Governance Institute of Australia

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Manager
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By email: superannuationgovernance@treasury.gov.au

Dear Minister Frydenberg

# Superannuation Legislation Amendment (Governance) Bill 2015

Governance Institute of Australia is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance advisers and risk managers are second to none.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies. They frequently are those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC), and in listed companies have primary responsibility to deal with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules. Our members have a thorough working knowledge of the operations of the markets and the needs of investors. We have drawn on their experience in our submission.

## General comments

Governance Institute supports the introduction of a requirement for one-third independent directors and an independent chair on the trustee boards of all APRA-regulated superannuation funds (corporate, industry, public sector, and retail funds, but not self-managed funds).

### One-third independent directors and independent chair

Equal representation was an important aspect of the governance structure established with the introduction of compulsory superannuation in 1993. As the government noted at that time: ‘One of the most important ways in which members are able to participate in the management and protection of their retirement savings is through representation on the board of trustees’. However, employee representation through third parties such as trade unions is no longer automatically applicable due to the introduction of choice in superannuation — many members of funds are not represented by unions. And unless an employer has a defined benefits scheme, where it bears the risk of underperformance, there is no longer a reason to ensure employer representation on the board of trustees either directly or through third parties such as employer associations.

Appointment of directors by third parties such as trade unions and employer associations entrenches potential conflicts of interest, as the directors may have competing loyalties between the members of the superannuation entity to which they owe a primary duty and the organisations which they represent. Such situations present a risk, real or perceived, that directors may make decisions based on these external influences, rather than the best interests of members.

The central premise of independence in superannuation is that directors should take decisions objectively in the interests of the members. Conflicts of interest (perceived and real) do not provide assurance that such objective decision-making is undertaken.

Governance Institute is of the view that the introduction of a requirement for one-third independent directors and an independent chair will improve board renewal processes, because they will assist the boards to identify the skills, knowledge, experience and capabilities they need — in contrast, a 'nominated representative ' process is not focused on meeting a requirement identified by a board skills matrix, but in ensuring representation of particular third parties. The potential pool of director candidates with appropriate skills and experience is substantially increased versus the 'nominated representative' pool candidates. In assisting the board to develop a board skills matrix, there is the opportunity for considered reflection and productive discussion on how the board of directors is constituted currently and also how it believes it should best be constituted in the future to align with the strategic objectives of the entity and the best interests of members.

Moreover, when assessing the skills and competencies needed to align with the strategic objectives of the superannuation fund, the board can also assess the current and desired diversity that it seeks. Improved diversity of thinking has been shown to correlate with high performance.

Governance Institute continues to advocate for a majority of independent directors (with appropriate election and accountability requirements), because independent directors need to be able to influence how the board is operating. Furthermore, research shows majority independence is the most prevalent standard internationally and that retirement schemes in developed countries are moving towards appointing more independent directors. Further a majority of independent directors on the boards of superannuation funds aligns with board composition on their investee companies, which is a better governance outcome.

Notwithstanding our preference for a majority of independent directors, we are of the view that a one-third requirement is a pragmatic, initial step in ensuring board effectiveness. Moving to a board structure comprising one-third independent directors will assist in improving board renewal, as it will introduce new skills onto boards.

**We recommend** that board committees also be encouraged to apply the requirement of one-third independent directors and an independent chair.

## Members should decide independence

In retail or for-profit funds, the members are essentially acquiring a service for a fee and, if they are dissatisfied with that service or the performance or governance of the fund, they can transfer their funds to another service provider. Members do not expect a significant say in the governance of retail funds any more than they expect a significant say in the governance of, say, a bank. Rather they rely on strict prudential regulation by APRA to ensure that their interests are properly protected.

Industry and other employer-sponsored funds are a different case. They are not offering a service for a fee in an open market. They are not seeking to generate a profit for an owner. They exist solely for the benefit and to protect the interests of their members. The principal say in the governance of **these funds should be in the hands of the members of the fund, not third parties**, such as trade unions and employer associations**.**

Governance encompasses the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. It encompasses transparency, accountability, stewardship and integrity. As a matter of good governance, therefore, members should be provided directly with the final say in the governance of their superannuation fund.

The best governance outcome would be to introduce a mechanism which allows members of the fund — both at the contributory/accumulation and pension recipient phase — to appoint and remove directly the directors of the trustee and hold those directors accountable to members. That is, no-one apart from members should have the decision-making power as to the appointment of directors.

If members are granted the right to elect — or not elect or re-elect directors — an independent director is essentially therefore one who has been elected by members, because members are of the view that the director is acting in their best interests.

Board composition, definitions of independence and management of conflicts of interest are only components of a governance framework. That is, the key governance outcome from which questions of board composition and management of conflicts of interest flow is to aim for greater empowerment to members and greater accountability of directors to members.

**Governance Institute recommends** that the key good governance outcome is to provide for members of defined contribution schemes to appoint and remove directors of trustees and for those directors to be accountable to members. This provides a governance framework in which other questions of governance structure can be assessed and decided.

An example of a similar governance arrangement outside of superannuation is the manner in which members of a corporation (shareholders) have the right to appoint directors of the board and hold those directors accountable for the performance of the corporation.

It has been argued by many in the superannuation industry that providing for members to appoint directors would lead to ‘gaming’ of the voting, and third parties controlling voting outcomes. Yet the Cooper Review noted that some large APRA funds already provide for members electing directors and we note that, currently, an example of members electing directors is the Retirement Benefit Fund of the Tasmanian Public Service (a non-APRA-regulated fund), which has two member-elected directors on the trustee board. Representatives of third parties (in this case, a union) were also free to and did stand for election and candidates lobbied members for their votes. The members made the final decision. As in the political process, where lobbying efforts are also made by various parties, the decision ultimately rested in the hands of those whose interests were being represented.

It is incorrect to suggest that providing members with the right to decide who represents their best interests might lead to chaos. All listed companies directors are elected, even companies where, like superannuation funds, most of the members are individuals. For example, listed investment companies, by their very nature, are comprised predominantly of retail shareholders who vote regularly on director elections and re-elections pursuant to the listing rules. This sector of the market has operated soundly and stably for many decades.

Managed investment schemes also provide an example of members having genuine influence over the body managing their investment. Members can change the constitution of the scheme and even remove the responsible entity, which is the equivalent of removing a trustee. There is no reason why members of superannuation funds should not have the same rights.

Further, we believe that all members should have the right to appoint and remove directors. Currently, in some funds, only contributing members have the right to elect directors, whereas those in pension mode do not. This results in the inequitable situation where a young member who has just commenced work, with a small amount of, say, $2,000 might have the right to elect directors, whereas an older member with a much larger sum in their retirement savings, say, $200,000, has no such right. Again, like managed investment schemes, all members of a superannuation scheme, regardless of which class of member they are, should have voting rights proportional to the value of the member's interest in the scheme.

## Detailed comments

### Potential unintended consequences attached to the proposed definition of independence

Governance Institute is of the view that there are potential unintended consequences attached to the proposed definition of independence. We set these out below. Our view is that any strictly prescriptive definition will inevitably lead to difficulties, not least because it is challenging to update legislation in a timely manner to align with changing community values concerning independence.

Governance Institute continues to advocate for a non-prescriptive approach to independence. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* set out criteria in Box 2.1 against which independence can be assessed, but it cannot be assumed that independence of judgment is lost if only some of those criteria are met. The criteria are examples of interests, positions, associations and relationships that may raise doubts about independence and require consideration, but they do not *prescribe* a loss of independence.

Also importantly, under the 'if not, why not' approach taken by the Principles and Recommendations, if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it —- a flexibility tempered by the requirement to explain why to its shareholders.

Governance Institute is of the view that it would be preferable for the legislation to set out the principle of independence, but not prescribe a definition. A mechanism similar to the ASX Corporate Governance Council could be established — for example, a Superannuation Governance Council — which could flesh out how the principle could be assessed and applied in a way that is difficult to achieve in legislation or prescriptive prudential standards. As noted in the Cooper Review, 'APRA could coordinate membership of the council and provide secretariat support'.[1]

**Examples of potential unintended consequences**

If the objective of the proposed definition in the exposure draft of the legislation is to increase the number of independent directors on the boards of superannuation trustee boards, the drafting of the current definition has the potential to lead to a greater number of non-independent directors sitting on such boards.

In the Exposure Draft of the Superannuation Legislation Amendment (Governance) Bill 2015, the definition is as follows:

[1] *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System*, 2010, p 62, also known as the Cooper Review

> A person is independent from an RSE licensee if the person:
> (a) does not have, and is not directly associated with a person who has, a substantial holding (within the meaning of the Corporations Act 2001) in the RSE licensee, or in another entity that is a member of the same group as the RSE licensee; and
> (b) does not have a material relationship with, and is not employed by an entity that has a material relationship with:
> (i) if the RSE licensee is a body corporate—the RSE licensee; or
> (ii) if the RSE licensee is a group of individual trustees— any of the trustees; and
> (c) has not at any time in the last 3 years been an executive officer or director of a body corporate that has, or has at any time in the last 3 years, had a material relationship with:
> (i) if the RSE licensee is a body corporate—the RSE licensee; or
> (ii) if the RSE licensee is a group of individual trustees— any of the trustees.

While this definition will exclude those associated with employer groups, it will not necessarily exclude those associated with industrial groups. While the proposed definition captures those who have been in the last three years an executive officer or director of a body corporate that has had a material relationship with the licensee, a trustee could have ex-employees on the board who did not hold the position of executive officer or director in the last three years. Nonetheless, due to their employment relationship which introduces the concept of 'representing' the employing body, they are not independent.

Unlike the current definition of 'independent director' in the *Superannuation Industry (Supervision) Act 1993* (the SIS Act), the definition of independence does not exclude those associated with industrial organisations representing the interests of members of the fund (unless the organisation has a material relationship with the licensee). It is possible, under the proposed definition, that two-thirds of the directors of a superannuation fund could be nominated by a trade union.

Moreover, in some corporate funds, the shares in the superannuation fund are owned entirely by the corporation. In other instances, the shares are held in the trustee company, and while employee-elected directors hold shares, appointed directors do not hold shares, but companies signatory to the trust deed hold shares. It would be an unfortunate consequence should the legislative definition of independence encourage parties to structure shareholdings in such a manner so as to avoid being captured by the definition.

In relation to the current definition in the SIS Act, which requires that an independent director not be a member of a fund, we do not believe this restriction should be retained. If anything, a director is more likely to have a conflict because they are a member of a different fund. By comparison, we note that directors of public listed companies are encouraged to hold shares in the company, as this is seen to align their interests with those of shareholders — directors holding shares in the company on whose board they sit is not seen to affect independence.

Governance Institute is of the view that being a member of a fund should not render a director 'not independent'.

### 'If not, why not' reporting

The draft regulations introduce a requirement to disclose, on an 'if not, why not' basis, in the annual report on whether a superannuation fund has a majority of independent directors commencing 1 July 2019.

There is some potential for confusion given that the legislative requirement is for one-third independent directors, yet the reporting requirement is for a majority. The disjunction between these requirements could create ambiguity as to what superannuation funds should be aiming for.

We would welcome the opportunity to meet and elaborate on these issues.

Yours sincerely

Tim Sheehy
Chief Executive