13 July 2018

Ms Karen Chester and Ms Angela MacRae
Deputy Chair and Commissioner
Productivity Commission

Dear Ms Chester and Ms MacRae

Thank you for the opportunity to provide a submission to Phase 3 of the Productivity Commission's enquiry into efficiency and competition in Australia's superannuation industry:

> *Superannuation: Assessing Efficiency and Competitiveness*.

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.

Prior to entering academia in 2010, I worked for ipac (1986-1994) and Frank Russell Company (now Russell Investment Group) (1994-2009, including five years as Director of Research and four as Director of Product Development). Much of that time was spent actively involved in advising superannuation funds and their stakeholders on governance matters and in investment manager research and selection.

The views expressed in this submission are informed by my experience and research but they are my own and ought not be taken to reflect the views of UNSW or 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.

Submission

I gave testimony at the Public Hearing held by the Commission in Sydney on Wednesday 20 June 2018 in respect of:

1. **The potential role of independent directors** in the superannuation system. I noted then, and reiterate here, that:
    a. That although cognitive independence on the part of directors of superannuation fund trustees is crucial, there is no reliable empirical evidence that structural independence measures of the type envisaged in the *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017* ('Bill') will deliver superior investment performance. That conclusion is documented in M Scott Donald and Suzanne LeMire, 'Independence and the governance of Australian superannuation funds' (2016) 31 *Australian Journal of Corporate Law* 80.

b. That the listing of circumstances in which a director would not be deemed independent in the current drafting of the Bill is deficient (being both under and over-inclusive in certain respects) and that the Bill would also need to address buttressing issues such as appointment, tenure and remuneration if it was to have a positive effect in practice.

2. **The roles of APRA and ASIC**. I noted then, and reiterate here, that:
   a. Standard prudential regulation (which is designed to promote the satisfaction of financial promises) is a poor fit in a DC-dominated superannuation system. The most obvious symptom of this are attempts by APRA to identify the 'promise' in superannuation which, unlike banking and insurance products based on a contractual promise, is subject to a trust undertaking. It is obviously desirable that superannuation funds and their trustees have processes and resources in place to limit operational and payment risks. It is also desirable that regulators look to the robustness of DB promises. Beyond that, it is hard to see how prudential regulation, specifically, can get traction in a DC environment. The current focus on member outcomes is not prudential regulation unless one dilutes the notion of 'prudential regulation' to the point where it ceases to have any real meaning. If requiring trustees to strive for better returns, lower costs and greater accountability is desirable (and I think it is hard to argue against that), it would be better to have a regulatory approach tailored specifically to that set of objectives, rather than an approach originally designed to limit the impact on customers of insolvencies in the insurance and banking sectors. Whether APRA, with its processes, systems and culture oriented towards prudential regulation, as conventionally understood, is the optimal site of such responsibility is moot.
   b. The Royal Commission into the Banking, Superannuation and Financial Services industry has confirmed that both APRA and ASIC have been ineffective at enforcing the existing laws. However, both APRA and ADIC have in recent times received (and in some cases are in the process of receiving) enhanced powers and resources designed to remedy this shortcoming. This development is, in my opinion, far better than simply imposing more rules on regulated entities, as has been too often the case in the past decade. I would however point to the Statements of Expectation of the current government (available at https://treasury.gov.au/the-department/accountability-reporting/statements-of-expectations/) , which emphasise to both regulators the need for efficient, light touch regulation. I believe that the Productivity Commission ought to recommend to the government that it adjust its Statements of Expectation in relation to APRA and ASIC to emphasise more prominently the need for more decisive and effective prosecution of wrong-doing in the sector. This would align more closely the formal instructions to these regulators with public statements of both the Treasurer and the Minister for Revenue and Financial Services demanding more decisive action by ASIC and APRA.

3. **The value of transparency** to discipline the sector. I noted then, and reiterate here, that accurate, timely and relevant data assists stakeholders, including members, potential members, regulators and commentators to make informed choices, to analyse issues and to regulate more precisely and confidently. Further, the knowledge that stakeholders will have access to that information disciplines market participants for, as Brandeis noted over 100 years ago, 'Sunshine is said to be the best of disinfectants, electric light the most efficient policeman '. Transparency, then promotes both efficiency and accountability within institutions and across the system.

There are three other issues I would like to take this opportunity to present for the Commission's consideration.

1. **Conflicts of Duty in the Superannuation system.** In the course of my testimony in Sydney the issue of conflicts of interest in the superannuation system was raised. I would like to take this opportunity to amplify and explain my comments. There is no doubt that conflicts of interest and conflicts of duty are pervasive in the financial services industry, as they are in many contexts. The law historically has had a clear line on such conflicts: they have to be avoided by all fiduciaries unless specifically excused by the fully informed consent of a legally-competent principal. There is an accumulation of empirical evidence that many conflicts in the financial sector are not addressed in accordance with this time-tested rule. I believe one reason for this is that regulators in Australia and elsewhere have employed a less exacting standard, requiring merely that fiduciaries (such as trustees and directors) 'manage' the conflicts. That not only dilutes the proscription, it exposes the rule to precisely the risk that the exacting standard of the law was crafted to address: the inability of any individual to exercise an independent, undistracted judgment in the interests of his or her principal when aware of a conflicting interest or duty. That awareness necessarily impinges upon, and distorts, the judgment (including where the fiduciary tries to err on the side of the principal). Hence the law's absolute proscription on conflicted decision-making. References to fiduciaries 'managing' conflicts must therefore be limited to fiduciaries which are organisations, where it is possible to quarantine different deliberative processes by careful institutional and process design, for instance by creating stand-alone subsidiaries and committees. Those deliberative bodies can then be expected to exercise an independent judgment, untainted by conflicts, and can be sanctioned if they do not. This perspective is more fully articulated in M Scott Donald, 'A Servant of Two Masters? 'Managing' conflicts of duties in the Australian Funds Management Industry' appearing in the forthcoming issue of the *Journal of Equity*.

2. **Governance best practices.** The Commission's Draft Report makes reference to a variety of practices alleged to be indicative of superior governance, including Skills Matrices and Annual Effectiveness Reviews. As compelling as these processes can sound on paper, they are fatally undermined if implemented in a 'tick-the-box' manner. For instance, research conducted by Professor LeMire and me in relation to the role of independent directors touched on Annual Effectiveness Reviews (See M Scott Donald and Suzanne LeMire, 'Drawing the ruler over Board Performance Assessments' (2018) 30(3) *Australian Superannuation Law Bulletin* 35. That research concluded:

> 'notwithstanding a general acceptance of the value of the concept, the processes employed in practice often lack the incisiveness and impact required to make it effective.'

APRA, in its recent report into governance arrangements in the superannuation sector, reached a similar conclusion. Our research further concluded:

> 'no matter how embedded and nuanced they are, there are limits to what Board Performance Assessments can achieve in a world in which board nominations are controlled outside the Board. So although attention to the integrity of Board Performance Assessments is laudable, it is important not to lose sight of the fact that Board nomination and tenure arrangements are so much more important for ensuring the cognitive independence, expertise and member-orientation of Board members. No amount of ticking the boxes in a Board Performance Appraisal can remedy the damage done to members' interests from a complacent or structurally compromised board.'

It is submitted here that the 'tick-the-box' mentality reflects the interaction between a regulator committed to principle-based regulation (APRA) and a regulated community viewing its responsibilities through a narrow legal lens. To some extent this is probably inevitable. However, I submit that the key to reconciling this mismatch is to ensure that APRA uses its licensing power, including the 'fit and proper' requirement and the MySuper authorisations, more decisively than it has in the past. I reach this conclusion because failure to maintain effective governance processes and structures will only in extreme situations give rise to a justiciable event (such as a conflict-compromised transaction or a grossly negligent decision) that might sound in a regulatory sanction. Rather, appropriate governance processes and structures aim to steer the organisation clear of such events; they are prophylactic not remedial. Appropriate governance processes and structures ought therefore to be seen as an essential pre-condition of the licence to operate the business and their absence or failure ought therefore to be addressed as part of the licensing regime.

3. **The Expert Panel and selection of Best-in-Show Funds.** The proposal to reform the default superannuation arrangements for new entrants to the workforce has attracted much comment. I don't propose to comment on the policy dimensions of that proposal but do have some observations of a more practical nature deriving from my experience, prior to entering academia, as Director of Research for Frank Russell Company (now Russell Investment Group). They are:
   a. I recommend against changing the fund list once every four years. It would be preferable to change it progressively, perhaps changing 2 or 3 funds each year on a rolling basis. There are a number of reasons why this is preferable:
      i. It reduces the dislocation arising from the process if only a minority of funds are up for review and potentially switched in/out at a time;
      ii. It reduces the risk that funds selected will share the same investment style biases (given investment performance, even over 10 year periods, can be heavily influenced by temporary market swings);

iii. It reduces the pressure on the Panel each time the list is reviewed, which (from personal experience) will be intense if everything is 'up for grabs' at once; and

iv. It will keep aspiring fund trustees continuously interested, and penalise 'tournament' behaviour.

b. Although the Expert Panel may meet periodically, the process of fund monitoring must be continuous. There are two reasons why this is crucial:

i. Researchers trying to analyse funds in retrospect are very vulnerable to ex post justifications by the entities they research. One of the key advantages that asset consultants with properly resourced manager research teams have traditionally enjoyed is continuity of contact and record keeping.

ii. The process must expect that one or more funds in each cohort will not remain in the cohort for the full four years and will need to be reviewed and potentially replaced. This can come about through changes in ownership, management structure, investment personnel or even regulatory issues. The idea that even the most expert Panel will identify ten funds, none of which will encounter changes over the ensuing four years, is, in my experience, untenable. Possible solutions include the use of a narrower list for the remaining period after exclusion of a fund, or the creation of a 'reserves' bench to replace a faltering fund.

Concluding Comments

The efficiency of the superannuation system is of crucial importance to Australia's future. In addition to the governance and regulatory issues raised above, I believe that the Commission's attention to the costs of insurance from an individual (potentially multi-account holder's) perspective and to legacy products are particularly important in this regard. Both place a material drag on members' realised performance but are difficult to address for individual trustees to address.

Finally, I commend the Commission for the work so far undertaken in this Review and look forward to seeing the Final Report. 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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