, these independent directors may include persons who are independent directors on the parent company or on another subsidiary company.²³
- Private health insurers can appoint a director of a parent company or a subsidiary company as an independent director, provided that the person meets certain other criteria of independence.²⁴

All regimes other than for managed investment schemes also require or recommend that the chairperson be an independent director.²⁵ In the case of managed investment schemes, there is no specific requirement.

¹⁹ Managed investment schemes: *Corporations Act 2001*, s 601JA; banks and insurance companies: APRA Prudential Standard CPS 510 – *Governance*, para 29; private health insurers: Schedule 1 of the *Private Health Insurance (Insurers Obligations) Rules 2009* (APRA’s draft Prudential Standard HPS 510 – *Governance* replicates this requirement.)

²⁰ A “non-executive” director is defined to mean a director who is not a member of the institution’s management. However, a non-executive director may include Board members or senior managers of the parent company of a locally incorporated institution or of the parent company’s subsidiaries, but not executives of the institution or its subsidiaries: APRA Prudential Standard CPS 510 – *Governance*, para 27.

²¹ APRA Prudential Standard CPS 510 – *Governance*, paras 39 – 41

²² Ibid

²³ APRA Prudential Standard CPS 510 – *Governance*, para 42

²⁴ Rule 4, Schedule 1 of the *Private Health Insurance (Insurers Obligations) Rules 2009* and draft APRA Prudential Standard HPS 510 – *Governance*

²⁵ APRA Prudential Standard CPS 510 – *Governance*, para 30

CONCEPT OF INDEPENDENCE

For non-superannuation boards, “independence” is typically defined by reference to business and personal relationships and the following ties are generally excluded:

- present or past employment within a certain ‘look back’ period;
- majority shareholdings or material interests;
- material business connections, such as a connection with a service provider or material professional adviser within a certain ‘look back’ period;
- family ties; and
- in some cases, duration of acting as director.

For example, under APRA Prudential Standard CPS 510 *Governance*, an “independent director” is a non-executive director who is free from any business or other association — including those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser — that could materially interfere with the exercise of their independent judgment.²⁶ APRA notes that this definition is based on the concept of “independent director” in the ASX Principles.²⁷

Under section 601JA(2) of the Corporations Act, a director is an external director if they are not (and have not been in the previous 2 years) an employee of the responsible entity or a related body corporate, are not (and have not been in the previous 2 years) a senior manager of a related body corporate, are not (and have not been in the previous 2 years) substantially involved in business dealings, or in a professional capacity, with the responsible entity or a related body corporate, do not have a material interest in the responsible entity or a related body corporate and are not a relative of a person who has a material interest in the responsible entity or a related body corporate.

Appendix A contains a table summarising the definitions of “independence” for non-superannuation boards.

The current definition of “independent director” under the SIS Act is designed to achieve independence from stakeholders (i.e. employers and members and their representative organisations) rather than independence from management, service providers and advisers.²⁸

The current requirements for superannuation trustee boards therefore differ from corporate governance concepts in the following key ways:

- The SIS Act definition of “independent director” does **not** exclude executives of the trustee, material business connections or family ties. Further there is no ‘look back’ period with respect to *past* associations with the sponsoring employer or employee organisations.²⁹
- Independent directors are **not required** for equal representation boards. However, boards may appoint up to one independent director.³⁰

In APRA SPG 510 – *Governance*, APRA has recommended that trustee boards consider appointing at least one independent director (as defined in the SIS Act) or a “non-affiliated” director to the Board. According to APRA a “non-affiliated director” is someone who is free from any business or other association that could materially interfere with the exercise of their independent judgment. APRA also provides seven criteria to take into account in determining whether a person is a “non-affiliated” director.³¹ These criteria are based on the ASX Principles, but modified to also include some aspects of the existing SIS Act definition — such as no association with employer or member groups.

²⁶ APRA Prudential Standard CPS 510 – *Governance*, para 25

²⁷ See Attachment A to CPS 510

²⁸ Under s 10(1) of the SIS Act, an independent director is a director who is not a member of the fund, not an employer-sponsor of the fund or associate of an employer-sponsor, not a representative of a trade union or other organisation representing the interests of members and not a representative of an organisation representing the interests of employer sponsors.

²⁹ SIS Act, s 10(1)

³⁰ SIS Act, s 89(2) – APRA has power to modify this provision to allow more than one independent director to be appointed, however.

³¹ See Appendix C

INDUSTRY CODES AND BEST PRACTICE RECOMMENDATIONS

For listed companies and members of the Financial Services Council (FSC), both the ASX Principles and the Blue Book³² recommend a majority of independent directors and an independent Chair. The ASX Principles are not mandatory, but apply on the basis of 'if not, why not', meaning that companies choosing not to comply with the recommendations must disclose their reasons to investors. The ASX Principles require an independent director to be free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, in a material respect, his or her capacity to bring an independent judgment to bear on issues before the board and to act in the best interests of the entity and its security holders generally. Examples that may cast doubt on the independence of a director are also highlighted.³³

There is less consensus among industry bodies about the structure of superannuation trustee boards:

- The FSC requires the board of a public offer fund trustee to have a majority of independent directors and an independent Chair.³⁴ In addition, a quorum for a Board meeting is only satisfied if a majority of independent directors is present.³⁵ The FSC's definition of "independent" is similar to the definition in APRA Prudential Standard CPS 510.³⁶
- The Australian Institute of Superannuation Trustees (AIST) supports allowing up to a third of equal representation board directors to be non-representative directors. AIST also has stated that boards should have a positive obligation to report to APRA that they have followed an appropriate process in deciding on their board composition and that their board structure is in the best interests of members.³⁷ In relation to the definition of "independent", the AIST believes the current SIS Act definition for equal representation boards should be retained, but modified to remove the exclusion of members of the fund.³⁸
- The Association of Superannuation Funds of Australia (ASFA) supports the position that at least one-third of the directors on superannuation boards should be independent.³⁹ ASFA has proposed its own definition of "independence", which is broadly modelled on the ASX Principles but includes detachment from stakeholders and competitors.
- Industry Super Australia (ISA) does not support mandating independent directors on the trustee boards of public offer funds, but would support removal from the SIS Act of any restrictions on the ability to appoint independent directors and for independent directors to be members of the fund.⁴⁰ ISA also supports placing a positive obligation on boards (as part of the annual skills assessment and board performance review) to consider their composition, including whether appointing additional independent representation at board level (up to one third of total board membership) is in the best interests of members. The outcome of this review, together with the reasoning, would be reported to APRA. ISA's proposed definition of "independence" is broadly consistent with the ASX Principles.⁴¹

³² IFSA Guidance Note No. 2.00 "Corporate Governance: A Guide for Fund Managers and Corporations" (commonly known as the "Blue Book"), paras 8.2.3 and 8.2.5. (IFSA is now the Financial Services Council or FSC.)

³³ These examples are included as 'Specific Prohibitions' in the table at Appendix A.

³⁴ FSC Standard No 20: Superannuation Governance Policy, para 8.1

³⁵ Ibid, para 8.1(c)

³⁶ Ibid, paras 8.2.2 and 8.2.3(a); see also above n 32

³⁷ AIST's submission to the Governance Discussion Paper (February 2014), p 22

³⁸ Ibid, p 20

³⁹ ASFA's Submission to the Governance Discussion Paper (12 February 2014), p 12

⁴⁰ *Financial Standard* "Industry funds reject majority independent directors" (8 December 2014)

⁴¹ ISA submission to the Governance Discussion Paper (12 February 2015), p 26



Appendix B contains a table summarising the definitions of “independence” proposed by these Australian industry bodies.

Finally, it is worth noting that pension governance theory would suggest that pension funds should be subject to the same standards as they expect of their investee companies.⁴² The Governance Guidelines issued by the Australian Council of Superannuation Investors (ACSI) are interesting, since they recommend for boards to have a majority of independent non-

executive directors,⁴³ as well as an independent chairperson.⁴⁴ The ACSI Governance Guidelines provide a framework by which superannuation funds can assess the Environmental Social and Governance practices of investee companies, particularly when exercising their voting rights.⁴⁵ These guidelines are not binding, but provide a reference for chairpersons, directors and senior executives of listed companies about the contemporary governance expectations of superannuation fund investors.

⁴² KP Ambachtsheer “Pension Revolution: A solution to the Pension Crisis”, p 40

⁴³ ACSI Governance Guidelines: A guide for superannuation funds to monitor listed Australian companies, p 14

⁴⁴ Ibid, para 4.1

⁴⁵ ACSI website

4

WHAT'S HAPPENING AROUND THE WORLD?

LISTED COMPANIES

In February 2014, the Organisation for Economic Co-operation and Development (OECD) issued its first report providing an overall landscape of corporate governance practices for listed companies around the world. In relation to Board structure and independence the report states:

“Despite differences in board structure, almost all jurisdictions have introduced a requirement or recommendation with regard to a minimum number or ratio of independent directors. The recommendation for majority independence is the most prevalent standard.”⁴⁶

There are three notable differences between Anglo-American jurisdictions, such as the UK, United States and Australia, and the European Union (EU) and other jurisdictions:

- **Employee representation on boards:** many EU countries have established a minimum threshold for employee representation on the board of a listed company, which varies from one board member (e.g. Estonia) to 50% (e.g. Germany), with 33% being the median (e.g. Austria, Luxembourg, Hungary).⁴⁷ Outside the EU, no jurisdiction requires employee representation on the board of a listed company.
- **Board structure:** Many EU countries have a two-tier board system, where the governing body is comprised of two boards – a supervisory board and a management board.⁴⁸ This provides a structural separation between the monitoring/supervisory function and the active management function. In contrast, Anglo-American jurisdictions have a one-tier board structure.

⁴⁶ OECD Corporate Governance Factbook, p 30 (2014). The second edition of the Corporate Governance Factbook was issued in April 2015.

⁴⁷ Ibid, p 32 and Table 5.9

⁴⁸ Ibid, p 31 and Table 5.1. Table 5.1 shows that, in some countries, two tier structures are mandatory (e.g. Argentina, Austria, Germany), while other countries have an option of a one-tier or two-tier structure (e.g. Denmark, Finland, France, Hungary).

- **Ownership and control:** In most OECD and non-member countries, there is more ownership concentration in the hands of a few shareholders. In contrast, the Anglo-American system is characterised by a more dispersed ownership structure.⁴⁹ As such, there are different motivations as between the two types of jurisdictions for having independent directors on boards. In the EU, independent directors are used to ensure that representatives of the majority shareholders act in the best interests of *all* shareholders. In contrast, the purpose of independent directors in Anglo-American jurisdictions is to supervise management to ensure that managers act in the interests of the shareholders, rather than maximising their own interests.

CONCEPT OF INDEPENDENCE

In relation to the definition of “independent”, the typical approach is to include one or more of the following restrictions:

- not to be a member, or an immediate family member of a member, of the company’s management;
- not to be an employee of the company or a company in the group;
- not to receive compensation from the company or its group, other than directorship fees;
- not to have material business relations with the company or its group;
- not to have been an employee of the external auditor of the company or of a company in the group;
- not to exceed a maximum tenure as a board member; and
- not to be or represent a significant shareholder.⁵⁰

This concept appears consistent with the Australian corporate governance approach.

⁴⁹ Ibid, p 9 and Table 1; see also MA Mendez “Corporate Governance A US/EU Comparison – Course Outline” <http://foster.uw.edu/wp-content/uploads/2014/12/MiguelMendezFinal.pdf>

⁵⁰ OECD (2014) Corporate Governance Factbook, p 32 and Table 5.6

EQUAL REPRESENTATION FOR PENSION FUNDS IN OECD COUNTRIES

In nearly all OECD countries,⁵¹ boards for occupational pension arrangements are comprised of an equal number of employee and employer representatives.⁵² However, this approach needs to be considered in the context of the different legal framework operating in many OECD countries, when compared to Australia:

- **Fund Structure:** The legal form of a pension arrangement has a bearing on the structure of the board.⁵³ The trust is used in countries with an Anglo-Saxon legal tradition (e.g. Australia, the United Kingdom, Ireland and Canada) and in these countries member representation on the board is not always required.⁵⁴

In other jurisdictions, pension arrangements can be 'institutional' or 'contractual'.⁵⁵ Institutional funds can be structured as corporations (e.g. Austria, Germany) or as foundations and associations (e.g. Denmark, Finland, Hungary, Italy, Japan, Norway, the Netherlands, Switzerland).⁵⁶ The representational board model is typically found in institutional funds, with board members selected by employers and employees.⁵⁷

Alternatively, the pension arrangement may be structured as a contract with a financial institution (e.g. a bank, insurance company or funds management company). In these arrangements, the governing body for the pension arrangement is ultimately the board of directors of the financial institution (e.g. Czech Republic, Mexico, Portugal, Spain⁵⁸ and open schemes⁵⁹ in Italy and Poland).⁶⁰

In the United States, the governing body may be the fund sponsor, the trustee or a third party.⁶¹ However, transactions with related parties are generally prohibited under the *Employee Retirement Income Security Act 1974*.⁶² Certain multi-employer schemes (similar to Australian industry funds) are structured as trusts and must have an equal number of employer and employee representatives on their trustee boards.⁶³

⁵¹ The main exceptions are Canada, Ireland, Israel, Mexico and the United States (for single employer plans). In some countries, member representation is required, but not necessarily in equal numbers e.g. Austria, the United Kingdom (occupational pension plans), Brazil and Hungary.

⁵² F Stewart and J Yermo "Working Paper on Pension Fund Governance Challenges and Potential Solutions" *OECD Working Papers on Insurance and Private Pensions* No 18, Table 1 (2008)

⁵³ J Yermo and A Marossy "Pension Funds Governance" *OECD Insurance and Private Pensions Compendium for Emerging Economies* Book 2 Part 1.4(b) (2001); International Organisation of Pension Supervisors, "Supervisory Oversight of Pension Fund Governance" Working Paper No 8 (August 2008)

⁵⁴ In Australia, member representation is not required on the trustee board of a public offer fund with an independent trustee (colloquially referred to as a 'retail fund'); in Canada, member representation is not required for single company funds and in the United Kingdom a third of the trustee board must be member representatives: above n 52. (See however, the next section headed 'United Kingdom Reforms')

⁵⁵ An institutional fund is described as an independent entity with legal personality and capacity.

⁵⁶ International Organisation of Pension Supervisors, "Supervisory Oversight of Pension Fund Governance" Working Paper No 8 (August 2008)

⁵⁷ Ibid

⁵⁸ In Spain, some responsibilities are shared with an oversight committee.

⁵⁹ An 'open scheme' is a pension arrangement with no membership restrictions.

⁶⁰ Above n 52

⁶¹ Above 52, p 6

⁶² Y Hu et al "Collective Pension Funds: International Evidence and Implications for China's Enterprise Annuities Reform" *OECD Working Papers on Insurance and Private Pensions* No 9 Annex A4 (2007)

⁶³ Known as TAFT-Hartley schemes; see above n 52

- **Two-Tier Board Structure:** Some 'institutional' pension funds, such as in Germany and the Netherlands, have a two-tier structure made up of a supervisory and management board.⁶⁴ The managing board is considered the governing body and is accountable to the supervisory body. Equal representation requirements typically apply to the supervisory board, but not to the management board. In these countries, the supervisory board may set the strategy, but day-to-day decisions about the management of the pension fund are vested in the management board.
- **Investment restrictions:** Some OECD countries have very prescriptive quantitative investment restrictions,⁶⁵ which go further than the 'in-house asset' and 'arm's length' investment rules imposed on superannuation funds in Australia.⁶⁶ For example, it is not uncommon for there to be maximum and/or minimum limits on investment in asset classes such as equities, bonds, real property and foreign securities.⁶⁷ These restrictions effectively limit diversification options for the fund, which in turn limits the discretionary powers of the governing body. In contrast, Australian regulation of investments is based on 'professional investor' principles and certain prescribed factors to be considered in formulating an investment strategy.⁶⁸
- **Guaranteed returns:** In some OECD countries, pension legislation requires defined contribution (DC) pension fund providers (or sponsors) to guarantee an absolute rate of return.⁶⁹ For example, in the Czech Republic, pension fund managers must guarantee the nominal value of contributions made by fund members every year and contributions cannot receive a negative rate of return in a single year.⁷⁰ In other OECD countries, instead of an absolute rate of return, the law requires pension funds to meet a 'relative return' guarantee, defined by relation to the industry average or some market benchmark.⁷¹ For example, in Hungary, mandatory pension funds must ensure that the investment return is not less than 15% lower than the yield on Hungarian government bonds. In Slovenia, DC fund providers must meet a minimum return of 40% of the average annual interest on Slovenian government bonds.⁷² Guaranteed returns shift some of the investment risk away from beneficiaries to the fund provider or sponsor.

⁶⁴ Under the new governance reforms, it is now possible to choose a one-tier board structure as an alternative: see 'The Netherlands' section below.

⁶⁵ OECD *Annual Survey of Investment Regulations of Pension Funds 2014*, Table 1. For example, **Bonds:** in Hungary there is no limit for investments in government bonds but there is a limit of 10% on Hungarian corporate bonds, 10% in Hungarian municipalities bonds and 25% on mortgage bonds. Similarly, in Greece, funds cannot invest more than 70% of assets in corporate bonds, but there is no limit on investments in government bonds. **Equities:** Spain limits investment in unlisted equities to 30%. Norway, on the hand, has no limits on exposure to listed companies in OECD/EU countries, but has a 10% limit on listed shares outside OECD/EU countries, unlisted shares, private equity and "special funds" (e.g. hedge funds). Investment in **real estate** is prohibited in many countries, although indirect investment in real estate (i.e. through bonds or shares of property companies) is possible in Chile, Italy, Mexico, Armenia, Costa Rica, Hong Kong (China), Macedonia (FYR), Peru and Thailand. Some countries impose **investment floors**. For example, in Israel, new pension funds and old-pension funds must invest at least 30% of their portfolios in earmarked bonds. In New Zealand, a KiwiSaver default investment fund option is required to invest not less than 15% (or more than 25% if default) of members' assets in growth assets. However, there is a trend towards the relaxing of investment restrictions in pension funds around the world.

⁶⁶ See SIS Act, ss 65 – 67B and Part 8; see also regs 13.17A and 13.17AA

⁶⁷ OECD *Annual Survey of Investment Regulations of Pension Funds 2014*

⁶⁸ See SIS Act, ss 52(2)(b) and 52(6)

⁶⁹ P Antolin et al "The Role of Guarantees in Defined Contribution Pensions" OECD *Working Papers on Finance, Insurance and Private Pensions* No. 11 (2011)

⁷⁰ Ibid p 12

⁷¹ Ibid p 13

⁷² Ibid



- **Prescribed minimum qualification:** The 'fit and proper' requirements vary between countries in the OECD. Unlike Australia, some countries prescribe minimum qualifications for directors. For example, in Austria, members of the board of directors of a multi-employer pension fund must have at least 3 years of management experience and also prove their professional experience in the areas of pension fund management, banking or insurance.⁷³ In Poland, at least one third of the directors must have a professional certificate in law or economics or be registered on a list of investment advisers and at least two thirds of directors must have a minimum of 7 years' work experience.⁷⁴ Finland and Germany also require board members to have specific qualifications and professional experience.⁷⁵ The EU is proposing further tightening of its 'fit and proper' requirements. This may impact board composition, as many employee and employer representatives could struggle to meet the higher standards.

UNITED KINGDOM REFORMS

Following the introduction of 'auto-enrolment' in 2012,⁷⁶ the Office of Fair Trading in the United Kingdom commissioned a review of the pension market.⁷⁷ The review revealed several areas where standards need to be raised, particularly in an environment where millions of people are defaulted into workplace pension arrangements.

The outcome of this review was the enhancement of governance requirements for defined contribution (DC) workplace schemes, including the introduction of independence requirements. The new laws came into effect on 6 April 2015.

There are two main types of DC workplace pension schemes in the UK: workplace personal pensions and occupational schemes. Workplace personal pensions are contract-based arrangements, whereas occupational schemes are typically trusts. Contract-based arrangements are regulated by the Financial Conduct Authority (FCA) and pension trusts are regulated by the Pensions Regulator.

⁷³ Above n 52 Table 2

⁷⁴ Ibid

⁷⁵ Ibid

⁷⁶ This is similar to the Australian 'default fund' system.

⁷⁷ Office of Fair Trading (OFT) *Defined Contribution Workplace Pension Market Study* 1505 (2013)

The changes introduce new independence requirements for DC workplace personal schemes (i.e. contract based arrangements)⁷⁸ and occupational multi-employer schemes (e.g. master trusts):⁷⁹

- **Workplace personal schemes** – providers of contract-based schemes are required to set up a new governance body called an “Independent Governance Committee” (IGC). The purpose of the IGC is to assess, and if necessary challenge, the ‘value for money’ delivered by the scheme and report on how it meets quality standards, given that the provider of these schemes is generally selected by the employer and members may therefore be disengaged.

The composition requirements of the IGC are as follows:

- a minimum of 5 trustees, the majority of whom, including the chairman, are independent; and
- an open and transparent recruitment process.⁸⁰

Independence is not legislatively prescribed. Instead, a company is required to determine whether an IGC member is independent in character and judgment and whether there are relationships or circumstances that are likely to affect, or could appear to affect, the member’s judgment.⁸¹

The FCA guidelines state that a person is unlikely to be considered independent in the following circumstances:

- current or past employment ties with the company or the group; or
- a current or past material business relationship of any description, directly or indirectly.⁸²

- **Trustees of multi-employer schemes** (e.g. master trusts) will have the following requirements:⁸³

- a minimum of 3 trustees, the majority of whom, including the chairman, are “non-affiliated”.
- “Non-affiliated” is defined to mean independent of providers of advisory, administration, investment or other services of the fund (**service providers**).⁸⁴ When determining whether a person is “non-affiliated” the following factors must be taken into account:
 - › current or past employment ties with a service provider or an undertaking connected with the service provider;⁸⁵
 - › any payments or other benefits received from a service provider; and
 - › whether the person’s relationship with the service provider will conflict with their obligations to the scheme and if so, whether their obligations as trustee will take priority;
- limited terms of up to 5 years, with a cumulative maximum of 10 years. Individuals acting as representatives of employer sponsors may be appointed for a maximum term of 10 years;
- an open and transparent recruitment process; and
- a process to encourage scheme members, or their representatives, to make their views known on matters that affect them.⁸⁶

⁷⁸ *Personal Pension Schemes (Independent Governance Committees) Instrument 2015*, by which the FCA added new rules to the Conduct of Business Sourcebook (COBS).

⁷⁹ *Occupational Pension Schemes (Charges and Governance) Regulations 2015*.

⁸⁰ In its Policy Statement PS 15/3 issued in February 2015, the FCA has stated that, while it supports the recruitment of independent IGC members from employers, contributing members and deferred members, it is conscious of the practical difficulties in attracting suitable candidates and/or in organising elections and therefore does not propose to prescribe the recruitment process.

⁸¹ COBS 19.5.11R

⁸² COBS 19.5.12G(1)(b): In relation to past employment, the ‘look back’ period is 5 years prior to appointment as an IGC member. COBS 19.5.12G(1)(c): In relation to past business relationships, the ‘look back’ period is 3 years prior to appointment as an IGC member.

⁸³ Above n 79

⁸⁴ Trustees that sit on a provider’s IGC may still be considered “non-affiliated”: the Pensions Regulator “The essential guide to governance standards and charge controls from April 2015” (February 2015)

⁸⁵ Above n 79, reg 28: The ‘look back’ period is 5 years prior to appointment as a trustee.

⁸⁶ This appears to be a similar concept to the policy committee concept under s 93(3) of the SIS Act, but the UK requirements are not prescriptive.

HONG KONG

Under the Mandatory Provident Fund (MPF) System, every MPF scheme must be operated under a trust arrangement and be managed by a trustee approved by the MPF Schemes Authority. There are three types of MPF scheme: master trusts, employer sponsored schemes and industry funds.⁸⁷

The MPF legislation requires that one director of the corporate trustee must be an independent director. "Independent" is defined to mean no past or present association (financial or otherwise) with the trustee, its controllers or associates that could affect the impartiality of the director's independent judgment.⁸⁸

The MPF legislation also requires investment managers to be independent of the trustees and custodians of the MPF scheme. MPF schemes are prohibited from investing in securities of the trustees, the custodians, investment managers or the guarantors.⁸⁹

THE NETHERLANDS

Following the Global Financial Crisis, the Dutch Government established the Frijns Committee to advise the Government on the risk management and investment policies of Dutch pension funds.⁹⁰

One of the findings was the need for boards to have specific and proven expertise in the fields of investment and risk management in order to deal with the challenges and increasing complexities facing pension funds. However, the Committee also acknowledged the advantages of direct representation from stakeholders.⁹¹

Another important recommendation was to shift the trustee model *"to a more democratic model driven by the preferences of participant groups, and where the Board can be held accountable for their policy choices and the quality of implementation."*⁹² To meet this challenge, the Committee felt that pension funds should be given some degree of freedom to determine their own structure.

Following these recommendations, the Dutch government passed new laws requiring pension funds to change their governance structure from 1 July 2014 and choose one of three board models: a joint model, an independent board model or a mixed board model (which has three further options). The new laws are very complex, but the main focus is on increasing the representation of independent expertise on boards, participation of pensioners in the governing structure and enhancing 'suitability' requirements for board members.⁹³

⁸⁷ MPF Schemes Authority website

⁸⁸ International Organisation of Pension Supervisors "Mandatory Provident Fund Schemes Authority, Hong Kong, China" Working Paper No 8 (August 2008) p 46

⁸⁹ Ibid

⁹⁰ JM Frijns "Dutch Pension Funds: Aging Giants Suffering And from Weak Inconsistent Risk Management" (2010) *Rotman International Journal of Pension Management* Vol. 3, No. 2

⁹¹ Ibid, pp 19-20

⁹² Ibid

⁹³ AM de Kruijf and M de Vries "Governance and Stakeholder Involvement in the Dutch Pension Industry, Lessons for Developing Countries" (2014); J de Deken "Pensions, health and long-term care – The Netherlands" (March 2014).

THE EU DIRECTIVE

On 27 March 2014 the European Commission adopted a legislative proposal for new rules regulating an occupational pension fund (IORP). The proposal aims at improving the governance and transparency of these funds in Europe, promoting cross-border activity, and helping long-term investment.⁹⁴

Under the proposed Directive, all persons who run an IORP or have key functions in relation to an IORP must have professional qualifications, knowledge and experience that are adequate to enable sound and prudent management of the IORP, to properly perform their key functions ('fit') and to demonstrate that they are of good repute and integrity ('proper').⁹⁵

This is a significant change from the previous requirements under which it was possible to employ appropriately qualified service providers as an alternative to having people on the governing body with professional qualifications.⁹⁶ Some commentators have observed that this change in requirements may be too onerous for employee representatives. As a practical consequence, the new standard may impact on the composition of the governing body of an IORP and indirectly provide an impetus for more professionals to fill these roles.

To address these concerns, there have been proposals to relax some of the requirements as the Directive moves through the EU legislative process. The proposed adjustments include removing the requirement for qualifications to be 'professional' and allowing the 'fit' test to be met on a collective basis, rather individually by each director. The Directive and the proposed changes are currently being scrutinised by the European Parliament with a view to being finalised and adopted later this year.

⁹⁴ http://ec.europa.eu/finance/pensions/iorp/index_en.htm#maincontentSec1

⁹⁵ Article 23 of the revised Directive 2003/41/EC on the activities and supervision of Institutions for Occupational Retirement Provision – IORP Directive II

⁹⁶ Article 9, para 1(b) of Directive 2003/41/EC on the activities and supervision of Institutions for Occupational Retirement Provision – IORP Directive.

5

OUR THOUGHTS ON THE AUSTRALIAN GOVERNANCE MODEL

RESPONSIBILITIES OF AUSTRALIAN SUPERANNUATION TRUSTEES

Australia has a highly developed superannuation system, supported by mandatory employer contributions.

In Australia, the SIS Act places sole responsibility for management of a regulated superannuation fund on the trustee. The SIS covenants reinforce this responsibility for all key decisions, including investments, insured benefits and risk management. This means that, in Australia, the range of decisions required to be made by a superannuation trustee is very extensive. It is perhaps not surprising that the Stronger Super reforms elevated the requisite standard of care, skill and diligence to that of a professional for both the trustee and its directors. APRA's prudential standards further reinforce the expectation that the trustee board will make, and be accountable for, all key decisions.⁹⁷

By comparison with pension funds in many OECD countries, Australian superannuation trustees face few investment restrictions, other than those needed to preserve the integrity of the tax concessions.⁹⁸

Rather, Australian trustees have a broad discretion in the formulation of investment strategies and the investment of fund assets, subject only to the prescribed factors required to be considered under the investment covenants.⁹⁹ With member investment choice, the formulation and monitoring of investment strategies and the selection of individual investments can be quite complex, requiring specialist knowledge of a wide range of asset classes and measures for mitigation of investment risk. Unlike some OECD countries, there is no requirement for returns to be guaranteed. Further, Australian 'fit and proper' requirements do not prescribe particular professional qualifications.

The sophistication of Australian superannuation fund offerings (including contribution choices, investment choices, insurance choices and pension choices) has necessarily led to trustees providing some form of advisory service to members to assist them in their own decision-making. 'Choice of fund' has also led to more intense competition between funds, requiring trustees to develop marketing and engagement strategies to ensure the commercial viability of their funds.

⁹⁷ Under the APRA Prudential Standards for Superannuation, there are currently 44 matters that must be either approved or satisfied by the board or for which the board is held to be responsible.

⁹⁸ For example, the sole purpose test in s 62, the prohibition on loans to members in s 65, the limitations on borrowing in ss 67 – 67B, the in-house asset rules in Part 8 and the requirement to invest on an 'arm's length' basis in s 109.

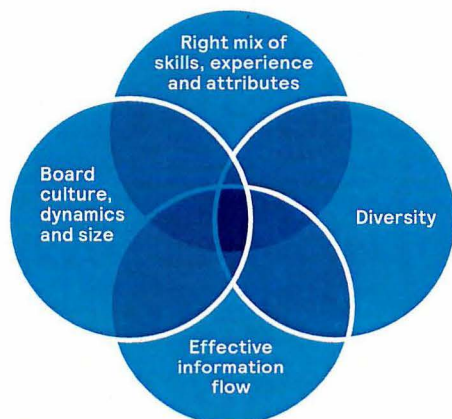
⁹⁹ In fact, a provision in the trust deed that purports to constrain discretion by specifying mandatory investment entities, products or service providers is void: SIS Act, s 58A.

In the context of the Australian superannuation environment, where investment risk increasingly lies with members and with the primary roles of the board being fund strategy, investment decision-making, insurance strategy, financial control and risk management and member engagement strategy, it is more essential than ever before that Australian trustee boards have the right mix of skills and experience and a diversity of thinking.

MANDATING INDEPENDENT DIRECTORS

The aim in mandating a governance structure for superannuation trustee boards is to optimise the quality of decision-making in the interests of fund members. The trust model for regulated superannuation funds is an inherent governance control, because it imposes an obligation to act in members' interests on the trustee and its directors. Equally, a competent and diverse board is vitally important.

Our research demonstrates that many overseas jurisdictions are either mandating independent directors¹⁰⁰ or considering elevating competency levels to a professional standard (with the result that boards would need to consider the appointment of independent directors in order to meet the standard).¹⁰¹ In our experience with funds that already have independent directors, we find that independent directors can be invaluable in supplementing the skills and experience on the trustee board and in bringing a range of views to the debate.



We therefore consider that the boards of Australian superannuation trustees should include a number of independent directors since many superannuation funds are now very significant and complex financial businesses. It is hard to argue that superannuation funds should be held to a lesser standard of governance than the standards applicable to Australian listed companies, banks and insurers.¹⁰² It is equally hard to argue that superannuation funds should be held to a lesser standard of governance than they expect of their investee companies. In addition to enhancing the overall competencies of a board, independent directors can bring objectivity and detachment from stakeholders.

However, we do not believe that independent directors should be required to the exclusion of member representation in a fund's governance structure. Fund members are generally represented on overseas pension fund boards and the perspectives of member representatives (including pension member representatives) will be increasingly valuable as funds seek to engage and connect with their members in an environment of heightened competition. The challenge will be to include independent directors as a complement to existing boards, without growing them to an unwieldy size. We therefore favour flexibility (say, *up to a majority*), rather than a fixed quota.

However, it must be acknowledged that structural independence requirements alone will not achieve effective decision making at board level. Other important factors include:

- the overall experience and competence of directors,
- diversity,
- effective and timely information flow; and
- Board culture and dynamics, including an effective chairman.

¹⁰⁰ As in the UK and Hong Kong

¹⁰¹ As in the Netherlands and some OECD countries – see also the EU Directive

¹⁰² Subject to some exceptions

A PRINCIPLES-BASED DEFINITION

The definition of “independent director” should reflect its purpose and be crafted in order to enhance objectivity and impartiality. It should not, in our view, preclude an independent director from being a member of the fund.

We recommend a principle-based definition along the following lines:

a non-executive director who is free from any business or other association that could materially interfere with the exercise of independent judgment, including those arising out of the director or a close relative of the director having:

- *a personal shareholding in the trustee company or its related bodies corporate;¹⁰³*
- *involvement in an employer, employee or member organisation; or*
- *significant involvement in the management of the fund or as a service provider;¹⁰⁴ auditor, actuary or adviser to the fund, whether currently or within the past three years,*

but who may be a member of the fund.

Our definition is aimed at distancing an independent director from conflicting duties, personal interests (other than as a fund member) and affiliations and past associations that might impair the director's ability to bring ‘fresh thinking’ to the board table.

MEMBER REPRESENTATION

While an absence of conflicting duties, external affiliations and past associations is conducive to the exercise of independent judgment, representation on the board from individuals who are fund members is seen as important for occupational superannuation, because members are increasingly bearing the investment risk. From a corporate governance perspective, some listed companies even require a director's remuneration to include shares in the company, in order to better align their personal interests with those of the company. For superannuation trustees, the inclusion of directors who are members of the fund serves a similar purpose.

Member (and pensioner) representatives can also provide an avenue for engagement with, and ready access to, members' needs and preferences. The challenge in an environment of disengaged members is to source individual member representatives, but with increasing numbers of members moving to retirement phase, pension members might be willing to serve as member representatives and may well have relevant experience to contribute from their working lives.

CONCLUSION

Ultimately, we believe that the Australian superannuation industry should remain focused on achieving the right composition of skills and experience for each fund, since in our experience the collective skill set, objective judgment and dynamics of a trustee board are critical for effective decision-making. Mandatory appointment of independent directors is therefore an opportunity for funds to consider the optimal skills, experience and attributes they wish to have as a collective and to build better trustee boards as a result.

Pam McAlister
Partner

Liana Brover
Principal

Pam and Liana are governance consultants within Mercer's Governance Practice in Australia.

¹⁰³ In some ‘not for profit’ funds each director holds a nominal number of shares, but the shares are required to be transferred when the director's term expires. In these situations, the shareholding does not generate any personal profit, but rather is an incident of the office of director. We would not consider this kind of nominal holding to be a personal shareholding.

¹⁰⁴ Including related party service providers.



A

APPENDIX A

INDEPENDENCE REQUIREMENTS FOR NON-SUPERANNUATION ENTITIES

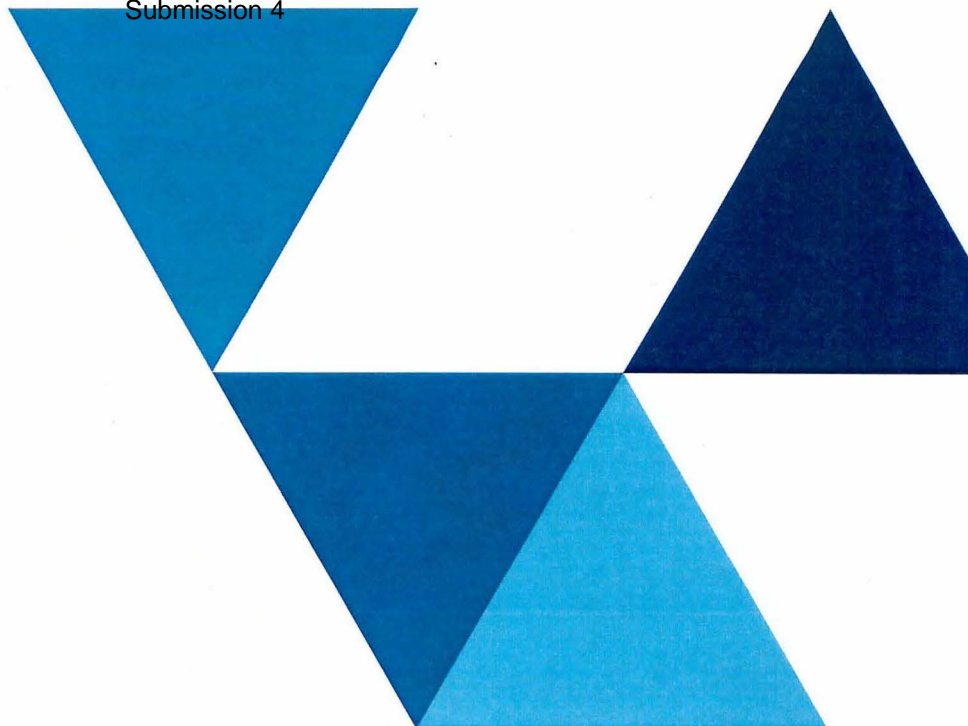
ELEMENTS IN THE CONCEPT OF INDEPENDENCE	MANAGED INVESTMENT SCHEMES ¹⁰⁵	BANKS, LIFE & AND GENERAL INSURANCE COMPANIES ¹⁰⁶
GENERAL PROHIBITION		
	N/A	A non-executive director who is free from any business or other association — including those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser — that could materially interfere with the exercise of their independent judgment.

¹⁰⁵ *Corporations Act 2001*, s 601JA

¹⁰⁶ APRA Prudential Standard CPS 510 – *Governance*

¹⁰⁷ FSC Standard No. 20: *Superannuation Governance Policy*

¹⁰⁸ ACSI Governance Guidelines: *A guide for superannuation funds to monitor listed Australian Companies* (2013)



ASX CORPORATE GOVERNANCE PRINCIPLES AND RECOMMENDATIONS

FSC STANDARD 20¹⁰⁷

ACSI GOVERNANCE GUIDELINES¹⁰⁸

A director of a listed entity should only be characterised and described as an independent director if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, in a material respect, his or her capacity to bring an independent judgment to bear on issues before the board and to act in the best interests of the entity and its security holders generally.¹⁰⁹

The director is not an employee (and thus a non-executive director) of the relevant licensee or a related body corporate or a related entity of either (**relevant entity**) other than being an employee of the relevant entity or having a relationship with a relevant entity by virtue of the holding of office as a director.

The definition of independence is subject to a "no conflict rule".¹¹⁰

A parent company director cannot be treated as independent on a subsidiary RSE licensee board under any circumstance.¹¹¹

A person who is regarded as an independent non-executive director is expected to be able to make decisions in the best interests of the company in a manner that is independent of management and free of any business (or other) relationships that could materially interfere with their judgment. This is particularly the case where there is a potential conflict of interest arising in a board decision, be it actual or perceived.

A board should be comprised of a majority of independent non-executive directors who are sufficiently motivated and equipped to fulfil the function of independent scrutiny of the company's activities.¹¹²

¹⁰⁹ Commentary to Recommendation 2.3 of the ASX Corporate Governance Principles and Recommendations, 3rd Edition (ASX Principles)

¹¹⁰ Under this rule, a non-executive, independent director of a related entity of an RSE licensee, also may act as a non-executive, independent director on the Board of the RSE licensee (and vice versa) if and only if in holding each of these positions there is no real or sensible conflict of duty (or interest) and no possibility of such a conflict arising: FSC Standard No.20, para 8.2.3(b).

¹¹¹ FSC Standard No.20, para 8.2.3(a)

¹¹² ACSI Governance Guidelines, Section 10

ELEMENTS IN THE CONCEPT OF INDEPENDENCE	MANAGED INVESTMENT SCHEMES ¹⁰⁵	BANKS, LIFE & AND GENERAL INSURANCE COMPANIES ¹⁰⁶
SPECIFIC PROHIBITIONS		
Employment ties	The director is not, and has not been in the previous 2 years, an employee of the responsible entity or a related body corporate.	The director is not, and has not previously been, employed in an executive capacity by the institution or another member of the group, or there has been a period of at least three years between ceasing such employment and serving on the Board. ¹¹³
	The director is not, and has not been in the previous 2 years, a senior manager of a related body corporate.	
Majority shareholding	The director does not have a material interest in the responsible entity or a related body corporate.	The director is not a substantial shareholder ¹¹⁵ of the APRA-regulated institution or an officer of, or otherwise associated directly with, a substantial shareholder of the institution.

¹¹³ Attachment A to APRA CPS 510 – *Governance*. The circumstances outlined in Attachment A are adapted from the guidance on 'Relationships affecting independent status' to be considered by a Board when determining the independent status of a director set out in Box 2.1 of the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (2nd Edition 2007).

ASX CORPORATE
GOVERNANCE
PRINCIPLES AND
RECOMMENDATIONS

FSC STANDARD 20¹⁰⁷

ACSI GOVERNANCE
GUIDELINES¹⁰⁸

The director is not, and has not previously been, employed in an executive capacity by the entity or any of its child entities or there has been a period of at least three years between ceasing such employment and serving on the board.¹¹⁴

The director has not, within the last three years, been employed in an executive capacity by a relevant entity or been a director of a relevant entity after ceasing to hold any such employment.

The director has not been employed by the company in the past 3 years.

The director is not a substantial security holder of the entity or an officer of, or otherwise associated with, a substantial security holder of the entity.¹¹⁶

The director does not have a substantial holding in the relevant licensee or any of its related bodies corporate (**relevant entity**) or is not an officer of such a relevant entity, or otherwise associated directly or indirectly with, a person having a substantial shareholding in a relevant entity.

The director is independent of substantial shareholders. The director is not an officer, director, representative or employee of a shareholder that holds more than 5% of the voting rights in the company's shares.

The director is not a director or employee of another company in which the main company has invested more than 5% of its share capital.

¹¹⁴ Box 2.3 of the ASX Principles

¹¹⁵ A 'substantial shareholder' is a person with a substantial holding as defined in s 9 of the Corporations Act.

¹¹⁶ Box 2.3 of the ASX Principles

ELEMENTS IN THE CONCEPT OF INDEPENDENCE	MANAGED INVESTMENT SCHEMES ¹⁰⁵	BANKS, LIFE & AND GENERAL INSURANCE COMPANIES ¹⁰⁶
Material business connection	The director is not, and has not been in the previous 2 years, substantially involved in business dealings, or in a professional capacity, with the responsible entity or a related body corporate.	The director has not within the last three years been a principal of a material professional adviser or a material consultant to the institution or another member of the group, or an employee materially associated with the service provider.
	The director is not a member of a partnership that is, or has been in the previous 2 years, substantially involved in business dealings, or in a professional capacity, with the responsible entity or a related body corporate.	The director is not a material supplier or customer of the institution or another member of the group, or an officer of or otherwise associated directly or indirectly with a material supplier or customer.
		The director does not have a material contractual relationship with the institution or another member of the group other than as a director.
Family ties	The director is not a relative of a person who has a material interest in the responsible entity or a related body corporate.	The director is free from any business or other association. ¹²⁰

ASX CORPORATE
GOVERNANCE
PRINCIPLES AND
RECOMMENDATIONS

FSC STANDARD 20¹⁰⁷

ACSI GOVERNANCE
GUIDELINES¹⁰⁸

The director is not, and has not within the last three years been, a partner, director or senior employee of a provider of material professional services to the entity or any of its child entities.¹¹⁷

The director has not within the last three years been a principal or employee of a material professional adviser or a material consultant to a relevant entity.

The director has not held senior employment with a significant professional adviser in the past 3 years.

The director is not, and has not been within the last three years, in a material business relationship (e.g. as a supplier or customer) with the entity or any of its child entities, or an officer of, or otherwise associated with, someone with such a relationship.¹¹⁸

The director is not a material supplier or customer of a relevant entity or an officer of or otherwise associated directly or indirectly with, a material supplier or customer of any relevant entity.

The director is not a major supplier or customer to the company (or their representative or executive).

The director does not have a material contractual relationship with the entity or its child entities other than as a director.¹¹⁹

The director has no material contractual relationship with a relevant entity.

The director has no material contractual relationship with the company.

The director is not receiving fees for services to the company at a level indicative of either significant involvement in the company's affairs, or significant in relation to the salaries received by other directors.

The director does not have close family ties with any person who falls within any of the categories described above.¹²¹

The director is free from any interest and any business or other relationship which could, or reasonably could be perceived to materially interfere with the director's ability to act in the best interests of the relevant RSE's beneficiaries.

The director is independent from a relationship with a related party (spouse, de facto spouse, parents and children of affiliated directors, executive directors, senior executives and advisers).

¹¹⁷ Box 2.3 of the ASX Principles

¹¹⁸ Box 2.3 of the ASX Principles

¹¹⁹ Box 2.3 of the ASX Principles

¹²⁰ APRA Prudential Standard CPS 510 – *Governance*, para 25

¹²¹ Box 2.3 of the ASX Principles

ELEMENTS IN THE CONCEPT OF INDEPENDENCE	MANAGED INVESTMENT SCHEMES ¹⁰⁵	BANKS, LIFE & AND GENERAL INSURANCE COMPANIES ¹⁰⁶
Duration acting as director	N/A	N/A
Other		

ASX CORPORATE
GOVERNANCE
PRINCIPLES AND
RECOMMENDATIONS

FSC STANDARD 20¹⁰⁷

ACSI GOVERNANCE
GUIDELINES¹⁰⁸

The director has not been a director of the entity for such a period that his or her independence may have been compromised.¹²²

N/A

Directors should continue to be independent despite the length of their board tenure. There is no firm threshold for when the length of a directorship affects independence. It is assessed on a case-by-case basis.

In each case, the materiality of the interest, position, association or relationship needs to be assessed.

Independent of relationships which may impact decision making

- Relationships (including other directorships) that could be (or be perceived to be) capable of materially interfering with acting in the company's best interests.
- Benefiting from a related party transaction

Independent of incentive pay

Participation in performance incentive schemes, including options that are also granted to executives

Independent in a takeover bid

Participating in a bid for the counterparty (either as buyer or seller).

¹²² Box 2.3 of the ASX Principles

B

APPENDIX B

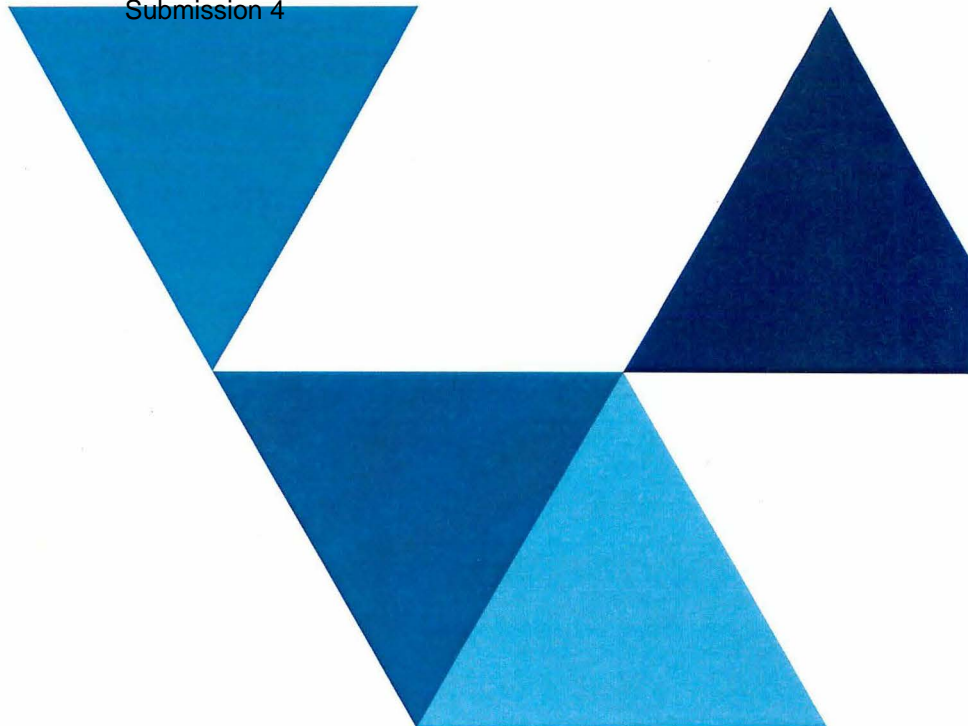
INDUSTRY BODIES – DEFINITIONS OF INDEPENDENCE

ELEMENTS IN THE CONCEPT OF INDEPENDENCE	ASFA ¹²³	ISA ¹²⁴
GENERAL PROHIBITION	N/A	An independent director is a non-executive director who is not a member of management (of the RSE licensee or any of its related bodies corporate) and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment.

¹²³ ASFA Submission, p 11

¹²⁴ ISA Submission, p 26

¹²⁵ AIST Submission, p 20



AIST¹²⁵

FSC STANDARD 20¹²⁶

Retain SIS Act 'independent director' definition for equal representation boards, but remove the exclusion of members of the fund.

The director is not an employee (and thus a non-executive director) of the relevant licensee or a related body corporate or a related entity of either (**relevant entity**) other than being an employee of the relevant entity or having a relationship with a relevant entity by virtue of the holding of office as a director.

The definition of independence is subject to a "no conflict rule".¹²⁷

A parent company director cannot be treated as independent on a subsidiary RSE licensee board under any circumstance.¹²⁸

¹²⁶ FSC Standard No. 20: *Superannuation Governance Policy*

¹²⁷ Under this rule, a non-executive, independent director of a related entity of an RSE licensee also may act as a non-executive, independent director on the Board of the RSE licensee (and vice versa) if and only if in holding each of these positions there is no conflict of duty (or interest) and there is no real or sensible possibility of that conflict arising: FSC Standard No.20, para 8.2.3(b).

¹²⁸ FSC Standard No.20, para 8.2.3(a)

ELEMENTS IN THE CONCEPT OF INDEPENDENCE

ASFA¹²³

ISA¹²⁴

SPECIFIC PROHIBITIONS

Employment ties

The director is not, and has not within the last three years been, a director of, a representative of or employed at an executive level by:

- the fund, the RSE licensee or a related entity of the fund or RSE licensee,
- a standard employer-sponsor or sponsoring organisation of the fund or a related entity of the fund or RSE licensee,
- any organisation directly representing the interests of one or more members (or groups of members);
- any organisation directly representing the interests of one or more standard employer sponsors of the fund; or
- an associate (as defined in section 10 of the SIS Act) of any such entities listed above.

The director is not employed, and has not previously been employed in an executive capacity by the RSE licensee or any of its related bodies corporate, or there has been a period of at least three years between ceasing such employment and serving on the board.

The director is not employed in an executive capacity and/or is not an officer of an employer representative group or employee representative group which is a shareholder of the RSE licensee, or which under the Trust Deed may appoint directors to the board of the RSE licensee, or there has been a period of at least three years between ceasing such employment and serving on the board.

Majority shareholding

The director is not a substantial shareholder of the RSE licensee or an officer of, or otherwise associated directly with, a substantial shareholder of the RSE licensee.

The director is not a substantial shareholder of the RSE licensee or any of its related bodies corporate or an officer of, or otherwise associated directly with, a substantial shareholder of the RSE licensee or its related bodies corporate.

AIST¹²⁵

FSC STANDARD 20¹²⁶

Modified ASX principles of independence to be added as further whole-of-industry guidance in APRA guidance material, adapted for the trust structure.

The director has not, within the last three years, been employed in an executive capacity by a relevant entity or been a director of a relevant entity after ceasing to hold any such employment.

Modified ASX principles of independence to be added as further whole-of-industry guidance in APRA guidance material, adapted for the trust structure.

The director does not have a substantial holding in the relevant licensee or any of its related bodies corporate (**relevant entity**) or is not an officer of such a relevant entity, or otherwise associated directly or indirectly with, a person having a substantial shareholding in a relevant entity.

ELEMENTS IN THE CONCEPT OF INDEPENDENCE	ASFA ¹²³	ISA ¹²⁴
Material business connection	The director is not a principal, director or employee of a material service provider, professional adviser or consultant to the fund, the RSE licensee or a related entity to the fund or RSE licensee and has not had significant and material involvement with a service provided to the fund, the RSE licensee or a related entity to the fund or RSE licensee within the last three years.	The director has not within the last three years been a principal of a material professional adviser or a material consultant to the RSE licensee or any of its related bodies corporate, or an employee materially associated with the service provider.
	The director is not an officer or employed at an executive level by a material supplier to the fund, the RSE licensee or a related entity, or otherwise associated directly or indirectly with a material supplier.	The director is not a material supplier or customer of the RSE licensee or any of its related bodies corporate, or an officer of or otherwise associated directly or indirectly with a material supplier or customer.
	The director does not have a material contractual relationship with the fund, the RSE licensee or a related entity other than as a director; and (unless an individual is personally exempted by APRA) does not sit on the board of another APRA regulated superannuation fund.	The director does not have a material contractual relationship with the RSE licensee or any of its related bodies corporate, other than as a director.
		The director is not a sponsor, or an employee or an officer of a sponsor that is a substantial shareholder of the RSE licensee.
Family ties	N/A	Family ties and cross-directorships may be relevant in considering interests and relationships which may affect independence, and should be disclosed by directors to the board.
Duration acting as director	N/A	N/A

AIST¹²⁵

FSC STANDARD 20¹²⁶

Modified ASX principles of independence to be added as further whole-of-industry guidance in APRA guidance material, adapted for the trust structure.

The director has not within the last three years been a principal or employee of a material professional adviser or a material consultant to a relevant entity.

The director is not a material supplier or customer of a relevant entity or an officer of or otherwise associated directly or indirectly with, a material supplier or customer of any relevant entity.

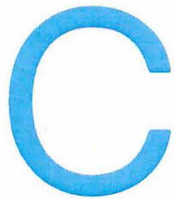
The director has no material contractual relationship with a relevant entity.

Modified ASX principles of independence to be added as further whole-of-industry guidance in APRA guidance material, adapted for the trust structure.

The director is free from any interest and any business or other relationship which could, or reasonably could be perceived to, materially interfere with the director's ability to act in the best interests of the relevant RSE's beneficiaries.

Modified ASX principles of independence to be added as further whole-of-industry guidance in APRA guidance material, adapted for the trust structure.

N/A



APPENDIX C

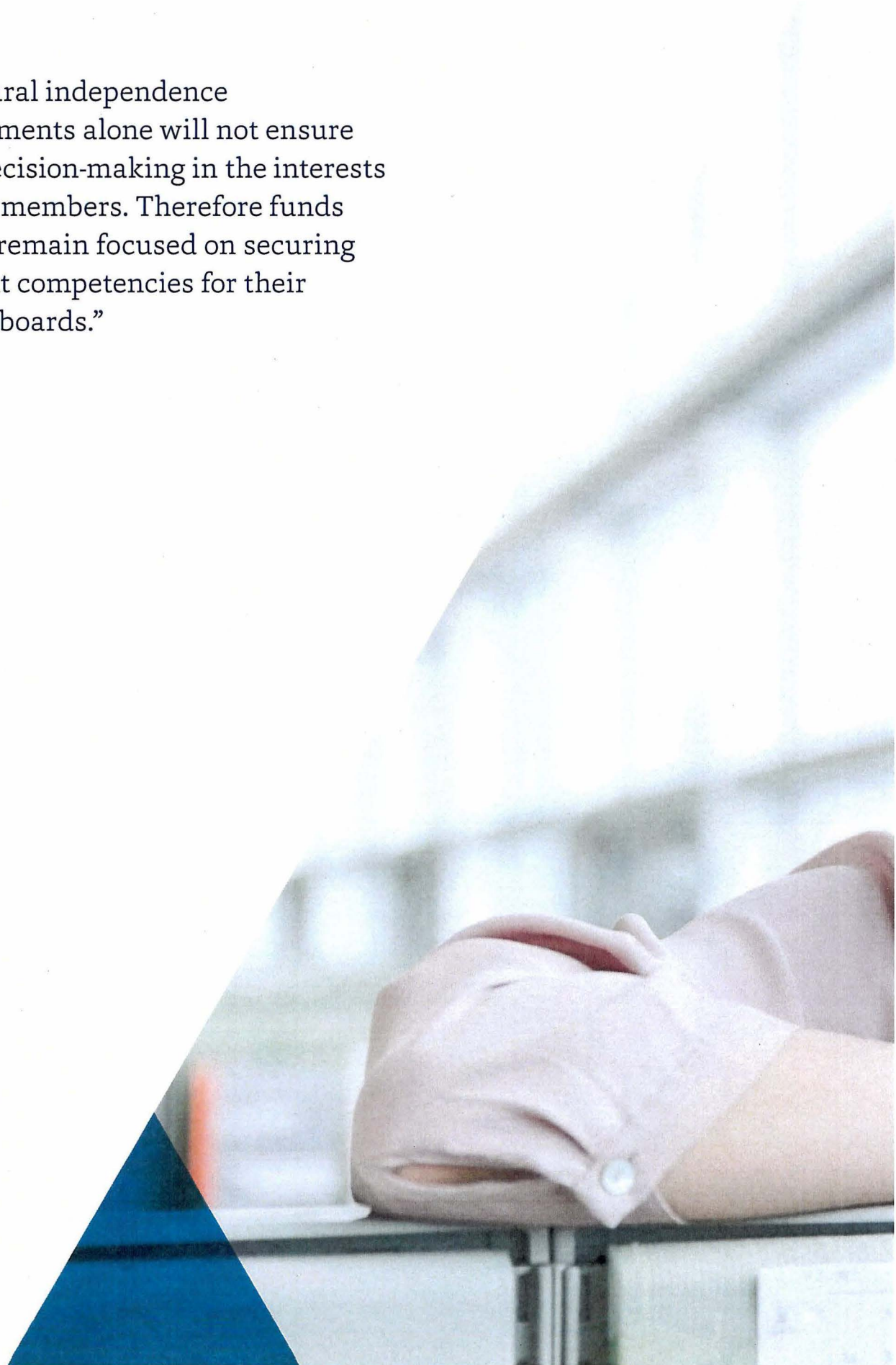
APRA GUIDANCE SPG 510 – FACTORS TAKEN INTO ACCOUNT IN DETERMINING WHETHER A DIRECTOR IS “NON-AFFILIATED”

SPECIFIC CRITERIA

Employment ties	The director is not employed, and has not previously been employed, in an executive capacity by the RSE licensee or another group member or there has been a period of at least three years between ceasing such employment and serving on the Board.
Majority shareholding	The director is not a substantial shareholder of the RSE licensee or an officer of, or otherwise associated directly with, a substantial shareholder of the RSE licensee.
Material business connection	The director has not within the last three years been a principal of a material professional adviser or a material consultant to the RSE licensee or another group member, or an employee materially associated with the service provider.
	The director is not a material supplier of the RSE licensee's business operations or another group member, or an officer of or otherwise associated directly or indirectly with a material supplier.
	The director does not have a material contractual relationship with the RSE licensee or another group member other than as a director.
Stakeholder ties	The director is not eligible to be a member representative or employer representative on the Board.
	The director has not served as a member representative or employer representative at any time during the last three years.



“Structural independence requirements alone will not ensure good decision-making in the interests of fund members. Therefore funds should remain focused on securing the right competencies for their trustee boards.”





FOR FURTHER INFORMATION, PLEASE CONTACT:

Pam McAlister, Partner

Pam.mcalister@mercer.com

Liana Brover, Principal

Liana.brover@mercer.com

Connect with us:

www.mercer.com.au

www.twitter.com/MercerAU

www.linkedin.com/company/mercer

This report has been prepared by Mercer Consulting (Australia) Pty Ltd ABN 55 153 168 140,
Australian Financial Services Licence #411770.

The material contained in this document is based on information researched in good faith from
sources publicly available within the market and on our understanding of legislation and government
releases, which we believe to be reliable and accurate.

'MERCER' is a registered trademark of Mercer (Australia) Pty Ltd ABN 32 005 315 917.

Copyright 2015 Mercer LLC. All rights reserved.



**MARSH & MCLENNAN
COMPANIES**