THE UNIVERSITY OF ADELAIDE AUSTRALIA

UNSW AUSTRALIA | CLMR Centre for Law, Markets and Regulation

23 July 2015

Manager
Insurance and Superannuation Unit
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Thank you for the opportunity to provide a submission to Treasury on

> *Superannuation Legislation Amendment (Governance) Bill 2015: Governance arrangements for APRA regulated superannuation funds*
>
> *Superannuation Legislation Amendment (Governance) Regulation 2015: Governance arrangements for APRA regulated superannuation funds*

We welcome the proposed reform's focus on the independence of superannuation fund boards. In our view such an initiative, if carefully crafted, could enhance the integrity and quality of decision-making and provide a firm foundation for public confidence in the superannuation system.

Whilst endorsing the general aims underlying the Bill and Regulation, we are concerned that, as it is currently configured, the exposure drafts are unlikely to achieve their stated aims.

Statements of principle in relation to independence in superannuation

Personal autonomy, and the independence of judgment that it permits, is a quality that is valued in many domains, from public domains such as politics and the judiciary to such private domains as medicine and financial advice. It is a hallmark of professionalism and crucial to situations in which individuals have formal or informal power to make decisions that affect the well-being of others.

Research in the corporate governance space suggests that 'cognitive' independence, the capacity and willingness to exercise an independent judgment, is crucial and should be distinguished from what has come to be called 'structural' independence. It is comparatively easy to regulate to achieve structural independence. It is far harder to regulate to achieve genuine cognitive independence. A number of the equitable duties on fiduciaries, including company directors

and trustees, aim to promote cognitive independence. So do their statutory analogues. The proliferation of reforms (including the current Draft Bill) suggests that policy makers around the world are unconvinced that those proscriptions and duties are achieving their aim.

The superannuation system is crucial to Australia's future well-being. It is increasingly integral to our social fabric and to our financial markets and public sector finances. Decision-making in the system is de-centralised. Many individuals make choices on their own behalf in respect of the fund to which they contribute, or the investment option within the fund into which their contributions are made. Others choose to establish and administer their own self-managed superannuation funds. There is however a set of entities which undertake tasks on behalf of the individuals enrolled in the system. The quality of the decision-making by these entities is clearly crucial to the integrity and efficiency of the system. Common sense would suggest that we would want the individuals working within those entities to be skilful, careful, diligent, impartial and free from any taint of a conflicting interest or duty. Part 6 of the *Superannuation Industry (Supervision) Act* specifically aims to ensure that the entities and the individuals within them demonstrate those qualities. It does so, however, recognising a broader policy position, namely that participants in the system should be free to organise themselves, to develop products and interact with current and prospective customers however they see fit, subject to those minimum standards. This is crucial for innovation and for the democratic legitimacy of the system. The result is a system that is highly dynamic and in which there is great differentiation of roles and operating structures across entities.

Specific observations and recommendations

The statements of principle inspire several points that we believe the government should consider in relation to the *Bill* and *Regulation*:

- Superannuation trustees are sufficiently different from other corporate entities to require bespoke regulation. Regulatory initiatives should be tailored to the unique circumstances of the superannuation industry. The definitions of independence in the *Superannuation Legislation Amendment (Governance) Bill* appear to be transposed from the listed company sector, rather than adapted to the unique circumstances of the superannuation industry. We believe that they miss the mark and have the potential to place pressure on APRA to create more relevant and detailed definitions of independence in order to gain traction in the superannuation context. This outcome is problematic from the perspective of certainty and proper process.

- It is important that regulatory objectives are pursued using the legislative and other instruments that are most fit-for-purpose. Statutes are ideally suited for long-standing rules of general application and Regulations pursuant to that legislation are suited for more detailed elaboration of statutory provisions. Prudential Standards are suited to a more specific purpose that can have regard for context and the interplay of different rules and regulatory priorities. Section 34C of the *SIS Act* grants APRA power to determine Prudential Standards specifically in respect of prudential matters. The Wallis Committee described prudential matters as being those affecting the capacity of an entity to meet its financial promises. We believe it is undesirable, for reasons of regulatory overreach, for APRA's power to issue prudential standards to be employed on tasks more properly the province of Statute or Regulation. It may also be

constitutionally questionable given the constrained basis on which the power is granted. We believe the current delegation of authority to APRA to define independence (as opposed to supervising the processes by which fund boards comply with the requirement) potentially breaches this principle.

- Turning to the definition itself, there are a variety of ways in which individuals are currently appointed to superannuation fund boards. We do not believe the draft Bill as it stands will change the existing demography of the board for most funds. A more tailored definition would nominate specifically the following types of relationship:
    - Being or having been in the past three years an employee or director of a body corporate that provides services under contract to the RSE licensee
    - Being or having been in the past three years an employee or director of an entity from the same corporate group
    - Being or having been in the past three years an employee or director of a standard employer sponsor
    - Being or having 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
    - Being a substantial shareholder of the RSE licensee
    - Being directly associated with any of the above
    - Any person determined by APRA not to be independent from the RSE licensee.

  We note that some industry participants have adopted a similar view.

- Research around the world confirms that structural independence is no panacea for failures in governance. As we have written elsewhere,[1] for independence to flourish further initiatives will be needed. Creating an environment on a board in which cognitive independence flourishes is ultimately a cultural question. But that does not mean that the regulatory regime cannot and should not intervene to encourage the creation of that environment and to protect against its erosion even beyond the imposition of a minimum number of 'independent' directors. It seems to us that the delegation to APRA of power to ensure that fund boards have carefully crafted policies and procedures in respect of board appointment, tenure, remuneration and disclosure is desirable. Such measures should be designed to encourage and protect cognitive independence on boards. They should complement other measures already in place, such as conflicts policies and registers.

- It also seems to us that the requirement for the Chair to be one of the independent directors has merit given the distinctive responsibility of the Chair in Australian law for the efficient and effective running of Board processes.

- We note that there is currently uncertainty in the industry about how the appointment of independent directors to a superannuation fund is to occur. The members of super fund boards have typically not been appointed by stakeholder ballot and the

---

[1] Scott Donald and Suzanne Le Mire, 'Is Independence Enough?' available at http://www.clmr.unsw.edu.au/article/prudential-regulation/superannuation/superannuation-governance%3A--is-independence-enough%3F

infrastructure for facilitating such a ballot, such as Annual General Meetings, is not common. One solution would be for APRA to require the creation of a Board Nominations Committee, or more generally a Governance Committee, to oversee that process. The Chair of that Committee should also be an independent director, ideally not the Chair of the Board itself.

- We note further in passing that some industry comment, at least, seems to view an inability to claim independent status as being somehow pejorative. This may reflect a belief, valid in our view, that many of the individuals acting as directors on superannuation fund boards are cognitively independent even if the circumstances of their appointment to the board do not enable them to satisfy the definition of 'independent'. The perception that not satisfying the definition of independent for the purposes of this part of the regulatory regime somehow diminishes the individuals so designated is unfortunate, but it is important to bear in mind that other parts of the regulatory regime are designed to ensure that all directors act free from the distraction of any interest or duty other than the best interests of members, that is, that they are cognitively independent. It should also not distract the government into making exceptions to accommodate current governance structures.

- Finally, should a definition of independence that requires significant board changes be adopted, we note that the transition process for some boards will potentially be quite complicated. Nomination processes complying with the current equal representation rules will not necessarily be eliminated by the removal of Part 9 of the *SIS Act*. They may require amendment of various legal arrangements, including trust deeds and trustee constitutions. There are also possible practical issues. Our preliminary empirical analysis suggests that of those existing funds that would need to change, the median number of board members is 8. If these boards were simply to add members to satisfy the independence requirement, that number would grow to 12. (We note that a small number of funds (~18) with representative boards already have an independent Chair and so would require one less additional independent appointment). Governance research suggests that although larger boards may be effective at providing constituency representation, they are typically less effective at decision-making than smaller boards. This implies that it may be desirable from an efficiency perspective for some current nominators to relinquish the powers of nomination they currently hold. The circumstances of each fund will determine how feasible such a change might be but it seems unlikely that imposing a reduction universally will be effective.

These views are derived from our experience as practitioners and researchers in the superannuation and corporate governance fields over several decades. Details of our qualifications, experience and previous research can be found at www.law.unsw.edu.au/profile/scott-donald and www.adelaide.edu.au/directory/suzanne.lemire. Funding for research into the topic 'Independence and the Governance of Superannuation Funds' has been generously provided by the Centre for International Finance and Regulation (Project Number F008) which is a Centre of Excellence for research and education in the financial sector, funded by the Commonwealth and NSW Governments and supported by consortium members (see www.cifr.edu.au). The views

expressed in this submission are those of the authors and are not necessarily those of UNSW, University of Adelaide, CIFR or any of its consortium members.

We trust that these comments capture and convey the substance of our concerns in relation to the *Superannuation Legislation Amendment (Governance) Bill* and its attendant *Regulation.* Please do not hesitate to contact us on so.donald@unsw.edu.au or suzanne.lemire@adelaide.edu.au if you have any questions or require any further information.

Yours sincerely

Dr Scott Donald
Director - Centre for Law, Markets and Regulation
UNSW Law

Dr Suzanne Le Mire
Senior Lecturer
University of Adelaide