Senate Select Committee on Superannuation and Financial Services

Main Inquiry
Reference (a)

Submission No. 30

Note: Also Submission No. 9 to Reference (b)

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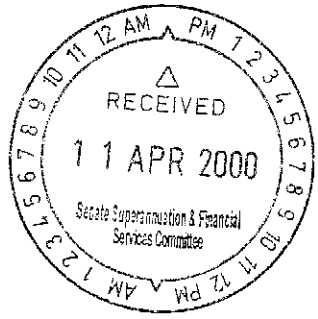

6 April 2000

Sue Morton
Secretary
Senate Select Committee on Superannuation and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Ms Morton

Submission – Inquiry into matters pertaining to superannuation and financial services

In this letter we provide comments relating to paragraphs (a) and (b) of the Select Committee's terms of reference:

(a) prudential supervision and consumer protection for superannuation, banking and financial services;
(b) the opportunities and constraints for Australia to become a centre for the provision of global financial services.

Our comments concern the investment of superannuation schemes' cashflows. In the case of large superannuation schemes, it is very common for the scheme trustees to hire external investment managers to undertake the important function of investing the scheme assets. The two issues we focus on are:

i) **Whether the existing law provides a clear and reliable basis for trustees to delegate the investment function.** We submit that there is a reasonable degree of uncertainty in the current law, and that therefore the *Superannuation Industry (Supervision) Act* 1993 (Cth) should be amended to clarify the power of superannuation fund trustees to delegate investment-related functions (subject to appropriate conditions).

ii) **Whether, as some corporate governance activists are currently arguing, a legal obligation to exercise voting rights should be imposed on superannuation fund trustees holding shares in publicly listed companies.** We submit that any such requirement would be inappropriate.

Our full submission begins on the next page.

Yours sincerely

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1. The power of trustees to delegate the investment function

1.1 There has been some concern about whether superannuation fund trustees have the authority to confer upon an investment manager the right to vote. This concern arose out of a paper prepared by Professor John Farrar for the former Australian Investment Managers' Association (AIMA) (Farrar 1993). AIMA was sufficiently worried about the situation that it made submissions to the State Attorneys-General, seeking the introduction of wider delegatory powers into the State trustee statutes; and to the former Insurance and Superannuation Commission, seeking an amendment to the *Superannuation Industry (Supervision) Act* 1993 (Cth) (**SIS Act**) or a new regulation under the SIS Act, to clarify the matter (Pheasant 1994, Ries 1994).

1.2 The voting right issue is really just a subset of a wider, more fundamental, issue: the capacity of superannuation fund trustees to leave the choice and making of investments to a fund manager. It is this wider issue that is addressed below.

The legal position independently of the SIS Act

1.3 It is helpful in the first instance to consider the wider issue independently of the SIS Act. Besides duties imposed by the SIS Act, there are three relevant factors:

(i) the general law duty of trustees to act personally;

(ii) the power provided by the general law and State trustee statutes for trustees to employ agents; and

(iii) the power provided by the trust deed for trustees to delegate functions.

General law duty of trustees to act personally

1.4 Under the general law, trustees have a duty to act personally and not, in the absence of necessity, to delegate.[1] The general law and the State trustee statutes give trustees power to delegate only in very narrow circumstances, such as where trust property is situated out of the jurisdiction, or where a trustee is or will be absent from the State (Ford and Lee 1996, paras 9620-9640).

Power of trustees to employ agents

1.5 The general law and the State trustee statutes also give trustees the power to appoint agents.[2] The relationship between the duty of trustees not to delegate and the power to appoint agents has never been analysed satisfactorily in private law (Finn 1977, p 20). Indeed, there has been an important difference of opinion amongst commentators and law reform bodies on this issue. Several of the State trustee statutes give trustees the power to employ agents "to transact any business or do any act required to be transacted or done in the execution of the trust or the administration of the [property of the trust]". One view is that, under provisions of this sort:

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[1] *Turner v Corney* (1841) 5 Beav 515 at 517; *Spencer v Topham* (1856) 22 Beav 573; *Ex p Belchier* (1754) Amb 218.

[2] See *Speight v Gaunt* (1883) 22 Ch D 727; (1883) 9 App Cas 1; *Trustee Act* 1925 (NSW), s 53; *Trustee Act* 1958 (Vic), s 28; *Trusts Act* 1973 (Qld), s 54; *Trustees Act* 1962 (WA), s 53; compare the more limited power in *Trustees Act* 1936 (SA), ss 19, 19a; *Trustee Act* 1898 (Tas), s 20.

> "trustees, whenever they wish, can employ and pay an agent to do specified acts as instructed by them, but they cannot authorise the agent to decide for himself [or herself] what acts to do. Thus ... decisions on which investments to buy or sell cannot be delegated to an agent." (Hayton 1990, p 88, referring to the similarly worded section 23 of the *Trustee Act* 1925 (UK))

1.6 A similar "narrow view" has been expressed by:

- the English Law Reform Committee (1982, para 4.16);
- the English Law Commission (1997, para 3.3);
- the UK Pension Law Review Committee (1993, para 4.9);
- the New Zealand Working Party on Trust Investment Powers (1986); and
- several commentators (Butler 1995, pp 134-135, 146; Lee 1987, p 304).

1.7 Austin (1989, p 124) (now Justice Austin of the Equity Division of the Supreme Court of New South Wales) disagrees. He suspects that the narrow view is based

> "either on the notion that if the choice of investments is left to the fund manager, the trustees have gone beyond the employment of an agent and have purported to delegate; or on the notion that it is necessarily a breach of the trustee's duty of care for him [or her] to leave the choice of investments to the agent."

1.8 Austin (1989, p 124) prefers a "broader view":

> "[T]hat there is no delegation unless the trustees have purported to abdicate their responsibility in favour of the delegate and [that] the use of professional managers to choose investments on behalf of the trust is an appropriate and responsible practice provided that the managers are competent and properly supervised."

This broader view has its supporters (e.g. Lehane 1995, pp 42-45; Ontario Law Reform Commission 1984, p 46).

Power to delegate provided in the trust deed

1.9 The difference of opinion was probably not of great practical importance before the introduction of the SIS Act in 1993. Even if the narrow view were correct, it is likely that an appropriately drafted superannuation trust deed could, before 1993, have resolved any problem.

1.10 Although "there is scant authority as to the extent to which the instrument constituting a trust can exempt a trustee from obligations which the law would otherwise impose" (Lehane 1995, p 38), it is probable that under the general law a trust deed can – subject to certain limitations – modify a trustee's duty to act personally.[3] It is strongly arguable

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[3] *Pilkington v IRC* [1964] AC 612 at 639; *Steel v Wellcome Custodian Trustees Ltd* [1988] 1 WLR 167 at 174: "In practice it is inevitable that the day to day investment decisions concerning a [trust] fund of this size [£3,200 million] would have to be delegated to advisers. ... [I]t is inconceivable that [the trustees] could apply their minds to every investment decision which has to be made"; Pension Law Review Committee (1993) para 4.9.25; Lehane (1995) p 39; Hayton (1990) p 88; Meagher and Gummow (1997) para [1723]. In several States, the limited statutory powers to appoint agents and to delegate are made subject to the provisions of the trust instrument: see Ford and Lee (1996) para [12010].

that, before the enactment of the SIS Act, a superannuation trust deed could validly have empowered the trustees to delegate their discretions regarding investment of trust assets, provided that:

- the trustees retained responsibility for the acts of the delegate (investment manager); or
- much less likely, the delegate (investment manager) accepted the responsibilities of a trustee (Austin 1989, p 126).

The position after enactment of the SIS Act

1.11 Whether the appointment of an investment manager with power to choose investments amounts to a delegation of discretion assumed great importance on the introduction of the SIS Act.

1.12 Under section 59 of the SIS Act, a provision of a superannuation trust deed is invalid if it permits a discretion, exercisable by a person other than the trustees, to be exercised without the consent of the trustees.[4] Therefore, if the narrow view is correct, superannuation fund trustees would have to vet each purchase or sale of a fund asset by an investment manager.

1.13 It is clear, however, that the drafters of the SIS Act intended that trustees should be able to leave the choice of investments to a competent investment manager. Under the Act, the trustees must formulate and give effect to an appropriate investment strategy (section 52(2)(f)). But they are authorised to engage persons "to do acts or things" on their behalf (section 52(3)). Significantly, section 102 envisages trustees hiring an investment manager to "control" fund money, "manage" investments, and report *afterwards* on the "making" of, and return on, those investments. The drafters of the SIS Act therefore appear to have adopted Austin's broader view.

1.14 It is arguable that the SIS Act has set up the following regime. The trustees must formulate an investment strategy. In so doing, the trustees are exercising a discretion. An investment manager may be appointed to choose and make investments in accordance with the trustees' investment strategy. However, in choosing particular investments, the investment manager is merely implementing the trustees' strategy and not exercising any delegated discretion.

1.15 But there is always a risk that a court will interpret the appointment of an investment manager to choose and make investments as involving a delegation of functions by the scheme trustees. Indeed, the UK legislature appears to have assumed that an investment manager choosing investments for a pension (superannuation) fund client *is* exercising a delegated discretion. Section 34(2) of the *Pensions Act* 1995 (UK) states:

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[4] There are limited exceptions: see SIS Act, s 59(1). Despite s 59, post-SIS Act superannuation trust deeds commonly contain a clause like the following (taken from an actual deed): "The Trustee may delegate to any one or more persons ... on such terms as the Trustee may think fit any of the authorities powers and discretions conferred upon the Trustee. Without limiting the generality of the foregoing the Trustee may appoint from time to time such one or more persons ... as the Trustee may think fit to act as ... investment manager ... subject to such conditions as the Trustee may from time to time determine and may delegate to and confer upon such an ... investment manager such authorities power or discretions, including the Trustee's power of delegation, as the Trustee may think fit."

> "Any discretion of the trustees of a [pension] trust scheme to make any decision about investments may be delegated by or on behalf of the trustees to a fund manager [authorised under the *Financial Services Act* 1986 (UK)] to be exercised in accordance with [a strategy formulated by the trustees]."

Our submission

1.16 There is a risk that a court will interpret the engagement of an investment manager by superannuation fund trustees as involving a delegation of discretions by the trustees. Any clause in the trust deed permitting the delegation would run the risk of being declared invalid due to section 59 of the SIS Act.

1.17 In substance, the risk is that a court will adopt the "narrow view" described in paragraphs 1.5-1.8 above. The size of this risk should not be underestimated, given:

- the strong support for the narrow view as demonstrated in paragraphs 1.5-1.6 above; and
- the legalistic approach of the current High Court – as evidenced in the *Re Wakim*[5] decision on the constitutional validity of the court cross-vesting scheme under the Corporations Law.

1.18 One of the Select Committee's terms of reference is "the opportunities and constraints for Australia to become a centre for the provision of global financial services". With the aging population in many industrialised countries, investment management is becoming an increasingly significant segment of the financial services industry. A global financial services firm considering basing a major investment management operation in Australia would place considerable weight on regulatory clarity and certainty. The current position in relation to delegation of investment-related functions by superannuation fund trustees is unacceptably uncertain.

1.19 Therefore, we believe the SIS Act should be amended to make it clear that superannuation scheme trustees have the power to appoint an investment manager and delegate investment-related functions to that investment manager. The amendment should also require any exercise of this delegated power by the investment manager to be in accordance with the investment strategy formulated by the trustees under section 52(2)(f). Section 34(2) of the *Pensions Act* 1995 (UK), set out in paragraph 1.15 above, provides a model.

[5] (1999) 163 ALR 270.

2. Should the law require superannuation trustees to vote?

The issue

2.1 Some corporate governance activists are currently arguing that a legal obligation to exercise voting rights should be imposed on superannuation fund trustees, and other institutional investors, holding shares in publicly listed companies. The Companies and Securities Advisory Committee (CASAC) (1999, paras 4.48-4.54) has recently raised the issue for debate in Australia:

> "The question is whether the interests of those who invest in managed investment schemes or [other institutional investment vehicles] need to be protected by requiring scheme managers or institutional shareholders to exercise the rights attached to shares in their portfolios, either by attending general meetings and/or voting their shares."

The current legal position

2.2 In Australia, the most relevant legal obligation of superannuation scheme trustees is their duty *to consider* whether to vote (and, if they decide to vote, to consider *how* to vote).[6]

2.3 It is common practice for superannuation scheme trustees to contract with an investment management firm. It is very common for the investment management contract to contain a clause like this:

> "The Trustee authorises the Manager to exercise any right to vote attached to a share or unit forming part of the Portfolio ... The Manager must use its best endeavours to implement any direction the Trustee gives [as to how votes should be cast] but in the absence of any direction may exercise or not exercise the right to vote as it sees fit, having regard to any [general investment instructions given by the Trustee]." (AIMA 1995, clause 12.1)

2.4 In this situation:

- the duty to consider whether to vote would rest with the investment manager; and
- the trustees would have a duty to monitor and supervise the investment manager's exercise of its discretion in regard to voting (Stapledon 1998, p 350).

Our submission

2.5 We would argue strongly against any legal rule requiring institutional investors to vote.

2.6 We agree that voting by shareholders is *an* important element of corporate governance. However, it is not the only mechanism available to ensure accountability and high-standard performance by directors and senior executives. In the light of this, and of the factors mentioned below, we believe that a compulsory voting rule would likely have greater costs than benefits.

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[6] *McPhail v Doulton* [1971] AC 424 at 449; *Karger v Paul* [1984] VR 161; Stapledon (1998) pp 342-354.

Supporting arguments

Voting only one piece in jigsaw

2.7 Supporters of a compulsory voting rule proceed on the premise that lack of voting equals lack of interest and lack of involvement in corporate governance. But the empirical evidence shows that this is simply not the case. Voting is merely one method by which institutional investors participate in corporate governance (Holland 1998, Stapledon 1996). The recent boardroom changes at AMP, for instance, reportedly involved behind-the-scenes lobbying by institutional investors.

Financial costs

2.8 Voting involves time and resources. The additional costs involved with a compulsory voting rule would initially be borne by investment managers. However, if the regulation applied effectively across the board then these additional costs could be expected to be passed on (directly or indirectly) to clients (for instance, superannuation scheme trustees and ultimately scheme beneficiaries).

Contract

2.9 Currently, voting is a matter of contract between the investment manager and the client. It is perfectly open to the client to include a provision in the investment management agreement obliging the investment manager to vote. (Technically, such a clause would usually oblige the investment manager to give instructions to the custodian – the registered owner of the shares.) Indeed, some UK pension fund trustees already insist on a clause like this being in their investment manager's mandate. Sometimes it is combined with a requirement to vote in accordance with the recommendations of a specialist proxy advisory service – in order to ensure "informed" voting rather than window-dressing.

2.10 Therefore, clients such as superannuation fund trustees can, if they consider it appropriate, already insist that their shares be voted by their investment managers. They don't need a government-imposed regulation.

Competitive industry

2.11 The investment management industry in Australia is highly competitive and client funds are quite mobile. Combine this with the fact that some investment managers (more-so in the US and the UK than Australia, at present) are now openly adopting an "activist" stance on corporate governance, and it is clear that clients have the freedom to move their funds (or a portion of their funds) to a "voting" investment manager if dissatisfied with the stance on corporate governance adopted by their existing investment managers.

2.12 That is, assuming for the sake of argument that there is currently a problem in the area of voting, it is inappropriate to construe this as a problem whose source lies with the investment management industry. If clients of investment managers want them to vote, they will vote or they will eventually lose that business. If clients want investment managers to vote in an informed manner, the clients have available the means to ensure this – the proxy advisory services mentioned in paragraph 2.9 above.

Not all motions are equally important

2.13 Some investment managers take the view that their votes have greater impact if used only on motions that are contentious or of major significance. They avoid voting on the routine AGM matters, believing that boards and CEOs will "stand up and take notice" when their votes *are* used. Unless it can be proved empirically that this is not the case, this appears to be a reasonable argument.

Proportionate influence

2.14 If all institutions are forced by regulation to vote, the proportionate influence of those institutions that currently vote willingly will decrease. Assume an investment manager controls 3% of the votes in a particular listed company. At general meetings, on average only 30% of the company's shares are voted. When the investment manager votes its 3% stake, it is actually casting 10% of total votes cast.

2.15 The introduction of compulsory voting for institutional shareholders sees an increase in the total votes cast: now 90% of the company's shares are voted. The investment manager's 3% stake now translates to just 3.33% of total votes cast. Many of the extra votes cast as a result of the regulatory requirement to vote involve "box ticking" by investment managers not convinced of the value of voting. The votes of the active investment manager have therefore lost a large amount of their proportionate influence.

Implications of US evidence

2.16 In the United States, private-sector pension plans are required (by regulations made under the Employee Retirement Income Security Act (ERISA)) to ensure that their shareholdings are voted. There is evidence, however, that "window dressing" or merely going through the motions is common among some investment managers (Coffee 1991, p 1353). This reflects several things, not least of which is that a regulation of this kind is incredibly difficult to enforce (Conard 1988, pp 151-152).

2.17 Indeed, even if the regulator charged with enforcing a compulsory voting rule were to be reasonably well resourced for that role (a generous assumption), its method of monitoring compliance could be expected to focus on *process* rather than *substance*. If the regulator did look for evidence of *informed* voting, what evidence could it realistically gather? Presumably interviewing investment managers would not produce the most reliable evidence – actions are more reliable than words in this area. Actions can of course be documented. This in turn would likely see investment managers producing lots of paper "proving" how dedicated they had been in performing their voting task. Producing this paper trail would be expensive, but would it produce much benefit?

Conclusion

2.18 Voting by institutional and other shareholders is an important corporate governance mechanism. However, it is but one of many mechanisms that serve to minimise any divergence between the interests of senior company executives and the interests of shareholders.

2.19 The benefits of imposing a compulsory voting rule on institutional investors like superannuation trustees and their investment managers would very likely be outweighed by the costs of such a regulation.

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