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Senate Standing Committees on Economics
PO Box 6100
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Canberra ACT 2600

Delivery by email to economics.sen@aph.gov.au

Dear Senators

Thank you for the opportunity to provide a submission on :

> *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017* ('Independence Bill'); and
>
> *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017* ('Member Outcomes Bill').

Preliminary

By way of introduction, I am Deputy Director of the Centre for Law, Markets and Regulation at UNSW Law. I research in the areas of trust law, superannuation, managed investments and the regulation of financial markets. I am also retained on a part-time basis as an External Consultant by Herbert Smith Freehills. The views expressed in this submission are informed by my research but they are my own and ought not be taken to reflect the views of either UNSW nor Herbert Smith Freehills, nor any of their clients, employees or associates. I make this submission in my personal capacity and not on anyone's behalf or at anyone's instruction. I would also like to acknowledge the valuable contribution to this submission made by Ms Kylie Zih; noting again that all the views expressed are mine.

Submission

The superannuation system has been subject to near-continuous regulatory change for over two decades. Most of those changes have followed concerted, focussed assessment of emergent problems or risks to the system. Although adjustment to the various changes has often been expensive, the system has usually emerged as stronger and more efficient as a result.

I believe there is a very real risk that the haste with which the current programme of legislative reform is being advanced will result in the enactment of legislation that is, in places, unworkable and ill-designed.

I am therefore making a submission addressing five issues arising from the current drafting of the Bills listed above. They are:

1. The definition in the Independence Bill of '**independence**';
2. The ambit in Schedule 5 of the Member Outcomes Bill of **APRA's directions power**;
3. The extension in Schedule 7 of the Member Outcomes Bill of APRA's Reporting Standard to permit **tracing of monies** paid by a trustee directly from a superannuation fund into the hands of third parties;
4. The requirement in Schedule 6 of the Member Outcomes Bill that funds hold an **Annual Members' Meeting**; and
5. The requirement in Schedule 1 of the Member Outcomes Bill that the trustees offering a MySuper product publicise their **annual MySuper Outcomes Assessment** within 28 days.

I deal with each of these in turn below.

1. The definition of independence

The Independence Bill reflects a belief that trustee decision-making will be enhanced by a requirement that the Chair of a trustee board and at least one-third of its members satisfy a statutory definition of independence. That belief is a contentious one. Research I conducted with Associate Professor Suzanne Le Mire in 2015 found little empirical evidence that structural independence measures such as those envisaged in the Independence Bill are associated with higher investment returns or lower risk, the usual metrics of performance in the superannuation and pensions domain globally.[1] That research did however recognise the potential for independent directors to act as a governance discipline on related party transactions[2] and merger and fund closure decisions, and also the potential for the presence of independent directors to inspire member confidence in the integrity and legitimacy of the system.[3]

I believe that the Independence Bill is likely to fail to achieve even these objectives. There are two main reasons for this:

i. **The definition of independence in the Independence Bill is deficient.** Few if any of the funds Associate Professor Le Mire and I interviewed in 2015 would need to adjust their board membership to comply with the rule that one third of their members satisfy the definition anticipated in the Independence Bill. Nominees of the entities entitled to

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1 M Scott Donald and Suzanne Le Mire, 'Independence and the governance of Australian superannuation funds' (2016) 31 *Australian Journal of Corporate Law* 80.

2 The 'de-entrenchment' rules introduced into the *SIS Act* by the Stronger Super reforms of 2011 are designed to reduce the severity of this problem by ensuring that such appointments are exposed to regulation by the conflicts of interest and duties rules. See further M Scott Donald , 'Regulating for Fiduciary Qualities of Conduct' (2013) 7 *Journal of Equity* 142, 156.

3 M Scott Donald and Suzanne Le Mire, Independence in Practice: Superannuation Fund Governance through the Eyes of Fund Directors' *CLMR Working Paper 16-3*, (April 2016).

nominate board members are seldom an employee or officer of the nominating entity, and so would most often satisfy the definition of independent in the Bill. Thus individuals who have been nominated by a union or employer group will in most cases be eligible to be identified as independent under the current definition. There is nothing to suggest that the sample of funds we interviewed (which included a diverse range of large and small industry, retail, public sector and corporate funds) is unrepresentative of the broader population of funds. Ironically then, given the apparent policy impetus behind this measure, the main group adversely affected by this measure will therefore be a handful of corporate funds (who typically appoint senior corporate executives) and retail funds (whose independent directors often serve on multiple group boards).[4]

In a submission to Treasury in relation to the earlier iteration of the Independence Bill, Associate Professor Le Mire and I suggested that the definition of independent should expressly exclude individuals who are or have been in the past three years 'a nominee of an entity or person, other than the RSE licensee, entitled to nominate persons to the Board of the RSE licensee' and individuals 'directly associated' such nominees (or other board members).[5] Such an exclusion is not a suggestion that such people ought not to be appointed to a board, nor that they are in any way excused from exercising an independent judgment in determining the best interests of members. It simply provides that such people should not be counted as 'independent' for the purposes of complying with the provisions anticipated in the Independence Bill. I continue to believe that such an exclusion is essential if the requirement for structural independence is to have integrity.

ii. **The Independence Bill fails to address how board members are appointed.**
Although the Independence Bill abolishes Part 9 of the *SIS Act* (which requires standard employer-sponsored funds to maintain an equal representation' model of board composition), the board nomination rules and processes currently in place to give effect to that model are not thereby amended. Those rules and processes are embedded in the trust deeds and trustee constitutions of each fund. The equal representation model will therefore remain intact in each fund until such time as those rules are amended, fund by fund. Moreover, it is worth recognising that at that time the shareholders of the trustee, in whom the power to make such amendments most often resides, could potentially eliminate the counter-balancing faction altogether, so that the 1/3 – 1/3 – 1/3 model apparently intended by the government would become 100% populated by the faction favoured by the shareholder (the financial institution in the case of a retail fund, employer in the case of a corporate fund and union in the case of an industry fund). Even if the definition of independence was tightened (see above), the members of the dominant faction could simply appoint sympathetic individuals to fill those 'independent' positions. So the balancing of powers implicit in both the 1/3 – 1/3 – 1/3

4 I note that the Financial Services Council's rules deem such individuals as independent but they would not be independent for the purposes of this Bill.

5 M Scott Donald and Suzanne Le Mire, submission to the Treasury on *Superannuation Legislation Amendment (Governance) Bill 2015* (23 July 2015).

model and the equal representation model would be completely lost. That would surely be an unintended and undesirable consequence of this initiative.

There is another, equally dystopic, outcome if the constitutional realities of the fund mean that a dominant faction cannot amend the funds rules in this way. In that situation, the prevailing industry view is that the independent directors will simply be appointed by the existing board members. In that eventuality it seems reasonable to expect that the current schism that supposedly exists between the two tribes on an equal representation board will simply be replicated by the new appointments. The employee representatives will appoint 'their' independent director(s), and the employer representatives will do the same. Nothing will have been achieved in substance. However the lack of actual independence of the new directors will be shielded by their designation as 'independent' directors. Again that that would surely be an unintended and undesirable consequence of this initiative.

2. *APRA directions power*

APRA has played and will continue to play a key role in disciplining the financial sector. Its prudential approach to supervision and regulation is specifically designed to ensure that financial firms are in a position to make good on their promises to customers. The power to make appropriate directions is a key part of that. I do however have three concerns about the directions power contained in the Member Outcomes Bill:

i. **The extent of the power granted to APRA under section 131D is too extensive**. Section 131D(1) is satisfied when APRA 'has reason to believe' that one of the criteria in (a) through (j) has been satisfied. This criterion would be satisfied by the presence of a single, perhaps not even compelling, reason. It would be better if APRA was empowered to act when it 'reasonably believes' one of the criteria has been satisfied. This form of words contains both an objective element (was the belief reasonable?) and a subjective element (APRA did actually believe it?). In addition, a number of the criteria in (a) through (j) are diluted by phrasing such as the RSE being 'likely to' contravene, or that there 'might be' a material risk or material deterioration. The result is that there is no effective boundary to this jurisdiction: APRA will be able to exercise this power in almost any circumstance it sees fit. More problematically, the express statutory basis for the jurisdiction will mean that APRA's exercise of this power will in a great many circumstances be difficult to challenge before the AAT and the courts.

ii. **The range of directions that APRA can make is too wide.** In particular, paragraph (n) which empowers APRA to make a direction 'to do, or refrain from doing, anything else in relation to the affairs of the Trustee or the Fund' is self-evidently without bound, but the extent of the powers denominated (j) through (m) are also very invasive of the trustee's right to manage its business affairs. Even more problematically, the power in (l) to prohibit the RSE licensee from discharging a liability incurred on behalf of the fund (whether properly incurred or not) will almost certainly discourage counterparties, including those in investment markets, from entering contracts with RSE licensees without some form of protection of their interests.

Further, it is conceivable that this power would enable APRA to collect forcibly information for use in its enforcement activities that would ordinarily not even be available under the rules of discovery in curial proceedings. Such powers may be justifiable in the context of a crisis or emergency situation (and perhaps not even then), but as we have seen above, this power is not so circumscribed by the Bill.

iii. There appears to be **no requirement that APRA's response to a situation be directed towards or be proportionate to the risks or potential costs of the situation**. Relevance and proportionality are important qualities of any regulatory scheme. Limiting the directions power to crisis situations would partly address this concern, but such circumscription would reduce the capacity of APRA to employ a proportionate response to less severe situations, and so some express requirement that the direction be crafted and calibrated to address the specific risk or harm would be preferable.

These concerns ought not to be taken as criticism of APRA's past conduct nor of its personnel. However the powers contemplated in the Member Outcomes Bill will be available to APRA and its officers decades hence, when economic and political pressures may be very different. The very low likelihood that current personnel operating in the current economic and political milieu would abuse such far-reaching powers should not obscure the fact that the extent of the directions power contained in the Member Outcomes Bill is far greater than is required and could, if taken to an extreme, encroach upon the rule of law itself.

3. *Tracing payments made by a superannuation fund trustee out of the fund*

The Member Outcomes Bill will amend the *Financial Sector (Collection of Data) Act 2001* to empower APRA to determine a reporting standard requiring an RSE licensee to

> 'provide information in relation to any money, consideration or other benefit given to another entity by the RSE licensee out of the assets of a registrable superannuation entity of the RSE licensee, including information about the …(a) details of the entity to which the money, consideration or other benefit is given; (b) the purpose for which the money, consideration or other benefit is given; (c) the way in which the money, consideration or other benefit is used by the entity to which it is given, and any entity with which that entity deals.'

No explanation for why APRA requires this power, nor why it should be part of a Reporting Standard (rather than simply an application of the directions power discussed above) is provided by the Explanatory Memorandum. It is difficult therefore to assess the need for such a power without engaging in speculation. What can be said confidently is that the power will almost certainly fail to be useful to APRA in its current form. Remunerated trustees minded to make payments beyond APRA's view under this power will simply make the payments out of their own resources, not out of the fund. Where disclosure is required, APRA will have no power to compel third parties to disclose in detail the use to which the monies they receive are put and so can expect to receive superficial responses that have little or no explanatory value. It is also noteworthy that the drafting of the Member Outcomes Bill currently does not give APRA the power to require the RSE licensee to disclose the amount of the payment, at least not expressly.

4. *Annual Members' Meetings*

The Member Outcomes Bill requires that the trustees of all superannuation funds with more than 5 members hold Annual Meetings of members (AMMs). The AMMs are intended to ensure 'greater accountability and transparency' by providing members with 'a forum to ask questions about all areas of the fund's performance and operations.'

At some level the idea has merit. Giving members the opportunity to engage interactively with their superannuation fund may engender confidence and enhance the legitimacy of the system. Even if members don't attend, or don't ask questions themselves, the mere opportunity may inspire confidence.

Considerable weight is placed in some quarters on the desirability of member engagement with their superannuation fund providers. It is possible, and common, for this enthusiasm to be misdirected. It is crucial that individuals can ascertain the state of their superannuation accounts efficiently. They should be able to have such enquiries as they may have about the administration of the fund or funds to which they have contributed answered accurately and quickly. Generic disclosure documents, however voluminous, cannot ever fully satisfy all the questions which a fund member may have. However there are existing mechanisms for these types of enquiry. Section 1017C of the *Corporations Act*, in concert with Section 101 of the *SIS Act*, gives members a right to have their questions answered. Whether such mechanisms are effective in practice is empirically untested and reliable research into this question would seem to be a priority.

However, close attention to the content of the proposal suggests that it may in fact be aimed in a slightly different direction. In many respects the key provisions in the Member Outcomes Bill emulates provisions found in the *Corporations Act* in respect of the Annual General Meetings ('AGM') held by corporations. As such it appears to be aimed at instituting a more developed form of participative democracy in the institution we know as a superannuation fund. That objective was expressed early in the policy development of compulsory superannuation[6] and, arguably, found its way into the ultimate design of the compulsory system in a diluted form in the requirement for equal representation on the boards of all standard employer-sponsored funds.

That objective will not be satisfied by an AMM configured in the way anticipated in the Member Outcomes Bill. The AGM plays an important role in the corporate context specifically because it is a deliberative forum; it makes decisions on key governance matters such as the appointment of directors and the auditor, adoption of financial accounts and, in listed companies, the approval of executive remuneration. The superannuation fund AMM, as invoked in the Member Outcomes Bill, has no such decision–making role. It could play such a role. As noted above, in a

6 Diana Olsberg, Ageing and Money, Australia's Retirement Revolution (Allen & Unwin, 1997); Bernard Mees and Cathy Brigden, Workers'Capital. Industry funds and the fight for universal superannuation in Australia (Allen & Unwin, 2017), 126.

submission to Treasury on the subject of independence on superannuation fund boards, Dr Suzanne Le Mire and I argued that having 'independent' directors elected by the members would enhance markedly the effectiveness of the Government's initiative to require all APRA-regulated superannuation funds to have a minimum percentage of directors satisfy a statutory definition of independence from relevant external affiliations.[7] The AMM could play a valuable role in this election process. Of course, the elevation of the AMM to such a role would require additional provisions, such as those provided by the *Corporations Act* and the general law in the contexts of AGMs, to buttress and protect the process from abuse.

In addition there appear to be a variety of practical issues not addressed by the Member Outcomes Bill. For instance:

i. Responsible officers of the fund are required to attend the meeting and to answer any and all questions put to them (other than those to which section 29PB(3) applies). It is unclear what attendance means in the context of an electronic meeting, and it is far from obvious that it would be appropriate for the obligation to answer the meeting to lie with the responsible officer. It would seem more sensible that the obligation lie with the trustee (which may of course draw on the knowledge of one or more of its officers to answer any given question).

ii. Moreover, section 29PB(2) would seem to suggest that the responsible officer must answer all questions (unless one of the exceptions listed in section 29PB(3) applies specifically to it). As those experienced in wrangling corporate AGMs know well, management of the questioning process is crucial if the exercise is to have any value.[8] Whether that involves questions being collected in advance, or somehow mediated through the Chair or some other body, ought to be a decision taken by the trustee in question, bearing in mind that the trustee (and directors of the trustee thanks to the covenants in section 52A of the *SIS Act*) is under an obligation to exercise its powers in the best interests of members. Any trustee who cherry-picks the questions so as to avoid difficult issues or unfavourable impressions would breach that covenant.

iii. The requirement to hold an AMM will apply to superannuation funds of a wide variety of fund types. However the requirement to hold an AMM appears to rely implicitly on a simple model of a trustee administering a fund on behalf of a set of beneficiaries with homogeneous rights. Variations from that paradigm are the norm. It is unclear how a

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7 M Scott Donald and Suzanne Le Mire, submission to the Treasury on *Superannuation Legislation Amendment (Governance) Bill 2015* (23 July 2015).

8 See for instance Governance Institute, *Good Governance Guide: Policy to promote effective communication at general meetings (including question time at the AGM)*, available at https://www.governanceinstitute.com.au/knowledge-resources/guidance-tools/good-governance-guides/?category=Rights+of+shareholders. Also AICD, 'AGMs', *Company Director* (September 2007); available at http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/september/agms; ASX, 'Ideas for better AGMs' *Investor Update* (July 2014) available at http://www.asx.com.au/education/investor-update-newsletter/201407-ideas-for-better-agms.htm

trustee responsible for a fund with multiple divisions (as in many corporate funds), or including one or more defined benefit plans (as in many corporate and public sector funds, but increasingly also industry, retail and master funds), or multiple sub-funds (as in a master trust) or a menu of investment or insurance options (as in some retail funds) could hold an AMM that was simultaneously relevant (and perhaps more importantly not confusing or misleading) for members across these various classes of members.

iv. Regard may need to be had for the possibility that the meeting occurs over an extended period. Few employers are likely to permit members to 'attend' an AMMs during business hours, even if the AMM was virtual and connection was technically possible. On the other hand, shift-workers and those working outside normal business hours, such as many in the retail and hospitality industries, may find evening time-slots impossible. The compulsory nature of superannuation differentiates this situation from that of a corporate AGM, in which shareholders are both not compelled to be members of the company and can appoint proxies to act on their behalf.

v. It is unclear why the Government wishes to specify the practicalities of the AMM in such detail in statutory form. Although basic duties, including the duty to hold the meeting, certainly belong there, the *SIS Regulations* or *Operating Standards* would appear to be a better location for the detailed rules than the *SIS Act* itself. (They would also appear to be superior to having the rules appear in an APRA Prudential Standard given the substance of the requirement is most certainly not a 'prudential matter', upon which APRA's power to determine such Standards depends). This exacerbates the problem, noted above, that there are a wide variety of superannuation funds which would be subject to the requirement to hold an AMM because it is quite likely that the AMMs of different funds will need to be designed to accommodate their unique structures and circumstances. By legislating at this level of detail, parliament limits the ability of trustees to craft and deliver a forum optimally suited to the needs of their members.

5. Annual MySuper outcomes assessment

In Schedule 1 of the Member Outcomes Bill, the Government is proposing, in substance, to elaborate on the annual 'scale' test already required of the trustees of MySuper products. Anecdotal reports suggest that some in the industry are concerned that the amendments to section 29VN of the *SIS Act* intensify the obligation inappropriately. There is merit in the suggestions that the requirement in section 29VN(3) for trustees to compare the tax position of their fund against competitors is infeasible in practice and should be removed (taxes not being disclosed publicly at a level of detail that would enable such a comparison) and that the timeframe for the return comparisons in section 29VN(3) should be expressly specified. Both of these shortcomings of the current Bill deserve attention.

However, as I have written previously, I believe the main mischief in section 29VN lies elsewhere.[9] As I noted at that time:

> 'There may however be particular care required where the trustee comes to the conclusion that the MySuper product lacks critical mass. Public communication of the strategy that the trustee intends to employ (for instance to seek a merger or to re-negotiate the terms of some service provider contracts) could seriously compromise the interests of members. It may also attract adverse press and public comment, which itself may compromise the interests of members.'[10]

That is to say, the last thing that the trustee of a MySuper product ought to do when it becomes concerned about its lack of scale is publicise the fact and risk inspiring a run on the product. At best that would render the forecast a *fait accompli.* More likely, it will see the better-informed or fleeter-of-foot redeem their interests, leaving behind those who are disengaged or unable to understand the implications of the declaration to incur the costs of winding up the more illiquid parts of the investment portfolio. This however may prove to be a hypothetical threat only. Under the current law, no trustee, exercising its powers and performing its duties in the best interests of members (as required by the covenant in section 52(2)(c) of the *SIS Act*), could ever make such a disclosure. A prudent trustee would prefer the possibility of future peer-relative uncompetitiveness to near-certain and imminent prejudice of members' interests every time.

It would seem therefore to be far preferable that the declaration be made to APRA privately. That would give the trustee and APRA an opportunity to decide an appropriate response, which may well take time to implement. It cannot be in the best interests of members (especially those in MySuper products) to be exposed to the risk of a run on the product. The requirement that the assessment be published within 28 days is therefore highly likely to harm those most vulnerable, for whom the MySuper regime was in large part designed to protect.

Concluding Comments

It is hard to find fault with the Explanatory Memorandum of the Member Outcomes Bill when it says:

> Having a modern, vibrant superannuation system, which is solely focused on delivering outcomes for members, culminating in the efficient delivery of income in retirement, is critical… A modern superannuation system empowers members; provides for transparency and accountability around funds' activities and performance; enables regulators to hold trustees to high standards and take appropriate action where they fall short; and ensures members get their full entitlements.[11]

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9 M Scott Donald, 'When Size Matters' *Australian Superannuation Law Bulletin*, (Sept 2012), 41.

10 Ibid, 42.

11 Explanatory Memorandum, *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Bill 2017,* [1.8]-[1.9].

Whether the amendments to the *SIS Act* and related legislation contemplated in these Bills will bring about those ends in their current form is arguable. I believe that the Annual MySuper declaration and Annual Members' Meeting, in particular, require more careful design and that the definition of independence needs to be reconsidered. Further, although I believe it is important to empower the regulator to prosecute its objectives, in my opinion the Member Outcomes Bill extends too far; threatening the rule of law on which Australia's regulatory environment relies.

Finally, I am aware that other submissions to both this consultation and the earlier consultation undertaken by Treasury have identified serious shortcomings in the drafting of the Member Outcomes Bill. It is important that those concerns be taken seriously: infelicitous drafting has the potential to cause much dysfunction in the regulatory scheme and the industry it seeks to regulate.

Please do not hesitate to contact me if you have any questions or require any further information or elaboration.

Yours sincerely

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