TREASURY CONSULTATION

One size does not fit all

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ABOUT INDUSTRY SUPER AUSTRALIA

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ONE SIZE DOES NOT FIT ALL

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EXECUTIVE SUMMARY

Industry Super Australia welcomes the opportunity to comment on the *Superannuation Legislation Amendment (Governance) Bill 2015: Governance arrangements for APRA regulated superannuation funds.*

Industry super funds support strong and effective governance arrangements that promote a strong culture of ethical behaviour, accountability, risk management and transparency.

This representative trustee model has seen industry funds outperform bank owned retail funds by 2 per cent over the eleven years to June 2014 while avoiding the scandals that have plagued the vertically integrated for-profit financial services sector.

Governance requirements should rest upon clear empirical evidence, and the case for change has not been made.

The different operating models within the superannuation sector give rise to different governance challenges and the Bill imposes an unworkable "one size fits all" model for board composition.

Industry super funds are deliberately governed differently to the retail and bank-owned sector.

ISA opposes the imposition of a new model of governance on the not-for-profit sector that has consistently outperformed its peers, while leaving largely unchanged the model that has underperformed and has been ineffective at preventing widespread misconduct.

We strongly oppose the repeal of the legislative guarantee for member and employer voice in fund governance through the representative trustee structure.

This will eradicate from the law books the most successful model of fund governance, in favour of a model that has failed to prevent the scandals and misconduct. These failings have led regulators such as the Reserve Bank Governor and the Chairman of ASIC to warn of a loss of trust in banks.

The approach adopted in the draft Bill will not strengthen the governance of superannuation funds, and there is a real risk that importing finance sector norms to the boardroom will undermine the member-first culture that has been a hallmark of the equal representation model.

ISA is also concerned that the Bill confers alarming and unprecedented powers and wide discretion on APRA to determine, administer and interpret the law.

ISA urges the government to abandon the proposed reforms.

> *"I am not so much concerned with the content of a corporate governance model as with the culture of the organisation to which it attaches... the key to good corporate governance lies in substance, not form"*
>
> *Mr Justice Owen, HIH Royal Commission*

1. Introduction

Industry super funds support strong and effective governance arrangements that promote a strong culture of ethical behaviour, accountability, risk management and transparency.

That is why industry super funds were vocal supporters of the enhanced governance requirements introduced through the Stronger Super reforms dealing with directors' fitness, skill and expertise, and enhancing policies around the management of conflicts of interest, transparency, risk management and board renewal.

Industry super funds understand that good governance is about much more than who sits at the board table.

But boards matter. Getting the right people around the board table - properly motivated and with the right mix of skills, experience and expertise - is integral to good governance.

The representative trustee model of governance that is found in the not-for-profit superannuation sector has a strong track record of getting this right - delivering boards comprised of people from diverse backgrounds united by their strong belief that superannuation funds should be run only to benefit members and have a single focus on advancing members' best interest.

The proof is in the pudding, with industry funds outperforming bank owned retail funds by 2 per cent over the eleven years to June 2014[1], while avoiding the scandals that have plagued the vertically integrated for-profit financial services sector.

It is hard to justify the imposition of a new model of governance on the not-for-profit sector that has consistently outperformed its peers, while leaving largely unchanged the model that has underperformed and has been ineffective at preventing widespread misconduct.

And it's hard to justify undercutting the governance obligations that retail and bank owned funds have only recently adopted on a voluntary basis.

To be clear, ISA does not oppose independent directors. We recognise that many independent directors (in both the non-representative and non-associated sense) make significant contributions to the boards on which they serve, and we support measures that ensure equal representation funds and their sponsors have the flexibility they need to respond to the different challenges they face, while retaining the integrity of the representative trustee model.

If the government insists on a uniform model of governance, it would be sensible to retain the strengths of the equal representation model and extend the requirement for member representatives to all boards.

Consistent with our member-only focus, we support efforts to ensure that directors are free from conflicts of interest when performing their fund role. We support the separation of the board from management, and we support efforts to encourage critical thinking in our superannuation fund boardrooms, including by drawing directors from a diverse pool of candidates.

Unfortunately however, the approach adopted in this draft Bill will not strengthen the governance of superannuation funds. It is misdirected, imposes rigid and inflexible regulation, intrudes into the private affairs of a corporation without a rational or compelling basis, and will undermine the representative trustee system. It will not achieve the policy outcomes it purports to address.

On behalf of its member funds, ISA opposes the draft Bill and associated regulation on the grounds that the

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[1] APRA, *Superannuation Fund-level Profiles and Financial Performance - interim edition 2014*, 20 May 2015 and ISA analysis

package:

- Fails to recognize that the different operating models within the superannuation sector give rise to different governance challenges;
- Imposes an unworkable "one size fits all model" for board composition;
- Removes the legislative guarantee for member and employer voice in fund governance through the representative trustee structure;
- Does not adequately address conflicts and lack of transparency in the retail sector; and
- Confers alarming and unprecedented powers and wide discretion on APRA to determine, administer and interpret the law.

In this submission ISA sets out its principled objections to the draft Bill:

- It is widely acknowledged that member and employer voices are important in fund governance; removing these voices would be a backward step;
- Governance requirements should rest upon clear empirical evidence, the case for change has not been made;
- Improving board performance involves a complex set of relationships that do not lend themselves to prescriptive regulation;
- Even if there were a case for prescriptive regulation of board composition, different sectors face different governance challenges, and any reforms should reflect these different challenges.

We then deal with the details of the draft Bill.

2. Abolition of the equal representation model

In seeking to introduce a single model of governance, the draft Bill completely removes the legal requirement for member and employer representation in the boardroom. The proposed repeal of Part 9 of the SIS Act, and related amendments, would remove the equal representation governance model from the law. The draft bill also abolishes the policy committees that currently provide member and employer voices in for-profit funds where the trustee does not operate under the equal representation model.

Make no mistake. This reform is radical.

This is the most significant change to superannuation since the advent of compulsory superannuation, put forward without explanation and without consideration of the longer term consequences on the retirement savings of ordinary Australians.

It would eradicate from the law books the most successful model of fund governance in favour of a model that has failed to prevent the scandals and misconduct that have led regulators such as Reserve Bank Governor and the Chairman of ASIC to warn of a loss of trust in banks[2].

Under the guise of a modest and benign proposal, the draft Bill strikes at the heart of employer and employee representation on fund boards. Funds operating under this model would be left to decide on a fund-by-fund basis whether to continue to have representative directors at all.

The effect of the Bill is to require that one-third of the board have no relationship to the member and employer-sponsors of the fund, the remaining two-thirds can be drawn from anywhere, and members no

[2] Banks 'deserve what they get', says regulator, *Financial Times*, June 21, 2015 2:17 pm, https://next.ft.com/44b666a0-16a1-11e5-b07f-00144feabdc0

longer have the right to participate in policy committees. Contrary to the claims of enhanced accountability, the abolition of the equal representation model will weaken the accountability of trustees to fund members and sponsoring employers.

The draft bill would also remove the current requirement that decisions of the boards of representative trustees must generally be made by a two-thirds majority vote. This provision has provided the basis for consensus based decision-making and has guarded against extreme risk taking.

ISA opposes in the strongest terms the repeal of Part 9 of the SIS Act.

The importance of member and employer voices in fund governance

Members and employers are represented on the boards of pension funds across the OECD, and there is broad agreement that their input is integral to strong governance.

Research conducted by UMR in June this year found that 67% of Australians say it's important that super funds are run by people who have a direct connection to the people in those funds, such as representatives of fund members and employers.

A recent report by Mercer[3] on the governance of superannuation funds argues that member representation is important because it enhances accountability to the members and beneficiaries of the fund, particularly in defined contribution schemes, where members bear the risk of poor investment performance. The report concludes that the introduction of more independent directors should not occur at the expense of member representation in the fund's governance structure.

A voice for employers is also important, particularly for default members where employers have assumed the rights of members to select the fund, and in the case of defined benefit funds where the employers take the investment risks on behalf of the members.

ISA recognises that the SIS Act constrains the ability of trustees to appoint a number of non-representative directors, where this suits the fund's circumstances. We are open to extending the scope for the additional appointment of directors/chairs who are not representative directors. We would support changes that would increase the scope to raise the number of non-representative directors and chairs on funds while retaining the strength of the equal representative model.

3. The case for change has not been made

> *"However, overall, there is a lack of compelling evidence to suggest that any one model of board structure should be viewed as clearly preferable in all cases. Therefore, the Commission does not consider it appropriate at this time for a particular structure to be mandated. Further, the Commission would not want to see restrictions placed on board structures without such restrictions having a sufficient evidentiary basis"*[4]
>
> *The Productivity Commission*

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[3] Mercer, *Governance of Superannuation Funds A report on independence requirements for trustee boards,* May 2015 http://www.mercer.com.au/content/dam/mercer/attachments/asia-pacific/australia/Governance/Governance-Independent-Report-0515.pdf

[4] Productivity Commission, *Default Superannuation Funds in Modern Awards Inquiry Report*, No. 60, 5 October 2012, p 102

The use of government power in relation to private firms – from environmental regulation to OH&S regulation, to consumer protection laws – is usually limited to restrictions on business conduct to ensure corporate activities do not run afoul of the public interest.

It is exceedingly rare for the laws of Anglophone jurisdictions to intrude into the internal affairs of corporations, such as to specify corporate governance and other arrangements. Instead, governments typically "enable" corporate structures with arrangements that shareholders can modify as they see fit.

Policy makers typically require a strong evidence base – such as major corporate scandals – before setting aside the presumption against intrusive governance laws.

There is no evidence that independent directors improve fund performance. In fact, the only evidence shows that majority representative boards outperform majority independent boards. The addition of a majority of independent directors has not prevented the scandals that have plagued the conflict ridden, for-profit financial service sector.

Industry super funds have previously provided detailed analysis of the academic literature regarding board composition, and the incidence of independent directors, and company or fund performance.[5] In summary:

- The available evidence does not support the view that mandating independent directors on not-for-profit superannuation funds would improve fund performance.
  - A study looking at the governance and performance of APRA-regulated funds found no evidence that board independence and chairman independence affect funds' performance.[6]
  - Empirical research on US public pension funds indicates that the proportion of "outside" trustees on the board has no significant relationship with funds' excess outperformance.[7]
  - Studies undertaken by international and Australian academics show that the introduction of majority independent arrangements on company boards either add limited or negative value to boards.[8]
- There is evidence of a strong relationship between the representative trustee model and the outperformance of the not-for-profit sector over the for-profit sector.
  - APRA has published a series of working papers demonstrating the outperformance of not-for-profit funds which are almost exclusively governed by representative trustees.[9]

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[5] Industry Super Australia, *In members' best interests: ISA submission to government discussion paper*, February 2014, http://www.industrysuperaustralia.com/assets/Submission/120214-ISA-Submission-Governance.pdf

[6] Liu, K., 2014, Governance and Performance of Private Pension Funds: Australian evidence, School of Risk and Actuarial Studies, University of New South Wales, Australia http://papers.ssrn.com.ezlibproxy.unisa.edu.au/sol3/papers.cfm?abstract_id=2484380

[7] Harper, J., 2008, Board of Trustee Composition and Investment Performance of US Public Pension Plans. International Centre for Pension Management

[8] See Lawrence, Jeffrey, and Stapledon, Geof, 'Do Independent Directors Add Value?', Centre for Corporate Law and Securities Regulation Faculty of Law The University of Melbourne 1999; Tung, Frederick, 'The Puzzle of Independent Directors: New Learning', *Boston University Law Review*, Vol. 91, No. 3, pages 1175-1190, May 2011; Fischer Marc-Oliver and Swan Peter L, 'Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment', Australian School of Business, University of NSW 18 November 2013; Koerniadi, Hardjo and Tourani-Rad, Alireza, 'Does Board Independence Matter? Evidence from New Zealand', *Australasian Accounting, Business and Finance Journal*, 6(2), 2012, 3-18; Jeremy Leibler, 'Let's drop independence obsession', *The Australian* October 16, 2013.

[9] See Coleman, A., Esho, N. and Wong, M., 'The investment performance of Australian superannuation funds', *APRA Working Paper*, APRA, 2003, Ellis, K., Tobin, A. and Tracey, B. 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation

- The Grattan Institute has found that these not-for-profit funds have lower fees and higher returns across a variety of investment options.[10]
- The McKell Institute found a direct and strong relationship between the representative boards and the higher returns delivered by the not-for-profit sector.[11]

- There is evidence that the representative governance model has promoted higher levels of diversity among trustees, and more effectively minimises conflicts.
- Significant evidence points to structural governance issues in the for-profit sector where boards more closely resemble the governance model favoured by the draft Bill. These include:
  - Greater prevalence of multiple directorships on the boards of for-profit funds;
  - For-profit fund directors spend much less time than representative directors on fund matters;
  - For-profit fund directors are commonly employed by the fund or are employed by service providers to the fund, creating a conflict of interest;
  - Service providers to for-profit funds are much more likely to be owned by the same parent company as the fund, and research shows they are more likely to be paid above market rates. In comparison, the not for profit funds were more likely to pay market rates to related parties for services.[12]

The Explanatory Guide does not rely on any evidence to support the changes. Rather, the proposed changes are justified on the basis that they are consistent with the findings of the Cooper Review (2010) and the Financial System Inquiry (2014).

However, ISA submits that neither of these reports provided an evidentiary basis for their recommendations on this matter.[13]

In contrast, in 2012 the Productivity Commission reviewed all of the arguments and evidence in relation to requiring a minimum number of independent directors on fund boards. Having thoroughly considered the material, the Commission found no compelling evidence to support one model of governance over another, and recommended against prescribing any particular structure for superannuation fund boards.[14]

Moreover the recently introduced prudential standards require funds to regularly review directors' and the board's skills, annual board evaluations, and the establishment of formal board renewal policies. The regime to ensure funds identify and manage conflicts of interest and duty has been enhanced, and

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Funds', *APRA Working Paper*, APRA, October 2008, Sy, W. & Liu, K., 'Investment performance ranking of superannuation' APRA Working Paper, APRA 2009 and Australian Prudential Regulatory Authority, *Response to Submissions - Fund level disclosure from the APRA superannuation statistics collection*, APRA, 2009.

[10] Grattan Institute, *Super Savings*, April 2015, p 20-22

[11] McKell Institute, The Success of Representative Governance on Superannuation Boards (2014)

[12] Kevin Liu and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', *APRA Working Paper*, 12 July 2010

[13] The Cooper Review Panel only received one submission from stakeholders and experts supporting increasing the proportion of independent directors on equal representation trustees, while the Financial System Inquiry (FSI) relied on research which does not actually support the thesis that replacing representative trustees with "independent" trustees improves governance or fund performance.

[14] Productivity Commission, *Default Superannuation Funds in Modern Awards Inquiry Report*, No. 60, 5 October 2012, p 102

governance risk is embedded into the risk management frameworks. APRA supervises this regime and is able to deal with any areas of concern through its ordinary oversight activities.

4. Adverse implications of proposed changes

Mandated changes by government to the composition of superannuation trustee boards create a number of risks, which over time may have a significant impact on the retirement outcomes of superannuation members. It would be a brave assumption that the strong outperformance of the representative trustee system will be preserved under a new governance model.

Research on US public pension plans[15] finds that board composition has no impact on fund performance, and indicates that trustees with a relatively higher proportion of trustee directors independent of plan sponsors (public municipalities) tend to have a more conservative portfolio allocation than trustees with lower proportions of independent directors.

The research suggests an increased proportion of outside or independent directors has no impact on excess returns for members, but that board composition has a significant effect on asset allocation and funding levels of US pension plans. Specifically the research suggests independent directors possess different investment beliefs and risk appetites than representative trustees. Significantly the research found a higher proportion of representative trustees (and by implication a lower proportion of outside independent trustees) had "a positive effect on funding levels of the pension plans and are more focused on a stable, sustainable plan to provide future benefits".

Loss of diversity and cultural alignment

> *"Culture is a nebulous concept, much more difficult to define and observe than capital adequacy. But strengthening culture, like strengthening capital, is critical to long-run stability."*[16]
>
> *Wayne Byers, Chairman APRA*

There is a real risk that instead of diversifying the composition of trustee boards, directors will be drawn from a more shallow and homogenous pool, comprised of mainly professional company and finance industry insiders.

This lack of diversity can lead to 'group think', poor decision-making and poor accountability, and cannot be overcome by "structural rules around independence".17 There is also a risk that the cultural norms that have proved problematic in the for-profit finance sector could be imported onto the boards of not-for-profit funds, undermining the member-first culture of the boards.

The clear alignment between member interest and the objectives of the employer associations and unions that nominate representative directors has underpinned the high ethical standards and culture of accountability that prevail in the representative trustee sector.

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[15] Joel T. Harper, 'Board of Trustee Composition and Investment Performance of US Public Pension Plans', Rotman International Centre for Pension Management, February 2008, p 18

[16] Wayne Byres, 'The post-crisis reform agenda – a stocktake', APRA Chairman address to the *Symposium on Asian Banking and Finance*, Singapore, May 2015

[17] Dr Sally Wheeler, Queens University Belfast; *Do we really need 'Independent' directors on super boards?*

The cost of regulation

In implementing changes to meet the requirements of the proposed Bill, funds would incur a number of costs, not least the potential indirect impact of the change on the drivers of outperformance discussed above.

There will also be direct costs.

These costs relate to higher director fees for both replacement and additional directors who meet the proposed definition of independence, additional recruitment and training costs, and administrative and legal costs. The total implementation cost over the first five years of reform is estimated to be between $89 and $168 million, depending on the degree to which increased demand for independent directors increases directors fees, search costs and so forth. Not-for-profit funds are estimated to incur over 90 per cent of the total costs.

In the not-for-profit sector, these costs will be ultimately born by fund members.

The full analysis of the direct costs is found at Appendix A.

5. A prescriptive approach is not justified

> *"Any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature, corporate governance is not something which 'one size fits all'."*
>
> *Mr Justice Owen, HIH Royal Commission*

Governance experts around the world argue that improving board performance involves a complex set of relationships that do not lend themselves to prescriptive regulation.

Yet the regulatory approach adopted in the draft Bill removes an existing governance option – the equal representation model – that has done well and hard-codes board composition. It also establishes a definition of independence into law without regard to the context within which that relationship operates.

As explained in the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations, there is little value in a checklist approach to corporate governance that does not focus on the particular needs, strengths and weaknesses of the company.

While we don't subscribe to the view that the governance of super funds should necessarily align with the governance of listed companies,[18] we note that the ASX principles do not include a definition of

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[18] The nature of listed companies differs significantly from super fund corporate trustees. As a result, even indicative best practice for fund governance must be different from listed company best practice.

In modern listed companies, shareholders are dispersed throughout the country, and often around the world. It is difficult for shareholders to monitor the behavior of the company and its board, much less individual board members. It is difficult for shareholders to discipline directors who they believe have acted outside of their interests. Shareholders of listed companies also have weak incentives to monitor and discipline directors because a shareholder who does so bears all of the monitoring and other costs, but the benefits are dispersed across all shareholders.

These differences have a major effect on the governance risks borne by a firm. For a listed company, there is a greater risk that a director or group of directors will seek to enrich themselves at the expense of the company and the shareholders. Indeed, the relationships that *will* give rise to a loss of independence, but rather provide examples of interests, positions, associations and relationships that may raise doubts about independence and require consideration.

This approach recognises that a relationship that could create a conflict of interest in one context might not in another (or could even be beneficial in a different context). As an example, a relationship with a substantial shareholder of the RSE licensee raises very different considerations where that shareholder demands profit, compared to where the trustee is not expected to and does not provide a profit to the shareholder.

And, importantly, under the 'if not, why not' approach, the ASX principles provide that if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it - tempered by the requirement to provide public disclosure of the rationale for this choice, so that its shareholders, academics and others can evaluate it.

This recognises that the company is in the best position to understand the context within which board composition decisions are made, including the skills, experience, character and other qualifications being sought, as well as the available candidates.

In stark contrast, the draft Bill provides no opportunity for trustees to consider whether meeting each of the obligations in the Act is consistent with the best interests of members.

The proposed Bill is inconsistent with the principles-based approach which is the hallmark of modern regulatory practice and which is particularly suited to the regulation of trustees whose primary obligations are determined by the fiduciary relationship and the covenants.

It is inconsistent with APRA's stated supervisory approach, which is to be 'forward looking, primarily risk based, consultative, consistent and in line with international best practice'

6. Independence is not an end in itself, but rather a means to an end

The proposed Bill will not achieve its stated objectives, which are: to manage conflicts; to ensure a separation of boards from management; and to deepen the pool from which directors are drawn.

The proposed Bill stops short of providing a proper separation of management and boards, allowing executive directors to comprise up to two-thirds of the board of an RSE licensee. The Bill fails to control the influence of conflicted directors who owe material competing duties, for example, the duty owed to by an officer or director of the for-profit shareholder or parent.

At the same time, as argued above, a more limited pool of potential directors available for appointment to a trustee board may see less diversity on boards, as the independent positions are filled by finance sector insiders.

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illumination of this agency risk arising from the separation of ownership from control by Berle and Means nearly 100 years ago, which risk is endemic to listed firms, is the catalyst for the corporate governance cottage industry that exists today.

By contrast, not-for-profit super funds trustee companies are closely held. Super fund shareholders or nominating organisations are far better placed to monitor trustee behavior and far better placed to remove directors in their discretion.

If the intention is to avoid conflicts of interest or duty, the definition of 'independence' would be drafted so as to meaningfully add to the prudential standard on Conflicts of Interest. If the intention is to foster diversity of skills and experience on boards, then the regulation would focus less on "independence" and instead supplement the "fit and proper" prudential standard.

This confusion is not surprising. The debate on director independence has proceeded in an environment where a common definition of independent has proven elusive.

"Independent" is variously seen as independent of management, independent of nominating organisations, and, in some cases, refers to people who possess particular subject matter expertise. Thus, while there is an appearance of consensus, in fact there is none.

Without clarity about the harm that the appointment of "independent directors" is designed to address, any regulatory response is likely to miss the mark. ISA submits that this Bill has fallen into that trap.

7. Not all super funds are the same

> *"Trustees have a legal duty to act in the best interests of fund members. …In the case of a public sector, corporate, or industry fund, the trustee is organised on a not-for-profit basis. In the case of a retail fund, though, the trustee (or the corporate group to which it belongs) has the strong expectation of profiting from its superannuation business. That retail trustees must reconcile their (group's) profit motives with their fiduciary duty to act in the members' best interest gives rise to agency risk."*
>
> *Kevin Liu Bruce Arnold, APRA Working Paper, July 2010*

The proposal ignores the fact that different corporate structures and business models within the superannuation sector face very different governance challenges. Indeed the Explanatory Guide that accompanies the reform package makes a virtue of uniformity. It states "there is currently an inconsistency in the governance frameworks (including self-governing guidelines) on the number of independent directors on retail and not-for-profit superannuation fund boards and the definitions of independence."

Yet the different sectors face different governance challenges, which command different responses. According to APRA, retail trustees, especially those within a financial conglomerate, face unique and potentially significant conflicts. [19]

The Cooper Review observed the same point and concluded that due to the difference in governance arrangements and potential conflicts, the value that independent directors bring differs between the for-profit and not-for-profit sectors.[20]

This focus on uniform obligations exposes a fundamental flaw in the draft Bill. In seeking to reconcile the competing demands of the different operating models in the superannuation sector the proposed reforms end up harming one sector and at the same time fall short of standards that the retail sector has recognised are essential if it is to restore trust and integrity within that sector.

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[19] In 2008, an APRA working paper articulated the difference in governance structures and related challenges in the following way:

"Unlike non-retail trustees who negotiate the best possible terms for investment management services for their funds, retail trustees who often have investment managers as executive directors on their boards have impaired incentive to negotiate best terms for investment management services. Retail pension firms are expected to maximize profit for company shareholders by setting or accepting prices for pension products (including managers' fees) within a competitive market. Note that this resolution of the multiple conflicts of interest does not imply per se that there is any breach of regulation." Wilson Sy, 'Superannuation fund governance: An interpretation', *APRA Working Paper*, August 2008, p 12

[20] Super System Review, *Final Report*, 2010, p 55

For all of the reasons above, ISA believes that the Bill is fundamentally flawed and should be withdrawn.

8. Governance challenges are in the for-profit sector

> *"Trust is a very hard slope to go up and very easy to slip down; trust has to be built. There's no good complaining about it."*
>
> *Greg Medcraft, Chair ASIC*

The proliferation of scandals in the for-profit finance sector suggests that it might be more appropriate for government to focus on enhancing governance within that sector.

In recent months, Australian regulators have voiced their concerns regarding the misconduct and scandals which have emerged across for-profit financial institutions. The breadth and frequency of the misconduct has lead regulators to voice concern about the overall governance and risk management systems in the for-profit sector.

These failures have material and negative impacts on consumers.

Independent directors on the boards of the for-profit finance sector have been ineffective in managing the conflicts which result from vertical integration and potential misalignment of shareholder and consumer interests.

There have been no such scandals in the not-for-profit sector.

The extent of the problem

The Financial System Inquiry (FSI) found in 2014 that "Previous collapses involving poor advice, information imbalances and exploitation of consumer behavioural biases have affected more than 80,000 consumers, with losses totalling more than $5 billion, or $4 billion after compensation and liquidator recoveries". This estimate does not include the more recent losses from advice scandals at Macquarie Bank, Commonwealth Financial Planning, National Australia Bank and ANZ that are the subject of ongoing parliamentary and regulatory scrutiny.

From a more institutional perspective, the prudential regulator APRA has noted that their "interest in the issue [of financial misconduct] — and this is industry-wide, such as the issues that have come out previously from the Senate inquiry into CBA and more recent revelations [at NAB Wealth] — is what those issues tell us potentially about governance, culture and risk management in the group more broadly. So, yes, we have paid attention to those issues."

Previous research by APRA has found that "In the case of a retail fund, though, the trustee (or the corporate group to which it belongs) has the strong expectation of profiting from its superannuation business. That retail trustees must reconcile their (group's) profit motives with their fiduciary duty to act in the members' best interest gives rise to agency risk."

This suggests that the poor consumer outcomes in the for-profit retail finance sector signal broader deficiencies in governance underpinned in large part by misaligned incentives.

The response to the problems has not proven effective

The Financial Services Council (FSC) recognised these risks before much of the misconduct became public. In 2013 it established a governance standard requiring that the superannuation fund trustees of their member companies (banks) have a majority of directors and a chair independent of management, the parent company service providers within the same group, and other material service providers (more or less the definition of independence in the ASX guidelines, and not inconsistent with the current proposal).

Unfortunately, having a majority of independent directors on the boards of these for-profit funds has not solved the problem. Testimony to the Senate Economics References Committee during the Scrutiny of Financial Advice Inquiry in 2015 revealed that serious misconduct including fraud, much of which was not reported to AISC in a timely manner, if at all, had been occurring at:

- Australia and New Zealand Bank's superannuation and wealth management businesses, Onepath since 2012.
- Commonwealth Bank of Australia's superannuation and wealth management business, Colonial First State and Commonwealth Bank Financial Planning, since 2011.
- National Australia Bank's superannuation and wealth management business (MLC) since 2009.
- During the periods in which the misconduct occurred, the boards of each superannuation trustee, as well as the parent bank had a majority of independent directors (as defined by FSC/ASX).

This is not to suggest there is a causal link between independent directors and misconduct, but it does establish that a mandated proportion of independent directors is not in itself sufficient to achieve improved governance, or deliver a good corporate culture.

In so far as a mandatory majority of independent directors has not resolved the conflicts of interest or cultural problems in the major for-profit financial services firms (just as independent directors did not prevent misconduct or failures at other firms, from Trio to HIH), there is a case for reforms to manage their conflicts of interest.

Increased public reporting on conflicts of interests, related party transactions and all direct and indirect profits by retail super funds and their corporate parents might go some way to identify the extent to which for-profit superannuation businesses may be prioritising corporate group profits rather than super fund beneficiaries.

Imposing a requirement that all related party transactions must be conducted on terms no more favourable to the related party than would be reasonable if the fund were dealing at arm's length, and that related party transactions must be disclosed, would be a meaningful adjunct to the prudential regulation of conflicts of interest. Appendix B sets out ISA's proposals in this regard.

9. The details of the Bill

9.1 Too many details are missing

It is impossible to provide comprehensive feedback on this draft Bill in isolation from the proposed prudential standards which flesh out the detail, and will affect our response to the draft law. Given that the legislation needs to work in harmony with prudential standards, it would be sensible to allow further comment on the legislation once draft standards are available, and a further period of consultation should be allowed after APRA has released draft standards, to allow stakeholders to comment on the package of reforms.

9.2 The new obligations

ISA understands the draft Bill imposes four new obligations on RSE licensees. These are:

- To have a minimum of one-third directors who are independent – that is, directors who do not directly or through an associate have substantial shareholding in the RSE directly or indirectly, do not have a material relationship with the RSE (including through their employer) and has not been an executive of the RSE within the past three years.
- That the chairman of the board must be independent.
- That the appointment and removal of independent directors comply with any relevant prudential standards made by APRA.
- That funds report annually (on an 'if not, why not' basis) whether they have a majority of independent directors.
- APRA also intends to impose requirements relating to committee composition.

9.3 One third of the board independent

The minimum quota of one-third directors being independent from the RSE - with a focus on the structural relationship between a director and an RSE – is too blunt a response to the complex governance issues that can arise in constituting a board.

As we note above, if the objective is a proper separation of board from management, then executive directors would be in the minority. Similarly, if the objective is to ensure that directors who owe a competing duty to the parent or a related party cannot influence the board to the detriment of members, it is appropriate that they also be in the minority on boards. In each case, these requirements should be subject to ‘comply or explain’ flexibility, consistent with longstanding practice.

On the other hand, if the objective is to promote board diversity, a hard and fast quota of directors who have one characteristic (for example not drawn from the industry the fund serves) will undermine the trustee’s ability to balance the other considerations associated with board composition – such as continuity, fresh thinking, skills and experience, industry connectedness, succession planning and gender diversity.

9.4 The chairman independent

ISA opposes the proposed requirement for an independent chairman of the board. Boards should be at liberty to select the best person for this role.

No rationale has been advanced for this requirement. We can only assume that, like so much of the debate around fund governance, the proposal arises from misguided effort to transpose into a superannuation environment the recommendation (not requirement) that the chairman of listed companies be independent (of management). The analogy is false, and should be resisted.

9.5 Appointment and removal practices dictated by a regulator

The Bill would require that the appointment and removal of independent directors comply with any relevant prudential standards.

As a matter of principle, industry super funds oppose any dilution of the rights of nominating bodies to nominate and appoint directors.[21] RSE licensees should retain the ability to best determine how to identify suitable candidates, consistent with their obligations in relation to fitness and propriety, and the board renewal policies.

Further, if the objective of this provision is to support the introduction of the quota, it is redundant. The strict obligation to meet the quota is sufficient. If however, as we suspect, the objective of the provision is to introduce via the standards a range of other pre-requisites that a director may need to satisfy to meet the definition of independent, then we would argue that these should be identified and subject to public scrutiny.

9.6 The focus on the mere existence of a relationship with the RSE is misguided

The draft Bill focuses unduly on the relationship that a director may have with the RSE, and not on the impact of that relationship on the directors' capacity to fulfil his or her role. This is departure from the typical way in which independence is determined.

As we have argued before, the mere existence of a relationship may or may not give rise to concerns about directors' capacities to undertake their duties in a manner that is loyal to the company. Whether the duty of loyalty is impaired will depend on the nature of the relationship and context within which that relationship operates.

Experts argue that structural tests of independence may produce boards that are separate from interpersonal or business parties, but it may not lead to the kind of behavioural independence that is desired.[22]

We note that APRA would be given power to override the legislated definition of independence and determine that a person who does not meet the definition of independent is nonetheless likely to be able to exercise independent judgement (and vice versa).

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[21] RSEs currently adopt a range of policies to identify suitable candidates for appointment as a director. Some are enshrined in the governing rules of the RSE, some in its board renewal policies. ISA supports APRA's power to direct a trustee to consider the composition of its board, trustee boards advising shareholders or nominating organisations of the skills and experience sought in a director nomination, the ability for trustee boards to remove directors for cause (subject to procedural safeguards, including recognition of shareholder rights), a requirement for trustee directors to be members of a relevant professional organisation and undertake ongoing training and development, and the appointment of trustee directors for renewable fixed terms.

[22] Dr Sally Wheeler, Queens University Belfast; Do we really need 'Independent' directors on super boards?, September 2013 http://www.clmr.unsw.edu.au/article/accountability/corporate-governance/do-we-really-need-independent-directors-super-boards

While this would appear to create flexibility, it is also another instance in which the judgment of a board and the rights of shareholders are set aside.

While the flexible application of any quota that is imposed is better than a hard-coded quota, a preferable approach is to avoid notions of independence that focus on form over substance.

9.7 The test of independence is unclear and unworkable

9.7.1 Substantial shareholders and their associates

Proposed section 87(1)(a) would exclude a director who holds a substantial shareholding in the RSE licensee, or a member of the same corporate group as the RSE. The provision applies regardless of whether the shareholding is held directly or through a direct associate.

In the absence of APRA guidance on the definition of a direct associate we are unable to comment on the scope of this exclusion.

That said, a provision of this type might have some role to play in the governance of funds in the for-profit sector, and the FSC has rightly acted to self-regulate.

However, in the not-for-profit sector the mere fact of being a shareholder does not enliven a conflict. Shareholders are not entitled to dividends. Indeed, where the only demand made by shareholders is that the trustee performs its responsibilities, as the trustee of the fund there is an absolute alignment of interests.

ISA is also aware of funds where the shares in the corporate RSE are formally held by the directors. It would be farcical if the fact of becoming a director of the licensee rendered the director ineligible to serve as an independent director.

9.7.2 Is it a "material relationship" or "relationship" that may be material? And whose relationship?

Proposed section 87(1)(b) would exclude a director who has a material relationship with the licensee, or is an employee of an entity that has a material relationship with an RSE.

How this provision would be applied is unclear, and one possible interpretation of it is unworkable.

APRA will define a material relationship, and has indicated that standard employer sponsors, nominating bodies and parent companies will fall within the definition of a "material relationship".

The content of the APRA standards is critical to understanding how this provision will operate.

On one reading of the APRA letter, it appears that if an entity has a relationship with the RSE that meets the definition of a "material relationship" then a person who is an employee of that entity will be ineligible to serve as an independent director, regardless of materiality of the relationship between the entity and the RSE, and regardless of whether the individual who would be a director has any material relationship with the RSE.

This occurs because the legislation combines two separate considerations into one concept. The first consideration is the relationship with an entity or organisation that might give rise to a conflict or otherwise compromise the director's ability to perform their role, and the second concept is the materiality of that relationship.

By way of illustration, the Explanatory Guide and APRA letter indicate that a standard employer sponsor has a “material relationship” with the RSE.

On a strict reading of the Bill and the APRA letter, this would mean that any employee of any standard employer sponsor of the fund would not qualify as independent, regardless of the position the person holds within a standard employer-sponsor, the materiality of the standard employer-sponsor relative to the total membership of the fund or the extent to which the employees of the standard employer-sponsor have exercised choice of fund.

The Bill’s lack of clarity around whether the relationship affecting independence is in respect of an individual or an entity also appears where the Bill extends the exclusion to all employees of “materially related” entities. This would exclude employees of service providers and suppliers to the funds, again regardless of how remote the employee is from the provisions of the services. While in some instances being an employee of a material service provider should disqualify a director, in other cases merely being an employee of a company could not reasonably be expected to impair the impartial judgment of a person, and a general prohibition on serving as an independent director is not warranted.

Similarly, the mere fact of a director having a relationship with a body that is entitled to nominate directors to the board of an RSE does not compromise the director’s ability fulfil their responsibilities as a trustee without fear or favour.

Proposed section 87(1)(c) would exclude current and former executives, advisors and service providers from qualifying as independent directors.

This is consistent with the governance theory that suggests that such “insiders” are unable to objectively monitor or review their own work, are conflicted in decisions regarding their appointment, termination and remuneration. The exclusion period of three years is reasonable, given that the desire to preserve their reputations could otherwise stifle former executives’ appetite to probe their past actions.

However, we note that the Bill does not clearly exclude all current employees of the RSE and care will need to be taken in drafting the APRA definition to ensure that an employment relationship is considered a material relationship.

9.8 Voting requirements

The draft Bill also removes one of the key mechanisms that makes representative boards work so effectively – the requirement that decisions of the boards of representative trustees be made by a two-thirds majority vote. This requirement has provided the basis for consensus based decision-making within representative trustees and has assisted in guarding against inappropriate risk taking.

9.9 Majority of independent directors on committees

APRA has announced an intention to require independent directors to comprise the majority of the board audit and remuneration committees. This not only raises workload issues, it undermines the ability of boards to allocate work according to the skills of the particular directors. It would be counter-productive if, for example, an independent director recruited because of his or her investment expertise was unable for workload reasons to serve on an investment committee.

9.10 Majority of independent directors reporting requirement

The government proposes a new Regulation under the Corporations Act to require all funds to report publicly each year on whether they have a majority of independent directors, and if not why not.

This requirement arises from a mistaken assumption that "best practice" governance of super funds involves having a majority of [non-associated] directors. In contrast, "best practice" governance for pension funds is an equal representation model. The avoidance of misconduct and quality of performance in Australia is confirmation of this, but it is also the case that across the OECD, pension funds are commonly governed by representative trustees as a result of private ordering: the natural stakeholders of pension funds have repeatedly decided to govern funds in this way.

The proposed requirement also would mandate funds to report against a standard that is different to the standard in the legislation, and may create a perception that a trustee who has complied with the legal quota is nonetheless non-compliant.

10. Unworkable timeline

The transition period is too short and is another indication that the Bill was drafted without adequate expertise in the operation of super fund trustee boards.

Boards will need to manage the transition while also balancing other competing demands related to board renewal and continuity. The obligation to appoint directors who meet the minimum number of independent directors is certain to disrupt succession plans and may require plans to recruit for particular sets of skills to be set aside.

These issues would be exacerbated if APRA proceeds with its announced intention to require independent directors to comprise the majority of the board audit and remuneration committees (in addition to the workload-related issues).

11. APRA's powers

Industry super funds have generally supported the role that APRA performs in developing and administering its standards and guidance.

However, when it comes to governance standards, the Australian Institute of Company Directors has been critical of APRA's approach.[23]

[23] See, Submission of the Australian Institute of Company Directors to the Financial System Inquiry, dated 31 March 2014 (stating that "Company Directors does not oppose the more vigorous surveillance of companies in the financial sector, particularly for prudential regulation, where APRA considers such an approach is justified in the circumstances. However, we do oppose the strict application of governance principles to all APRA-regulated companies without flexibility or exemptions. … Mandated standards of corporate governance result in a "one-size-fits-all" approach to regulation which should, in our view, be avoided wherever possible. The greatest strength and contributor to the success of the [ASX] Principles is that they apply on an "if not, why not?" basis which allows a company to adopt an alternative approach if the one recommended by the Principles does not suit the company's particular circumstances. Where the recommended approach is not taken, the company must disclose its reasons for choosing the alternative approach and why the recommended approach was not appropriate for its circumstances. The "if not, why not?" approach is appropriate for corporate governance regulation as it is not possible to say that there is one "right" approach to corporate governance. The flexibility that the "if not, why not" approach provides also encourages boards to put in place the best

The proposed Bill is alarming because it goes further than prior acts and grants wide-ranging powers to APRA to make, administer, effectively interpret and enforce the law.

The draft Bill gives APRA power to:

- Make prudential standards in relation to appointment and removal processes;
- To develop prudential standards in relation to the definition of independence, including but not limited to defining material relationships with an RSE and direct association with a substantial shareholder;
- Determine, on its own motion, whether an individual is likely or unlikely to be able to exercise independent judgement in performing their role; and
- Issue directions to comply, and to suspend or terminate the licensee’s ability to receive contributions.

It is extraordinary to concentrate the power to write the law, administer the law and enforce the law in one office. Regardless of whether these powers are technically administrative in nature, the effect of the concentration of power in APRA’s hands is overreach and may undermine the generally constructive relationship that APRA enjoys with the entities it regulates.

11.1 APRA’s powers to determine whether an individual can exercise independent judgement

The Bill would confer upon APRA power to determine whether an individual is or is not independent, including on its own motion.

These powers are far in excess of the powers that APRA enjoys in respect to ADIs and insurers, where boards self-assess whether directors meet the test of independence, and APRA’s capacity to determine independence is enlivened only where the board is in doubt and refers the matter to APRA.

The test that APRA can apply is not whether the person meets the statutory definition of independence (ie the absence of a material relationship with the RSE), but rather whether the director is likely or unlikely to be able to exercise independent judgement in the course of their duties. This appears to allow APRA to determine the director’s capacity for independent thinking at large. This is an extraordinary power, unrelated to the public policy objectives and if granted would seriously undermine the collaborative relationship that APRA enjoys with the funds that it regulates.

11.2 APRA’s new compliance powers

Finally, the proposed powers for APRA to issue a notice to comply or to direct an RSE Licensee to not accept contributions proposed will apply to non-compliance with the prudential standard relating to director appointment and removal. APRA’s powers to suspend or remove a trustee are generally linked to the financial stability of an entity, and it is incongruous that this standard would have a stand-alone compliance regime. Put simply, it is hard to see how a well-functioning, highly competent but non-compliant board poses such a different prudential risk than other standards as to warrant new a compliance regime.

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corporate governance arrangements for their companies' particular circumstances and can lead to the development of innovative, alternative practices that could produce better outcomes.

In our view, what is required is a more flexible system of governance regulation for APRA-regulated entities.”

12. Conclusion

The proposed legislation is a stark departure from the flexible, principles-based approach to corporate governance that has served Australia well. The proposed legislation undermines the successful representative trustee model, while failing to address the real governance shortcomings that arise in the delivery of superannuation within in vertically integrated for profit financial institutions.

The proposed changes are not supported by any evidence, will not achieve their stated policy objectives, and suffer from a number of unworkable provisions.

For these reasons, the government should not proceed with the Bill.

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