

28 September 2017

Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Mr Fitt

Inquiry into the Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members have primary responsibility for developing and implementing governance and risk frameworks in public listed, unlisted and private companies. They are frequently those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). In listed companies, they have primary responsibility for dealing with the Australian Securities Exchange (ASX) and interpreting and implementing the Listing Rules. Our members have a thorough working knowledge of the *Corporations Act 2001* (the Corporations Act). We have drawn on their experience in our submission.

Governance Institute is a founding member of the ASX Corporate Governance Council, which develops and issues the Corporate Governance Principles and Recommendations (Principles and Recommendations). We have been involved in the drafting of all three editions as well as the amendments to the second edition (concerning diversity). The key principle underpinning the Principles and Recommendations is the 'if not, why not' model. This model is based on an understanding that governance cannot be a 'one-size-fits-all' approach and that if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it — a flexibility tempered by the requirement to explain why. The Principles and Recommendations have played a vital role in improving corporate governance in Australian listed companies since the release of the first edition in 2003. Their history is one of practical statements on governance which have brought meaningful change to governance practice and behaviour.

Governance Institute of Australia welcomes the opportunity to comment on the Superannuation laws Amendment (Strengthening Trustee Arrangements) Bill 2017 (the Bill).

Governance Institute has long advocated for reform of superannuation governance and has consistently supported moves to increase the number of independent directors on superannuation trustee boards. We have provided submissions to Treasury in response to the Financial System Inquiry Final Report and to the governance review commissioned by the

Australian Institute of Superannuation Trustees and Industry Super Australia led by former RBA Governor and Treasury Secretary Bernie Fraser (the Fraser Governance Review). We attach a copy of our submission to the Fraser Governance Review dated 1 February 2016 which contains our detailed comments on the questions which fed into the review concerning director independence.

Minimum of one third of directors to be independent

We note the aim of the Bill is to strengthen governance standards in superannuation by introducing minimum independence requirements for directors and requiring superannuation trustee boards to have at least one third independent directors and an independent chair.

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

The Principles and Recommendations recommend a majority of independent directors on the board and an independent chair. Similarly, APRA applies to banking and insurance institutions not only the factors relevant to an assessment of independence found in the Principles and Recommendations as a prescriptive definition of independence but also the recommendation that the majority of directors be independent directors and the chair also be independent.

As noted in the influential Higgs Report (that led to the revised UK corporate governance code and also influenced the first edition of the ASX Corporate Governance Council's Principles and Recommendations):

As the non-executive director does not report to the chief executive and is not involved in the day-to-day running of the business, they can bring fresh perspective and contribute more objectively in supporting, as well as constructively challenging and monitoring, the management team. ... Although they need to establish close relationships with the executives and be well-informed, all non-executive directors need to be independent of mind and willing and able to challenge, question and speak up. ... At least a proportion of non-executive directors also need to be independent in a stricter sense. There is natural potential for conflict between the interests of executive management and shareholders in the case of director remuneration, or audit (where decisions on the financial results can have a direct impact on remuneration), or indeed in a range of other instances. Although there is a legal duty on all directors to act in the best interests of the company, it has long been recognised that in itself this is insufficient to give full assurance that these potential conflicts will not impair objective board decision-making.

Less than a majority of independent directors on a board may be seen as tokenism. Any fewer than a majority would not have the capacity to influence decisions taken by management, given that the central premise of independence is that all directors should take decisions objectively in the interests of the organisation.

Representation of superannuation entity members through third parties introduces conflicts of interest, as the directors may have competing loyalties between the members of the superannuation entity to which they owe a primary duty and the organisations which they represent. Such situations present a risk, real or perceived, that directors may make decisions based on these external influences, rather than the best interests of members.

Governance Institute therefore recommends adoption of Option 2 outlined in the Explanatory Memorandum to the Bill, that the Government legislate for superannuation boards to have a

majority of independent directors with an independent chair with a five-year transitional period. We consider that this supports the Government's stated view that:

'...independent directors provide an external, dispassionate perspective, enabling boards to benefit from a diversity of views and provide a check on management recommendations. By being free from relationships that could materially interfere with their judgement, they can provide an objective assessment of issues.'

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

Definition of independent

We note the Bill contains a new definition of independent.

Governance Institute continues to advocate for a non-prescriptive approach to independence. We believe that a better solution is to take a principles based approach and establish a superannuation industry-led body to collectively develop guidance on governance matters, similar to that applying to listed companies under the ASX Corporate Governance Council's Principles and Recommendations.

While we note that the Principles and Recommendations need to be tailored to the superannuation environment, it is vital that they do not 'define' independence.

The Principles and Recommendations set out in Box 2.3 the 'factors relevant to assessing the independence of a director'. The factors are examples of interests, positions, associations and relationships that may raise doubts about independence and require consideration, but they do not prescribe a loss of independence. It is for each board to assess if a director is independent, applying the lenses set out in Box 2.3 to the assessment process.

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

As a founding member of the ASX Corporate Governance Council we have been closely involved in the development of the factors set out in Box 2.3. We are a strong supporter of assessing independence as a lens for judging director capability but we note that it is not the only indicator of director suitability or capacity. While independence of judgment may be affected by the factors set out in Box 2.3, it cannot be assumed that independence of judgment is lost if some of those factors are met. There are other important indicators of director capability — the independence of mind and the willingness and ability to challenge, question and speak up referred to in the extract from the Higgs Report referred to above as well as skills, experience and diversity. It would defeat the overall policy intent of the legislation if the governance reforms led to boards of directors which were technically independent, but lacked the essential skills, experience and diversity to be capable and effective directors.

Governance Institute recommends that any approach to independence for superannuation boards takes a similar approach and sets out criteria for assessing independence, rather than a definition of independence. That is, boards would need to examine interests, positions, associations and relationships that may raise doubts about independence and, should any of those indicators be met, explain to members why the board considers that the director retains independence. The trust of members is sought in such disclosures — it is expected that the board will have given rigorous consideration to whether each director is independent or not. Clearly, the potential for abuse of this trust exists if members do not have the right to elect or re-elect directors.

Governance Institute also recommends that the criteria for assessing independence found in the ASX Corporate Governance Council's Principles and Recommendations be adopted and applied.

Appointing independent directors

The consideration of governance needs to extend beyond the question of independence. Governance encompasses the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. It encompasses transparency, accountability, stewardship and integrity. A central question in governance, which goes to the heart of accountability and stewardship, is: Who are you beholden to? The representative model in superannuation funds — which generally does not provide for direct member representation, but rather third party representation — gives rise to this question, as the third parties are inevitably beholden to their nominating organisation.

Not-for-profit superannuation entity boards are typically comprised of an equal number of directors appointed by either an employee body (a union) or employer body or, in the case of public-sector funds, a state or federal government. A conflict of interest or duty of loyalty or a perceived conflict of interest or duty of loyalty may arise where a director is appointed to the board by such a sponsoring body. For example, a director may have in mind that they have been appointed to a superannuation entity to represent the interests of a particular union or industry body — they may be of the view that their appointment has been made in order to ensure they can control or influence, as well as monitor, the activities of the superannuation entity to which they have been appointed. Alternatively a director appointed to the board by a sponsoring body could be perceived to have been appointed in order to control and influence, even when the director is clear that they have been appointed to represent the best interests of the beneficiaries rather than those of the sponsoring body.

Governance Institute is strongly of the view that the key governance outcome from which questions of board composition and management of conflicts of interest flow is to aim for greater empowerment of members and greater accountability of directors to members.

As a matter of good governance, therefore, members should have a direct say in the governance of their superannuation fund. We note that NFP superannuation funds exist solely for the benefit of, and to protect the interests of, their members. If the actual governance framework is to match this desired governance framework, then the principal say in the governance of these funds should be in the hands of the members of the fund, not third parties representing them.

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

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

Like managed investment schemes, all members of a superannuation scheme, regardless of which class of member they are, should have voting rights proportional to the value of the member's interest in the scheme.

However, we are of the view that the decision-making (voting) should not be connected to a statutory annual general meeting (AGM).

Members could appoint directors and influence board composition via direct voting and on a poll, with a default of online voting.

Direct voting enables members to exercise their voting rights:

- without the need to attend meetings, and
- improves the exercise of voting rights because it removes the intermediary between the member and the entity — members are not required to transfer their right to vote to another party as currently happens with the appointment of a proxy.

Currently superannuation funds provide members with an annual report that is made available to members on the website of the fund. When the report is provided to members, a voting form with the biographies of nominated directors and explanations as to why they are considered independent or not could also be sent to members. The voting form could be provided electronically (with an opt-in to hard copy). There would be a requirement for superannuation funds to keep the polls open for a set period of time (for example, 28 days) and the poll results would be announced as soon as practicable after the polls close (to allow for a proper review to ensure validity of voting). Voting results would be open to public scrutiny.

Voting would be on the basis of the dollar value per vote, in similar fashion to managed investment schemes (MISs). Indeed, given that the regulatory framework is already in place for MISs, and given that there is not a great deal of difference between superannuation funds and other funds management businesses (the difference being that in superannuation members cannot access their funds until retirement), it creates efficiency to adapt an existing regulatory framework to the superannuation industry.

We note that voting rights should not differentiate between those in different phases of membership. While members in different phases may have different interests, all members should have the right to appoint the directors they believe will act in their best interests. We note, for example, that members of credit unions may be depositors or borrowers, but there is no differentiation in their right to vote. Equitable voting rights need to be provided, regardless of which phase a member may be in.

A focus on voting will encourage greater engagement on the part of members. While Governance Institute recognises that there is considerable apathy on the part of members in relation to engagement with their funds at present, we are of the view that this:

- will not be permanent — as members are empowered through the capacity to influence board composition they will seek further engagement, and as financial literacy projects in Australia are furthered, member interest in superannuation is likely to increase
- is not sufficient reason to refuse members the right to elect directors to act in their best interests.

It is not good governance to allow employers, unions or employer organisations, that is, those with conflicts of interests, to have control of the voting process (except to set up the necessary administrative and procedural aspects).

Therefore, employers, unions and employer organisations should not:

- vote
- control or manipulate the voting process
- set the rules without approval by members.

The rules concerning voting should be set out in the constitution of the superannuation fund and made available to members in an easily accessible corporate governance section of the website. Constitutional amendment should be subject to member approval. Elections could be run by the Australian Electoral Commission, which would impose uniformity and potentially reduce costs.

Governance Institute recommends that:

- members of superannuation entities should have the right to elect directors via direct voting, but that the decision-making (voting) should not be connected to a statutory meeting

- employers, unions and employer organisations should not vote, control the voting process or set the rules for voting without approval by members
- the rules concerning voting should be set out in the constitution of the superannuation fund and made available to members in an easily accessible corporate governance section of the website
- constitutional amendment should be subject to member approval.

Given the short time available for consultation there are several issues in the Bill on which we have not had the opportunity to consult fully with our members and we would be happy to provide a supplementary submission on the Bill. Governance Institute would also welcome the opportunity to be involved in further deliberations in relation to the Bill.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Burrell', with a stylized flourish at the end.

Steven Burrell
Chief Executive

Attachment: Submission to the Fraser Governance Review dated 1 February 2016