Reforms to Superannuation Governance
APRA

31 July 2015

AIST Submission

AIST

The Australian Institute of Superannuation Trustees (AIST) is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the $650 billion not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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1 Executive summary

AIST does not support the proposed governance changes to superannuation funds outlined in the exposure draft legislation (Superannuation Legislation Amendment (Governance) Bill 2015 and its supporting Regulations), explanatory guide and APRA's letter, all circulated for consultation on 26 June 2015.

The explanatory guide sets out the matters to be addressed by APRA to support the implementation of the proposed legislation, and the exposure draft legislation provides APRA with extensive new powers. APRA's role in supporting the proposed reforms will include changes to the Prudential Standards and the ability to make determinations on a person's independence, or lack thereof.

AIST has made a submission[1] to the Treasury on the proposed reforms, submitted on 23 July 2015. This submission makes further comments with regard to the proposals outlined in the APRA letter and the proposed APRA powers set out in the exposure draft legislation.

AIST supports principles-based regulation around the governance arrangements of superannuation funds, as flexibility is necessary in an industry that has distinctly different sectors with significantly different structures and stakeholder interests.

AIST has long been a supporter of high governance standards in the industry and we are committed to working with Government and APRA to achieve best practice outcomes. We do not, however, believe that structural changes to board composition, in the form of mandating one-third independent directors, achieves that aim.

AIST makes the following recommendations:

- That the key terms of the definition of 'independent' should be defined in the legislation, and not in APRA Standards;
- That the term 'material relationship' should relate to the nature of the relationship, not the mere existence of a relationship that may not be material;
- That APRA not be granted the power to make determinations on an individual's independence, or lack thereof, but rather, give guidance to RSE licensees where it is requested or required;
- That the mandatory composition of audit and remuneration committees be revisited, and that there be no requirement for a majority independent directors on those committees where there is no financial conflict;
- That further guidance on the appointment and removal of directors be outlined in SPG 510, but that any changes to SPS 510 recognise the rights and powers of sponsoring organisations;

[1] AIST, (2015). *Reforms to Superannuation Governance 23 July 2015*. [online] AIST. Available at: http://tinyurl.com/qgw9w86 [Accessed 29 Jul. 2015].

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- That the transition timeline be extended
- That the requirements of the transition plan be clarified and achievable if required within the proposed short timeframe.

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2 Introduction

2.1 Reform package considerations

The Government has proposed significant changes to the composition of super fund boards in the exposure draft legislation, released for consultation on 26 June 2015. At the same time, APRA's letter of the same day outlines its intentions on supporting the implementation of the legislation. However, the detail of the proposed prudential framework reforms is not contemporaneously available for comment. Without being able to review the reform package as a whole, it is difficult to respond conclusively to the proposed changes to Prudential Standards.

It is in this context that AIST responds to the proposals outlined in APRA's letter, and we hope there will be a further opportunity to consult on the legislative instruments together with the draft Prudential Standards in due course.

In a recent submission to the Treasury, AIST has addressed the concerns we have with the proposals, in so far as we can determine their likely impact on the industry. For convenience, some of those relevant comments are reproduced in this submission.

We welcome the opportunity to provide feedback on the proposals.

2.2 APRA's powers to determine independence breaches the rule of law

AIST is concerned that the exposure draft legislation allows for APRA to supplement the proposed SIS Act definition of independent through its Prudential Standards making powers and then also determine whether a person is or isn't independent.

Clause 88 states that APRA may determine if a person is independent, based on APRA's assessment that the person is likely to be able to exercise independent judgement in performing their role as a director. Clause 90 states that APRA may determine that a person is not independent if it is satisfied that the person is unlikely to be able to exercise independent judgement in performing their role as a director.

It is unclear how APRA could be expected to undertake assessments of this type. Ultimately, this is an issue to do with conflict management, and that issue is dealt with already in the legislation and in the Prudential Standards. While APRA can consider what other interests and duties a proposed director may have, it cannot know whether the individual concerned is likely or unlikely to exercise independent judgment. A determination on that matter would require an assessment of the individual's character, past behaviour and the like, and this would be beyond APRA's capacity to undertake.

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As the OECD[2] has commented:

- A priority for good regulatory policy is to ensure that legal practices are consistent with and are supportive of the rule of law;
- It is important that regulators are not assigned conflicting or competing functions or goals.

AIST submits that the exposure draft legislation enabling APRA to supplement the definition of independent and then determine whether a person is independent does not meet the OECD principles.

CPS 510's definition of independent director also refers to a director's ability to exercise independent judgement, but only in the context of any of the person's associations or shareholdings materially interfering with that capacity. Entities regulated under CPS 510 are able to seek guidance from APRA on the question of independence and there are no determination powers such as those proposed in clauses 88 and 90 of the exposure draft legislation.

The exposure draft legislation provides no frame of reference within which APRA is required to make its determination, making the law uncertain. AIST **submits** that the power is too broad and unreasonable.

In any event, the requirement that all directors exercise independent judgement in their director role is a long established part of corporate governance law.

AIST submits that there should be no power for APRA to make determinations; only the capacity to give guidance, such as exists in CPS 510.

Should the power to make such determinations become law, **AIST submits** that guidance should be given in the first instance, with the RSE licensee given the opportunity to rectify any potential breach. A determination from APRA against independence should not automatically lead to a breach. The consequences of a breach can be significant, for example a direction not to receive employer-sponsor contributions.

2.3 Good governance practices

AIST strongly supports robust governance systems and practices, having led the industry by developing superannuation's first governance framework (relating to not-for-profit superannuation funds), published in March 2011. AIST's *Fund Governance Framework for Not-for-Profit Superannuation Funds* has been

[2] Publishing, OECD (2014). OECD *Best Practice Principles for Regulatory Policy*. Paris: OECD Publishing. Available at: http://tinyurl.com/o2vdn4w [Accessed 30.7.2015]; OECD, (2014). *Regulatory policy: improving governance July 2012*. [online] OECD. Available at: http://tinyurl.com/pt7tn79 [Accessed 30 Jul. 2015].

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updated twice since its first release to reflect changes in the prudential and regulatory landscape, continuing to outline not only the expectations of the regulator, but also highlighting best practice governance standards.

While AIST is highly supportive of continuous improvement in relation to governance in the superannuation industry, we do not believe that structural reforms to board composition in-and-of-itself achieves better governance outcomes.

2.4 Broader pool of experience and expertise already exists

AIST believes that the reforms as drafted will reduce diversity on boards. Diversity is essential for broad-ranging discussions in the board room and improved decision-making.

In considering governance in financial institutions post-Global Financial Crisis, the European Commission in 2010 said: "Empirical evidence highlights the benefits of diversity for corporate governance both in terms of efficiency and better monitoring. Diversity, not just of gender but also of race and social background, and the presence of employee representatives, broadens the debate within boards and helps, as some say to avoid the danger of narrow group think."[3]

Equal representation boards are drawn from a broad pool of talent. Through the nominating bodies, and in many cases elections, equal representation boards recruit directors from multiple stakeholder sources, naturally broadening the pool of candidates. The diversity this creates on boards has been central to the success of the not-for-profit superannuation sector.

Unlike many of the directors in corporate Australia, not-for-profit directors are not cut from the same cloth. AIST's membership data reveals that of a pool of nearly 600 trustee directors, nearly 100 employee, union and employer groups are involved in nominating or electing directors. In addition to the many different unions that nominate directors, employer-nominated directors come from a variety of sponsoring organisations including State and Federal Governments and religious institutions. While nominating bodies do in fact nominate individuals for board positions, those individuals are not necessarily officers or employees of those bodies, and come from a variety of different walks of life.

Not-for-profit funds, with their representative trustee governance structure, have also led the way in gender diversity on boards. Only 18.6% of directors on ASX 300 company boards[4] are women, whereas

[3] European Commission, (2010). Commission Staff Working Document, Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices. Accompanying document to the GREEN PAPER Corporate governance in financial institutions and remuneration policies. [online] Brussels: European Commission. Available at: http://tinyurl.com/awmq2xn

[4] Australian Institute of Company Directors, (2015), Statistics, Available at: http://www.companydirectors.com.au/Director-Resource-Centre/Governance-and-Director-Issues/Board-Diversity/Statistics

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female directors constitute 22 per cent of the board composition of AIST's member fund boards. The majority of these women are appointed by employee representative organisations.

In our membership, AIST also has 60 independent directors, as classified under the existing Superannuation Industry (Supervision) Act 1993 definition.

AIST supports diversity on boards and believes that the representative trustee system delivers a broad range of backgrounds and skills to the board table. A system that necessarily reduces the diversity of the talent pool diminishes the quality of board discussion and ultimately decision-making, and should be resisted.

2.5 Director skills and training covered by 'fit and proper' requirements

The independent director debate has in the past led to discussion on director skills and competencies. This discussion is absent from the current reform package presented for consultation, however it is important that this be addressed here.

Directors, regardless of their classification (representative or independent) bring a wide variety of skills to the board room. It is the collective skills, knowledge and expertise of the trustee directors that make a highly functioning and effective board. Diversity of skills, knowledge and expertise, as well as background and life experience is therefore important in challenging the development of 'group think' and provides for better decision-making and better outcomes.

AIST has long supported and enabled the development of trustee director competencies. In 2013 AIST launched its Trustee Director Course - a dedicated and intense training program that is superannuation specific - for superannuation fund directors. We support the continuous professional development of trustee directors and have dedicated significant resources to developing superannuation trustee-specific skill, competency and knowledge development programs.

It is an APRA requirement that trustee directors have knowledge of the industry that they are operating in. Any new independent trustee directors will therefore require appropriate training in superannuation, as expertise in one area (e.g. investments) will not provide the director with sufficient understanding of the superannuation industry as a whole. Appropriate training should be mandatory on an ongoing basis.

Appropriate skill and knowledge requirements already exist in APRA's Fit and Proper Standard (SPS 520). Appropriate education or technical knowledge, and the knowledge and skills relevant to the duties and responsibilities of an RSE licensee are required. APRA can use the powers it currently has to address any concern with current trustee director skill levels, and the management of director skills and ongoing professional development is a key focus of all super funds. The need for complementary skills on the board is sufficiently addressed within the current regulatory framework and the introduction of more independent directors does not in-and-of-itself strengthen existing requirements.

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2.6 Independents and other directors with conflicting interests

According to the Explanatory Guide, the proposed changes to superannuation governance 'allow for an increased accountability of decisions made by other directors who may have conflicting interests'. This principle stems from corporate boards where the independence sought is primarily from the executives of the company who might act in their own interests and not those of the shareholders. Yet on not-for-profit superannuation fund boards all of the directors are independent of the management.

Each director, and class of directors (representative and independent), on the board has the same fiduciary responsibilities, and the same obligations to act in the best interests of members above any other interest or duty they may have. While directors may be appointed by particular nominating bodies and referred to in Part 9 as 'employer representatives' and 'member representatives', all are required to set aside the interests of their nominating bodies when serving on the board. The 'conflicts covenants' in sections 52 and 52A of the SIS Act reinforce that position.

AIST is not opposed to independent directors, and recognises the valuable contribution many such independents make on super fund boards. However, the governance of a super fund - an organisation established within a trust structure- has high levels of fiduciary accountability attached, as well as a structure which prohibits the use of trust assets for the personal benefit of the trustee. A trust preserves the assets for the use of beneficiaries, and in the case of super funds, is also highly regulated.

In a not-for-profit context the directors of the super fund are not required to produce a profit for shareholders and cannot procure the sale of the fund to make a profit for themselves or someone else. There is no economic advantage to be had that creates the kind of conflict that could materially influence decision-making contrary to the best interests of members. Director fees are paid to directors on most super fund boards; however the amount of this remuneration is immaterial and does not create a conflict warranting the need for independent directors.

On retail fund boards, with super funds being a related entity of a parent bank or insurance company that has profit-seeking shareholders, pecuniary conflicts are more apparent. In a paper commissioned by AIST in 2009 on superannuation fund governance, Dr Mike Rafferty and others[5] noted that no person can serve two masters. In terms of the fiduciary duty concept, an agent should not have more than one principal.

APRA's 2010 report[6] into related party transactions in the superannuation industry highlights the fact that retail funds have significant financial conflicts at play in their related party transactions, and that these conflicts have resulted in significant additional costs to the super fund members. In the case of

[5] Dick Bryan, Gillian Considine, Roger Ham and Mike Rafferty, (2009). Agents with Too Many Principles? An analysis of Occupational Super Fund Governance in Australia. Workplace Centre, University of Sydney

[6] Liu, K. and Arnold, B. R. (2010) 'Australian superannuation outsourcing: fees, related parties and concentrated markets', Australian Prudential Regulation Authority Working Paper.

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administration fees, for example, APRA revealed that the fees paid by members of some retail funds were more than twice that of not-for-profit funds. It is these conflicts that the introduction of independent directors seeks to address. It is these considerations that should be central to what is meant by 'independence' – overcoming the impact of relationships and associations that due to the potential personal benefit to the director, could influence their decision-making in a way that does not prioritise the best interests of members.

Queens University Belfast academic, Sally Wheeler, in discussing the corporate governance failures of HIH, Enron and Northern Rock said:

> *History tells us that independence neither guarantees good financial performance nor freedom from scandal … Structural rules around independence fails on all counts … The injection of new blood is forced. … Policies that assume that structural independence is a panacea capable of addressing failures in group decision making are simply a recipe for disappointment.*[7]

2.7 Evidence-based reform and costs of transitioning

Superannuation funds are highly regulated and the prudential regulator, APRA, has a significant suite of powers currently at its disposal. Governance matters in the regulated superannuation industry can be dealt with under existing legislation and prudential standards, including the power to remove a trustee. The legal obligations imposed on individual trustee directors were heightened in the Stronger Super reforms, and all-in-all this has seen the Australian superannuation system's governance star rise even further at a global level.[8]

This lack of evidence to support governance changes highlights a significant flaw in this proposed reform process. Regulated superannuation funds are a major contributor to the Australian economy, with the not-for-profit superannuation sector representing $650 billion in funds under management. While good governance practices should be encouraged and pursued at all times, AIST submits that mandatory changes to board composition will mean significant changes to the culture of these large financial institutions, without any evidence of the need for such reform, or an articulated benefit to the members. These changes will also come at a substantial cost - to be borne by the members - and disruption to fund activities.

The costs will include legal costs for the amendment of constitutions, potential legal costs for RSE licensee ownership model restructuring, plus recruitment costs and new director training. Legal costs for constitutional changes are estimated at around $25,000 per RSE licensee (depending on the complexity of changes required), individual director recruitment costs estimated at $60,000 per new director (more for

[7] Wheeler, P. (2013). *Do we really need 'independent' directors on super boards?*. [online] UNSW. Available at: http://tinyurl.com/or7t7ap [Accessed 16 Jul. 2015].

[8] Australian Centre for Financial Studies and Mercer, (2014) *Melbourne Mercer Global Pension Index*, Melbourne. Available at: http://www.globalpensionindex.com/

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Chairs, some sources indicate $100,000 per Chair), advertising costs at an estimated $8,500 for a national newspaper, and director training a further minimum of $8,500 per director. We estimate the total, pure transitional cost to AIST member funds (based on 60 funds) to be $20 million in the first year. Director fees, and in particular the fees of Chairs, will increase and this greater expense will be ongoing.

AIST submits that the costs and risks associated with the adoption of the reform package are not supported by evidence that demonstrates beneficial outcomes for RSE licensees and their members. AIST has made representations to the Treasury opposing the introduction of the legislation.

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3 Government proposals

Despite our opposition to the changes for the reasons outlined above, we respond to the proposals set out in APRA's letter below.

3.1 Recognition of equal representation still ongoing

The exposure draft legislation seeks to repeal Part 9 of the SIS Act and thereby remove all reference to equal representation from the superannuation legislation. AIST strongly believes in the value of equal representation and the benefits this model of governance has offered members over the past decades.

Not-for-profit super funds with representative trustees have offered a voice to employers and employees, putting members first, as well as delivering ongoing outperformance of the for-profit retail funds. In its submission to Treasury, AIST strongly supported the retention of equal representation in the legislation.

By recognising the equal representation model of governance in the current Prudential Standards, APRA recognises the inherent differences that exist between the for-profit and not-for-profit sectors. Certain prudential requirements are set out differently in the standards in acknowledgment of the different structures. As equal representation will continue to exist as a model, even if the proposed changes are implemented, **AIST submits** that APRA should continue to recognise this important and successful governance model.

If part 9 of the SIS Act is repealed, and a minimum one-third independent director requirement is introduced, then equal representation will live on in the constitutions of not-for-profit superannuation funds. The varied ownership structures that currently exist in the not-for-profit superannuation sector will remain, and the residual two-thirds of the board will be equally constituted between member and employer representatives. Given that APRA, in order to provide appropriate prudential guidance and supervision, will need to continue to recognise the different governance structures in its Prudential Standards.

3.2 Meaning of independent – APRA's Prudential Standards – fails to address different structures

The proposed definition of 'independent' requires that a person must meet the legislative definition (set out in clause 87) as well as meet the requirements set out in relevant Prudential Standards (clause 87(2)). Commenting on the legislative proposals, without knowing the details of the proposed changes to the Prudential Standards has made informed comment on the Government's exposure draft legislation impossible.

AIST is of the view however, that the proposed definition that sits across both the not-for-profit superannuation fund sector and the for-profit retail sector, fails to address the nature of the sectors' distinctly different structures and the different interests of their key stakeholders. In our submission to the

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Treasury, AIST has proposed that a principles-based definition is more appropriate, where the definition allows funds greater flexibility to ensure that the concept of 'independence' is relevant to the unique structure of their governance framework. For a fund's unique business operations to be managed soundly and prudently within the context of any new board composition requirements, recognition of the different corporate structures, business models and governance arrangements must be factored in to the operation of any legislative changes. This will allow for the development of practices that are best suited to addressing areas of conflict that may arise in their particular circumstances. This is far preferable to a prescriptive approach with a one-size-fit-all definition that fails to capture some of the concerning conflicts.

We acknowledge the desire to consolidate the prudential requirements of APRA-regulated entities and the CPS 510 requirements regarding independent directors. However, CPS 510 independence issues are particularly targeted at executive directors, who owe duties to shareholders as well as duties to customers. Independent directors also contain the influence of executive directors, allowing for greater objective oversight of management. These considerations do not apply to the not-for-profit superannuation fund sector, and complete alignment with other APRA regulated industries is therefore of limited value.

Furthermore, AIST has expressed its opposition to the proposed handling of independence through a combination of a legislative definition and additional criteria set out in APRA Prudential Standards. While we acknowledge that guidance from APRA on whether an individual may or may not meet the regulator's expectation of independence is valid from time-to-time, we submit that leaving the definition of key terms in the legislative definition to subordinate instruments outside of the parliamentary arena, is not appropriate. This two-pronged approach adds unnecessary complexity and uncertainty, and moreover, we have advised the Treasury of our view that the powers granted to APRA in this model override the role of the legislature as law-maker. AIST opposes the inclusion of clause 87(2) in the legislation. APRA should be an arbiter of the legislative requirements regarding independence and should not have the power to add additional requirements outside of the legislative instrument.

3.3 Meaning of independent – material relationship – may cause unintended consequences

In addressing the law as proposed, however, we make the following comments with regard to the meaning of 'material relationship' pursuant to proposed sub-clauses 87(1)(b)-(c) and 87(4)(c).

Material relationships form the crux of the 'independent' definition and therefore what is meant by that term is fundamentally important. The material relationship relates to the RSE licensee of the independent trustee, and the consultation package seems to suggest that it is the fact that a relationship exists which is important, rather than the nature of the individual's relationship to the RSE licensee or independent trustee. Much of our discussion in relation to this matter has already been outlined in our submission to the Treasury.

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The as yet undefined limitations on material relationships (based on statements made by APRA, it appears this includes employees of professional advisers, suppliers, consultants, nominating bodies and employer sponsors) can be expected to reduce significantly the pool from which to draw appropriate trustee director candidates. This principle could unreasonably exclude non-conflicted and highly skilled potential trustee director candidates.

The extent of the employment relationship proposed poses unintended consequences. For example, AustralianSuper has 210,000 contributing employers of which 70,000 employers contribute as a result purely of member choice. This leaves 140,000 standard employer sponsors. Excluding anyone that has worked for one of these employers, regardless of their individual connection to the RSE licensee, excludes a substantial number of people from the pool. The operation of the provision, as drafted, applies regardless of the number of employees enrolled as members with the RSE licensee (it could be 3 out of 1,000), or whether the potential director candidate has any influence over, or knowledge of the employer's default super fund selection.

Standard employer sponsors are also not always static. Often an employer signs a deed with a super fund when one employee asks it to, even though the employee might turn out not to be a long- term employee. For reasons effectively outside of its control, a director might therefore fluctuate between independence and non-independence. In some diversified companies, what happens in one part or location of a business may not even be known in another part of the business, or by staff who are also a director of a super fund. A definition of what is considered to be a material relationship must exclude such occurrences, and should be road tested with the industry prior to implementation.

Also, AIST does not believe that excluding specific industry knowledge of the sector that a super fund services is in the best interests of members. For example, a director candidate with direct health industry knowledge for an industry fund such as HESTA (which services health and care workers) should not be excluded because their employer contributes to HESTA. AIST submits that the alignment of interest and the industry understanding helps the HESTA board to make better decisions as a result.

Similarly, not all employees of material service providers are potentially conflicted insiders. Many service providers to the superannuation industry are multi-national companies, with thousands of employees. A board director candidate might be ruled out because of their employment by such a company, even if they have had no involvement with services provided to the particular superannuation fund.

In SPG 510 APRA outlines considerations for identifying whether directors are 'non-affiliated' (as opposed to 'independent' as currently defined in the Superannuation Industry (Supervision) Act 1993). As APRA will no doubt have regard to these considerations in refining what it means by 'independent' under the proposed new laws, AIST makes the following observations:

- Employment with a standard employer sponsor should not be the determinant of a lack of independence, especially in circumstances where the individual has no influence over the

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employer's choice of default fund, or the membership of the fund through that employer is immaterial.

- Eligibility to be a member or employer representative director on the board, should not exclude an individual from being considered as potentially independent. Depending on an RSE licensee's constitution, there are a wide variety of people who may be eligible to serve as representative directors. In fact, in many cases, the nominating body is free (within the bounds of the legislation and Prudential Standards requirements) to nominate anyone they deem fit for the role, regardless of their connection to the nominating organisation. The process of nomination or appointment by a representative organisation, therefore, should not be a determinant of an individual's lack of independence.
- Having served as a member or employer representative director in the previous three years may not exclude an individual from being reclassified under the proposed legislative definition of independent. AIST supports this possible outcome, as many such directors are nominated by a sponsoring organisation to the RSE licensee, without the director having any material relationship, or employment relationship with that nominating body. Classification as independent, depending on the individual's other circumstances, may therefore still be possible.

APRA has stated that board renewal policies should ensure the fund "remains open to new ideas and independent thinking, while retaining adequate expertise. The policy must give consideration to whether directors have served on the Board for a period that could, or could reasonably be perceived to, materially interfere with their ability to act in the best interests of beneficiaries."[9]

Also in SPG 510 APRA sets out a number of governance principles. In relation to independence it says:

> "(D)emonstrated by a board that discharges its review and oversight role effectively and independent of the interests of dominant shareholders, management, and competing or conflicting business interests."[10]

AIST submits that APRA should remain true to these principles in providing guidance to the industry on independence of directors, or, if it should be given the powers to define key terms in the legislative definition, to take a principles-based approach that maintains the necessary flexibility to address sectoral needs within the industry.

Furthermore, **AIST submits** that consideration of material relationships should correlate with the potential of those relationships to materially interfere with the person's ability to exercise independent judgement. It

[9] Australian Prudential Regulation Authority, (2013), SPS 510: Prudential Standard– Governance, p. 4.

[10] Australian Prudential Regulation Authority, (2013), SPG 510: Prudential Practice Guide– Governance, p. 4.

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is not the relationship itself, but rather the nature of the relationship that should be considered. This approach will also more closely align with the CPS 510 requirements.

3.4 Meaning of independent – substantial holding – does not reflect varying structures

The term 'substantial holding' in the definition assumes that RSE licensees have a particular corporate structure. However, structures within the not-for-profit superannuation sector vary widely. An RSE licensee that is a public company limited by guarantee, for example, does not have substantial holdings vested in any person/s. Further, some funds have shares held by the directors from time-to-time, or under trust arrangements. This part of the proposed legislation would therefore require some RSE licensees to restructure. For example, it seems that it would no longer be permissible for shares to be held by the directors of an RSE licensee from time-to-time. AIST queries whether it is appropriate that restructuring should be required of RSE licensees by an indirect method such as this, and further queries whether there is evidence to suggest that structures of this nature are problematic.

In light of APRA's proposed power to define if someone is 'directly associated' with persons who have such a 'substantial holding' (clause 87(4)(a)), **AIST submits** that APRA should apply a flexible approach that recognises the different structures that exist in the not-for-profit sector.

3.5 Board committees – not in members' best interests

The proposed new independent trustee directors will have a significant workload should the changes proceed as suggested. Independent directors will be required to fill the following roles:

- One as Chair of the board
- One as Chair of the audit committee
- One as Chair of the remuneration committee
- Making up a majority membership of the audit committee
- Making up a majority membership of the remuneration committee

In the not-for-profit superannuation sector, we envisage that RSE licensees will maintain an equal representation model for the remaining two-thirds of the board that are not required to be independent directors. This is likely to result in board sizes of nine or 12 directors. On a board of nine, this will result in two independent directors (excluding the independent Chair of the board) sitting on both of the mandated committees, and Chairing at least one of these (with the existing requirement that these committees have at least three members).[11]

[11] SPS 510.36 and SPS 510.45

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In addition to their workload with the board, their mandatory committee commitments will reduce their capacity to take on other committee roles.

The proposed requirement for the independent directors to serve on these committees will result in a recruitment process where the skills to add value to those two committees will be specifically sought, rather than a broader determination of the necessary skills that can add value to the overall functioning of the board as a whole. **AIST submits** that the requirement for independent directors to serve on and Chair audit and remuneration committees will upset the skills matrices and succession plans of super funds, who have been diligently developing these since the introduction of SPS 510 and SPS 520 in July 2013. This requirement should be revisited. It is not in the best interests of members and beneficiaries that the recruitment of independent directors is focused solely on retired auditors and HR consultants, when a broader skills mix may be what is appropriate for an RSE licensee looking to strengthen its collective capacity.

Moreover, **AIST submits** that the conflicts that need to be avoided or carefully managed with audit and remuneration committees are principally concerned with the interests of executive directors. Not-for-profit super funds do not have executives of the RSE licensee as trustee directors; nor of a conflicted profit-making entity within the same corporate group. The same conflicts of interest do not apply.

AIST is also concerned that a majority independent director composition requirement on remuneration committees in the not-for-profit superannuation sector may lead to an increase in independent director fees. Self-interest and conflicts must be carefully managed, and **AIST submits** that a principles-based approach be adopted to the most appropriate committee composition, depending on the industry sector and their vastly different structures, stakeholder interests and real or perceived conflicts.

3.6 Appointment and removal processes – principles based approach needed

APRA has expressed its intention to amend SPS 510 to include processes for appointing and removing all directors, not just independent directors. This will include the process whereby candidate directors are nominated and their subsequent suitability for the role is assessed.

Paragraph 20 of SPS 510 already outlines the need for a board's renewal policy to "include the process for appointing and removing directors, including the factors that will determine when an existing director will be reappointed."[12]

Different sectors of the industry, and indeed, different funds within sectors, have diverse ownership structures and nominating processes for director roles. In some cases, directors are elected and not

[12] Australian Prudential Regulation Authority, (2013), Prudential Standard: SPS 510 Governance, p. 4.

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nominated for a director position. In the not-for-profit superannuation sector these elections can occur for employer or employee representative director roles. Any changes to SPS 510 by APRA must acknowledge and accommodate these differences.

Sponsoring organisations of superannuation funds have certain rights and powers under their trust deeds and constitutions that grant them a role in the director nomination (and sometimes appointment) process. Expanding the requirements of board renewal policies in SPS 510 with regard to a sponsoring organisation's existing rights and powers in this area should be pursued with great care.

With existing requirements around the management of conflicts of interest; the need for collective skills suitable for effective operation of the fund; and strict fitness and propriety requirements already in place in APRA's Prudential Standards, **AIST submits** that further direct intervention is unwarranted. **AIST submits** that additional principles-based guidance is a more appropriate mechanism to address any shortcomings APRA may have identified in existing board renewal policies.

3.7 Transition to the new arrangements – insufficient time may lead to loss of corporate knowledge

A transition period to the new governance arrangements of three years is proposed in the exposure draft legislation. This period appears to have been chosen to align with director terms under board renewal policies. AIST has found however that a significant number of its member funds have four-year terms (in some cases five-year terms), and the proposed transition period may therefore not allow them sufficient opportunity to rotate existing directors in a manner that is in the best interests of members or in line with existing contractual arrangements.

Some RSE licensees in the not-for-profit superannuation sector have multiple employer and employee group sponsors. The number of sponsors may in fact outnumber the optimal number of directors that a board should have, once a minimum one-third independent directors is factored in. While the existing arrangements for these funds are serving their members well, the proposed changes will change the balance of nominating rights if large board numbers are to be avoided. And while we dispute the need for board composition changes, **AIST submits** that, for these funds, a three-year transition period is far too short.

Also, as the proposed changes potentially require turnover of one-third of the board, including the Chair (AIST estimates that two-thirds of its membership may need to appoint a new Chair), we caution against the haste of transitioning in light of the potential risks. Board renewal policies were introduced from 1 July 2013 and for some funds this means that new directors have been recently appointed to their boards. Maintaining ongoing board effectiveness during the transition period, and in the years immediately following the transition, will prove challenging in these circumstances. The proposed changes will result in the loss of corporate memory and knowledge, and a shift in culture. The quality of decision-making may be impacted and **AIST submits** that this risk is contrary to the members' best interests.

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Risks arising out of the proposed changes will also impact on funds, members and the system as a whole. A transition that is too short could manifest itself in misunderstandings about the role of the trustee board, a lack of appreciation of the 'sole-purpose' test, excessive caution or excessive risk-taking. To manage these risks **AIST submits** that mandatory training and a transition schedule appropriate to the fund are appropriate. Previously when funds have moved to one-third independent directors in the past (in the case of HOST**PLUS** and MTAA Super), it was generally with a level of APRA scrutiny that will not be possible in this case.

AIST submits that the transition period for implementing the proposed changes is inadequate and that a five year transition period is more appropriate in the circumstances.

With regard to the impact on RSE licensees intending to cease operations before 1 July 2019, we submit that those RSE licensees attempting to merge during the transition period, who make all reasonable efforts, and act in good faith, should be exempted from the full consequences of non-compliance in the event that the merger fails just prior to the transition cut-off date. Such breaches should be judged on a case-by-case basis, and APRA should provide relief in genuine cases of best efforts made.

Similarly, those funds that make every effort to transition in accordance with an agreed transition plan, but fail for other reasons beyond their control, should similarly be reviewed on a case-by-case basis.

AST submits that the regulator be allowed to consider special circumstances for a failure to transition before 1 July 2019.

3.8 Transition plans – insufficient detail

As we do not have the complete reform proposal package available for comment, RSE licensees cannot begin to work on their transition plans until the full details are available. Whether existing directors or Chairs meet the criteria for independence will not be clear until 'material relationship' is defined. Where negotiations with multiple stakeholders are required, this will slow this process down. This may mean that a deadline of 1 July 2016 for a transition plan to be delivered to APRA may not be realistic. APRA's letter of intent indicates that it will require an assessment and plan for each individual director on the existing board. It is unreasonable to expect that this can be achieved within the timeframe, and AIST proposes that a transition plan containing details of the process to be undertaken, and the current status of individual directors, should be sufficient.

AIST submits that the transition plan due date be reviewed in the event that the full package of reforms is not available before the end of 2015. In any event, the requirements of the transition plan should be realistically achievable.

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4 Conclusion

AIST supports good governance practices in the superannuation industry, and the regulator's objective of continuous improvement. AIST has developed a Fund Governance Framework for the Not-for-Profit superannuation industry and trustee director-specific training courses to support premium governance practices in the industry.

However, AIST does not support structural changes that will not achieve better governance outcomes or improved results for members. AIST also supports a principles-based approach to reform as opposed to a prescriptive resolution to the Government's change intentions. Only a principles-based approach will allow for the necessary recognition of the distinct differences that exist between the not-for-profit and the for-profit retail sectors, and the variety of structures that abound within the not-for-profit sector itself.

AIST has identified some of the challenges that it perceives in the proposed reform package and has outlined these in this submission. However, without seeing the potential interplay of the proposed legislation and APRA's intended changes to the Prudential Standards, it is impossible to comment conclusively on the potential impact on AIST's member funds.

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