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# Superannuation Trustee Governance

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**Treasury**

**Australian Prudential Regulation Authority**

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## Executive Summary

This submission contains the Law Council's response to the:

- Exposure Draft Superannuation Legislation Amendment (Governance) Bill 2015: Governance arrangements for APRA regulated superannuation funds (the Bill);
- Exposure Draft Superannuation Legislation Amendment (Governance) Regulation 2015: Governance arrangements for APRA regulated superannuation funds; and
- APRA's proposals in its 26 June 2015 letter to RSE licensees.

It recommends:

- amending the Bill so that, consistent with the Explanatory Memorandum, it is clear that the independent chairperson is to be drawn from the independent directors, and is not additional to them;
- consideration be given to whether the Bill should merely include the new requirement for at least one-third of a board's directors to be independent with the balance of the board still being subject to the existing equal representation rules, rather than removing the equal representation requirements entirely;
- consideration be given to retaining the requirement for policy committees for employer plans within public offer funds as they provide an opportunity for members and employer-sponsors to provide their views to the trustee and for the trustee to meet with representatives of the members;
- amending the Bill to require an RSE licensee to form the view that a person is likely to be able to bring 'independent judgement' to the role of director, having regard to his/her associations and relationships, when appointing independent directors;
- reconsider the delegation of power to APRA to determine by prudential standard what constitutes 'direct association' or 'material relationship' on the basis that any associations or relationships that will qualify or disqualify a person from being an independent director should be included in the legislation – to leave this as a matter for the regulator is contrary to the rule of law;
- amending the Bill to narrow the scope of APRA's new powers:
  - under section 88 and 90, to determine that a person is 'independent from' or 'not independent from' an RSE licensee, so that APRA will be required to form any such opinion, based on relevant evidence, that a person is likely or unlikely to be able to exercise independent judgement;
  - under section 87(2) to disqualify a person from being independent of the RSE licensee because they do not meet any requirements of the prudential standards, to circumstances where the requirements are necessary to ensure the person is able to exercise independent judgement.
- extending the protection afforded by the new section 95 to conduct that may not be consistent with the RSE licensee's constitution;
- rather than deleting Regulations 13.16(2)(a)(ii) and (5) of the Superannuation Industry (Supervision) Regulations, those regulations should be modified so as to

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retain the power for any trustee to ask APRA to consent to an adverse alteration to a beneficiary's right or claim to accrued benefits (that do not relate to prescribed minimum benefits of members);

- that the proposal to amend SPS 510 to require that at least half of the members of a committee be independent directors be reconsidered, as the Act will require only a third of the RSE Board's directors to be independent, and the proposal could prevent the most qualified directors being appointed to board committees;
- that when drafting the prudential standards some flexibility be provided to accommodate different models for ensuring that directors of an RSE licensee are able to exercise independent judgement as board and committee members ; and
- in detail on the following points (refer *Additional comments on the independence test in section 87* of our Submission) concerning the proposed independence test contained in new section 87 of the Act:
  - Substantial holding;
  - RSE licensee constitutions;
  - Appointment of directors; and
  - Definition of independence
    - wholly owned service providers;
    - wholly owned investment vehicles;
    - 3 year look back provision.

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## Introduction

1. This submission has been prepared by the Law Council of Australia's Superannuation Committee, which is a committee of the Legal Practice Section of the Law Council (Committee). The objectives of the Superannuation Committee are to ensure that the law relating to superannuation in Australia is sound, equitable and clear. The Committee makes submissions and provides comments on the legal aspects of proposed legislation, circulars, policy papers and other regulatory instruments which affect superannuation funds.
2. The Law Council of Australia is the peak national representative body of the Australian legal profession and represents more than 60,000 legal practitioners nationwide. More information about the Law Council is at [Attachment A](#).

## Comments on Exposure Draft Bill

3. If the Exposure Draft Superannuation Legislation Amendment (Governance) Bill 2015: Governance arrangements for APRA regulated superannuation funds (the Bill) is enacted, it will remove the equal representation rules from the *Superannuation Industry (Supervision) Act 1993* (the Act). It will require one-third of the directors of a Registrable Superannuation Entity licensee (an RSE licensee) to be 'independent of the RSE licensee' and the chairman of the RSE licensee to be independent of the RSE licensee.
4. The same requirements will apply where the RSE licensee is a group of individual trustees. Directors of a corporate RSE licensee are considered below. Our comments apply equally to an RSE licensee that is a group of individual trustees.
5. Anecdotally, there is some confusion amongst industry participants as to whether the proposal is for one-third of the directors to be independent, plus an independent chairperson, or whether it is being proposed that one-third of directors should be independent, and that one of those independent directors should be the chairperson. The drafting should be clarified to make it clear that, consistently with the Explanatory Memorandum, the independent chairperson is to be drawn from the independent directors, and is not additional to them.

### **Composition of the board**

6. If the Bill is passed, the Act will no longer require the board of a trustee of a standard-employer sponsored fund to include any employer or member representative directors. This will create the possibility of two-thirds of a trustee board being comprised solely of, for example, employer representative directors or employee representative directors. We query whether this is the intention of the Government and, if not, whether the Bill should merely add the requirement for one-third of a board's directors to be independent of the existing equal representation rules.
7. The Bill and Regulations will also remove the requirement for trustees of public offer funds to establish policy committees for employer plans and attend a meeting of the policy committee at least annually. While policy committees have a limited role, they do provide an opportunity for members and employer-sponsors of public offer funds to provide their views to the trustee and for the trustee to meet with representatives of the members. We query whether there is merit in retaining the requirement for policy committees despite the equal representation rules being removed.

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### **Independent of the RSE licensee**

8. In order to work out whether a director (or a candidate to be a director) is independent of an RSE licensee, the RSE licensee will need to consider the new definition in section 87 of the Act. Under that section the RSE licensee will be required to form views about whether the director or candidate:
  - is 'directly associated with' a person who has a substantial holding in the RSE licensee or a member of the same group as the RSE licensee;
  - has a 'material relationship with', or is employed by an entity that has a 'material relationship' with the RSE licensee; or
  - has in the last 3 years been an executive officer or director of a body corporate that has, or has at any time in the last 3 years, a 'material relationship' with the RSE licensee.
9. While Part 9 is intended to bring directors who are able to exercise independent judgement to their role onto boards, the Part does not in fact require the RSE licensee to ask this question. Instead, the RSE licensee is required to make inquiries into the direct associations and material relationships of a candidate or director both of which may or may not be relevant to whether they will be able to in fact bring independent judgement to the role. We query whether the RSE, like APRA when it exercises its new powers under section 88 and 90, should be required, first, to ask whether the person is likely to be able to do so. In doing so, the legislation could require the RSE licensee to have regard to their associations and relationships.
10. Both the terms 'directly associated' and 'material relationship' leave a great deal of room for doubt and uncertainty. While the new section 87(4) of the Act will give APRA power to make prudential standards that specify when a person has a relevantly direct association or material relationship, it is unlikely that this will remove doubt or uncertainty except in specific cases that happen to be expressly considered in the prudential standard. The Committee considers that:
  - section 87(4) provides for a new power that should be exercised by government, and that any associations or relationships that will qualify or disqualify a person from being an independent director should be included in the legislation – to leave this as a matter for the regulator is in our view contrary to the rule of law; and
  - whether or not further detail about what amounts to a direct association or a material relationship is contained in legislation or prudential standards, that detail is unlikely to cover the full spectrum of associations and relationships.
11. The Committee suggests that a director should be deemed, for the purposes of the Act, to be independent of the RSE licensee if the RSE licensee is satisfied that the director does not have any relevant direct associations or material relationships that would prevent the director exercising independent judgement in performing the role of director. In exercising its power to determine that a particular person is or is not independent of the RSE licensee under the new section 88 of the Act, APRA will be required to determine whether it is 'reasonably satisfied' (our comments on this formulation are below) that the person is likely or unlikely to be able to exercise independent judgement. The Committee thinks that it would be appropriate for the RSE licensee to be able to determine whether a particular candidate or director is independent of the RSE licensee having regard to the same assessment. Given APRA's powers to determine that a person is not independent, it is difficult to see

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that there would be any mischief if this approach was also available to the RSE licensee. Moreover, this test appears to go to the heart of what it means to be 'independent' – the person's associations or relationships with the RSE licensee and its associates are merely examples of where they may not have the necessary independence.

12. We set out at the end of this submission further comments on the proposed requirements that an independent director not have a relevant association or material relationship.

### **APRA's powers to determine independence**

13. Under the proposed new sections 88 and 90, APRA will have the power to determine that a particular person is or is not independent of the RSE licensee if APRA is 'reasonably satisfied' that the person is likely or is unlikely to be able to exercise independent judgement in performing the role. This formulation is ambiguous. The Committee suspects that it is intended to require APRA to form its opinion on a reasonable basis, but the more natural reading is that it goes to the strength of APRA's opinion. The Committee does not think that it is appropriate for a director to be disqualified from being an independent director merely because APRA is 'reasonably satisfied' that the person is 'unlikely' to be able to exercise independent judgement. APRA should be required to form an opinion about the ability of a person to exercise independent judgement based on relevant evidence. We suggest that the provision be redrafted so that APRA is required to form the opinion, based on relevant evidence, that a person is unlikely to be able to exercise independent judgement.
14. Under the new section 87(2) APRA will also have the power to specify requirements which, if not met, will disqualify a person from being independent of the RSE licensee despite having no 'direct association' or 'material relationship' with the RSE licensee or a member of the same group. The Committee queries whether such a broad power is necessary and suggests that APRA's power under this section should be limited to circumstances where the requirements are necessary to ensure the person is able to exercise independent judgement.

### **Protection from breach**

15. The Bill includes a new section 95 which will provide that a person will not breach 'any provision of a trust deed or other rules which a regulated superannuation fund is administered' by complying with Part 9. The rules that apply to the appointment, removal and composition of a company board (including an RSE licensee) are usually contained in the company's constitution. This would not be a rule by which a superannuation fund is administered and therefore the new section will not protect a person from breach of the company's constitution. The Committee considers that it would be appropriate to extend the benefit of this protection to the company's constitution.
16. The Committee also notes that the SIS Act includes a definition in section 10 of 'governing rules' of a fund that includes the trust instrument and other rules governing the establishment or operation of the fund. We recommend that that term be used in the section although, again, the term governing rules is not broad enough to include the trustee's constitution and therefore the constitution should be expressly referred to.

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## Comments on Exposure Draft Regulations

17. The Exposure Draft Regulations include what are intended to be consequential amendments. They include the deletion of the regulations 13.16(2)(a)(ii) and (5). Regulation 13.16(2)(a)(ii) provides a trustee that has an equal representation board with the power to ask APRA to consent to the reduction of a beneficiary's right or claim to accrued benefits. By deleting these regulations, the only circumstances in which a trustee could approach APRA for consent would be with the approval of two thirds of the affected beneficiaries of the fund. The Committee thinks that, rather than removing this power, it may be appropriate to replace it with a power for any trustee to ask APRA to consent to an alteration to a beneficiary's right or claim to accrued benefits.
18. As a technical drafting point, proposed regulation 3.05 (voting to remove trustee of public offer entity) should refer to voting by 'members' rather than 'beneficiaries' to avoid any suggestion that non-member beneficiaries (e.g. spouses and dependent children) are entitled to vote on these resolutions. As drafted, each member would be entitled to one vote regardless of how high or low their account balance is. Notwithstanding intra fund consolidation, some members may have multiple accounts within the same fund and a question arises as to whether these members would have one vote for each account (or only one vote in total) and, equally, there is a question of what a trustee's position would be (or what the status of a resolution would be) if the trustee adopts the incorrect approach.

## Comments on APRA's proposal – SPS 510 and SPS 512

19. APRA proposes to amend SPS 510 and issue a new prudential standard SPS 512 that will apply during a 3 year transition period commencing on 1 July 2016.
20. In the section 'Proposed prudential requirements Definition of independence', APRA says that it will amend SPS 510 to 'supplement' the proposed definition of independence in the Act by substantially aligning SPS 510 with CPS 510 (that applies to banks and insurance companies). CPS 510 defines an 'independent director' as:

*a non-executive director who is free from any business or other association — including those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser — that could materially interfere with the exercise of their independent judgement. The circumstances that will not meet this test of independence include, but are not limited to, those set out in Attachment A.*
21. In assessing whether a director is free from any business or other association, the CPS focuses on relationships with the regulated entity. The Committee notes that whether a person is in fact able to exercise independent judgement will often turn on their competence and expertise and the other directors, rather than their association or relationship with the RSE licensee or a related company. These issues will go to the director's fitness and propriety. Consideration should be given to how these requirements will relate to the fit and proper person standard.
22. APRA also says that it proposes to amend SPS 510 to require an appropriate level of independence on the board committees with a proposal that at least half of the members of a committee be independent directors. The Committee notes that this is an odd requirement given the Act will require only a third of the directors to be independent. It also may prevent the most qualified directors being appointed to



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particular board committees and for this reason the Committee would recommend against this proposal.

23. The Committee would like to be able to comment on drafts of the proposed amendments to the prudential standards, but in the meantime notes that RSE licensees are not all the same and that there may be more than one model that ensures that directors of an RSE licensee are able to exercise independent judgement as board and committee members and that the prudential standards should allow for those differences.

## **Additional comments on the new independence test in section 87**

### Substantial holding

24. The 'substantial holding' provision will create unnecessary difficulties for trustees that are companies limited by guarantee, or that have constitutions that require all directors to hold shares in the company.

### RSE licensee constitutions

25. Despite the repeal of equal representation rules, many trustees will retain provisions in their constitutions which require the election of some directors by employers and some directors by members. It is possible that a trustee will not be able to meet its obligations under both the constitution and independent directors rules in the SIS Act. While the law can protect a director from breach of the constitution (insofar as a breach would be a breach of contract), the terms of the constitution may not provide any mechanism for appointing independent directors.
26. It would be helpful to give RSE licensees flexibility as to how they will comply with the new requirements. One approach would be to provide a statutory power (and obligation) for an RSE licensee to appoint independent directors to their existing board despite the terms of the constitution. This may result in boards comprising an increased number of directors. However, if there was an option for members and employers to elect directors who otherwise meet the definition of independence, this would allow the new requirements to be complied with, without necessarily causing an increase in board size.

### Appointment of directors

27. It is not clear from the draft Bill whether it is intended that a director appointed by a substantial shareholder of the RSE licensee, or by members or employers (or a body representing their interests) be disqualified from being treated as an independent director. The Committee does not think they should be disqualified merely because of the person who nominates or appoints them. The question should always be whether they can exercise independent judgement to the role as a director.

### Definition of independence – wholly owned service providers

28. Proposed section 87 precludes a person from being classified as an independent director if, in the preceding 3 years, they have been an officer or director of an entity which has had a material relationship with the RSE Licensee in the preceding 3 years. For example, if a person had recently held a board position with a service provider, they would not constitute an independent director.

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29. We query whether there should be an exception where the service provider (or the body corporate which has the material relationship with the RSE licensee) is wholly-owned by the RSE Licensee as a fund asset – in other words, where the fund and the service provider essentially operate as a ‘mutual’ arrangement. If an RSE Licensee wholly owns the service provider, we query whether the intention is to preclude the same persons serving as directors on both boards. As drafted, the proposed provisions would preclude a person from being treated as an independent director of the RSE Licensee if they also serve as a director on the board of a wholly owned service provider. Such a situation would not necessarily give rise to any conflict of duty, since the directors on the board of a solvent wholly-owned entity would be duty bound to act in the best interests of their sole shareholder, that being the RSE licensee in its capacity as trustee of the fund. In other words, the directors of a solvent wholly owned entity would have a duty to act in the best interests of the members of the fund which would be co-extensive with their duties as directors of the RSE licensee.

#### Definition of independence – wholly owned investment vehicles

30. Similarly, we query whether there should be an exception for cases where an RSE Licensee establishes a wholly owned entity to act as a holding vehicle for its investments. Technically, there would be a material (investment) relationship between the RSE Licensee and its holding vehicle. As such, any person who serves as a director on the board of the holding vehicle would be precluded from being treated as an independent director on the board of the RSE Licensee. We query whether such a prohibition is necessary.

#### Definition of independence – 3-year look back

31. The proposed drafting precludes a person from being an independent director if, in the previous 3 years, they have served as an officer or director of a body corporate that has had a material relationship with the RSE Licensee in the previous 3 years.
32. In some cases, the rationale for the 3 year look back is self-evident - for example, where an audit partner responsible for auditing an RSE Licensee leaves their audit firm and seeks appointment as a director of the RSE Licensee. However, if the material relationship between an RSE Licensee and a body corporate has been terminated, we query why an officer or director of that body corporate should in all cases be precluded from being treated as an independent director. For example, if an RSE Licensee has previously terminated the appointment of a particular investment manager or custodian, is there any reason why an officer of that service provider should be precluded from being classified as an independent director? Such a person would be unlikely to have any allegiance to the new incumbent service provider and indeed could well bring a helpful perspective to bear when monitoring the new incumbent service provider.
33. We also query whether the drafting should distinguish cases where the person was not an executive officer or director of the other company at any time while it was a service provider to the RSE Licensee. For example, if a person was a director of a body corporate until the end of 2014, and then retired, and then the body corporate was later appointed by the RSE licensee in 2015 to provide services, is there any reason why that person should be precluded from being treated as an independent director in all cases?

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## **Attachment A: Profile of the Law Council of Australia**

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The Law Council of Australia exists to represent the legal profession at the national level, to speak on behalf of its Constituent Bodies on national issues, and to promote the administration of justice, access to justice and general improvement of the law.

The Law Council advises governments, courts and federal agencies on ways in which the law and the justice system can be improved for the benefit of the community. The Law Council also represents the Australian legal profession overseas, and maintains close relationships with legal professional bodies throughout the world.

The Law Council was established in 1933, and represents 16 Australian State and Territory law societies and bar associations and the Large Law Firm Group, which are known collectively as the Council's Constituent Bodies. The Law Council's Constituent Bodies are:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia (formerly The Large Law Firm Group)
- The Victorian Bar Inc
- Western Australian Bar Association

Through this representation, the Law Council effectively acts on behalf of more than 60,000 lawyers across Australia.

The Law Council is governed by a board of 23 Directors – one from each of the constituent bodies and six elected Executive members. The Directors meet quarterly to set objectives, policy and priorities for the Law Council. Between the meetings of Directors, policies and governance responsibility for the Law Council is exercised by the elected Executive members, led by the President who normally serves a 12 month term. The Council's six Executive members are nominated and elected by the board of Directors.

Members of the 2015 Executive as at 1 July 2015 are:

- Mr Duncan McConnel, President
- Mr Stuart Clark, President-Elect
- Ms Fiona McLeod SC, Treasurer
- Mr Morry Bailes, Executive Member
- Vacant, Executive Member
- Vacant, Executive Member

The Secretariat serves the Law Council nationally and is based in Canberra.