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Governance-driven reforms stir controversy in superannuation sector

By Michael Chaaya, Partner, and Jonathan Gardner, Lawyer, Corrs Chambers Westgarth

- New laws propose that the boards of all superannuation trustees to have a minimum one-third independent directors and an independent chair of the board.
- Non-compliance with the proposed laws enlivens a new power of APRA to direct the RSE licensee to comply with the laws, for which non-compliance will be an offence.
- New APRA prudential standards will supplement the bill and include a requirement to have the RSE licensee's Audit Committee and Remuneration Committee comprised of a minimum one-third independent directors with an independent chair.

Superannuation has long been an emotionally charged area of Australian political debate. The highest standards of governance, coupled with regulatory stability, are essential to maintain the public's confidence in a system which manages over \$2 trillion of retirement savings.

New laws aimed at bringing increased rigour to board oversight and decision-making proposed by the Federal Government to commence from the day of Royal Assent have reignited a highly polarised debate amongst the superannuation industry and the major political parties.

The laws will require the boards of all superannuation trustees to have a minimum one-third independent directors and an independent chair of the board. These reforms are broadly consistent with the government's intention to professionalise the broader financial services industry. APRA, as the primary superannuation regulator, is concurrently developing new prudential standards which will go even further than the government's proposed reforms.

Perennial reviews into Australia's superannuation system have consistently identified the skills, independence and capability of superannuation trustee directors as an area deserving of considerable reform.

Most recently, recommendation 13 of the Financial System Inquiry proposed:

Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.

The government acted quickly on that recommendation, commencing consultation on draft legislation to reform superannuation trustee governance in June 2015. Critics of the proposed laws argue superannuation is different — traditional models of corporate governance theory should not be applied in superannuation. Two common arguments are offered:

1. The legal duties directors of superannuation trustees face are far more stringent than those faced by directors in other industries. Specific additional duties under the *Superannuation Industry (Supervision) Act 1993* (Act) and APRA Prudential Standards apply. Further, as directors of a corporate trustee, the company's duties as a trustee must be considered along with the directors' own general law duties as part of the decision-making of superannuation trustee boards.
2. Empirical research suggests the significant number of profit-for-member 'industry funds', comprised equally of employer and employee board representatives, consistently achieve higher returns on a fee-adjusted basis than their for-profit counterparts with

their more traditionally structured boards. The agency based conflicts independent directors are thought to manage do not arise for industry superannuation funds as the interests of both the employer and employee representatives on the board are uniquely united in doing the best for their employees.

Is this a purely ideological reform or are critics misrepresenting the benefits of independence on superannuation boards? In this article we examine in detail the proposed Superannuation Legislation Amendment (Trustee Governance) Bill 2015 (bill) and draft APRA Prudential Standards before canvassing the political landscape and considering the likelihood of these reforms being implemented.

Legislative reforms

The changes will be made by repealing Part 9 of the Act (which currently provides various rules for the equal representation of employers and members of employer sponsored funds) and inserting a new Part 9 to take effect from Royal Assent. New s 86 of the Act will require a minimum one-third independent directors and an independent chair of the board of APRA-regulated superannuation trustees (RSE licensees). Existing RSE licensees will have three years to transition to the new arrangements.

A director will be 'independent' under s 87 of the Act if they:

- do not have a shareholding interest of more than five per cent in the RSE licensee or a body corporate related to the RSE licensee
- have not, in the last three years:
 - been an executive officer or employee of the RSE licensee
 - been a director or executive officer of a body corporate that is related to the RSE licensee
 - had a business relationship with the RSE licensee that was material to the RSE, or been a director, executive officer of a company with such a business relationship or an employee of that company who involved in that business relationship, or

- been a director or executive officer of:

- o a large employer-sponsor of the fund
- o an organisation representing employer-sponsors, or
- o an organisation representing the interests of members of the fund; or members that have the right to appoint or nominate directors of the RSE licensee, and

- are not a person prescribed by the regulations.

Non-compliance with the new Part 9 is not an offence (s 93(1)), however non-compliance enlivens a new power of APRA to direct the RSE licensee to comply with the Part (s 92(1)). Non-compliance with the APRA direction is a strict liability offence, which attracts a fine of 60 penalty units (s 92(4)). At the time of publication, one penalty unit is \$180, such that the fine for non-compliance may be up to \$10,800. Any casual vacancies which cause the board to no longer satisfy the one-third independence requirement must be rectified within 120 days (s 91).

New APRA prudential standards

Draft prudential standards and practice guides released by APRA for consultation provide considerable detail on APRA's plan to supplement the bill. APRA expects its prudential standards and prudential practice guides to commence immediately upon their registration. Accordingly, understanding the changes proposed in draft prudential standard SPS 510 *Governance* and SPS 512 *Governance Transition* is crucial for industry. We have extracted the key components of each instrument in Table 1.

The timing for compliance with SPS 510 *Governance* is explained in SPS 512 *Governance Transition* as follows:

- **Date of registration:** New governance requirements commence in SPS 510 and SPS 512.
- **1 July 2016:** RSE licensees to complete preliminary assessment.

- **1 January 2017:** Transition or exit plan (as applicable) to be submitted to APRA.
- **Royal Assent + three years:** All RSE licensee boards must comply with the new governance requirements or have exited the industry.

While APRA has not published formal amendment to the draft Prudential Standards outlined in Table 1, it has indicated its intention to require that RSE licensees:

- establish a policy to determine the materiality threshold for when a director has, or has had, a 'material business relationship' with the RSE licensee. This policy will then be applied to determine the independence of current or potential directors, and
- where a director or executive officer of a large employer sponsor is appointed as an independent director, to assess whether changes to the number of employees of a large employee sponsor affect that director's independence.

Political landscape and commencement

Debate on the bill has largely split along partisan lines. Introducing the bill the then Assistant Treasurer Josh Frydenberg said:

'Independent board members bring different skills and expertise and they hold other directors accountable for their conduct, particularly in relation to conflicts of interest. In this regard, superannuation is lagging behind other corporate sectors, including listed companies, banks, and life and general insurers, who all, at a minimum, either have or are recommended to have a majority of independent directors with an independent chair.'

The federal Opposition has indicated it will not be supporting the bill. Shadow Minister for Financial Services and Superannuation Jim Chalmers has argued the following:

- 'The Bill represents nothing more than a change to our superannuation system, which is badly motivated, ideologically driven and unwarranted.'
- 'We will be opposing all of these amendments to the Act for these five reasons: one, there is no evidence

Table 1: Key components of APRA's governance reforms

Instrument	Significant items
SPS 510 <i>Governance</i>	<ul style="list-style-type: none"> • SPS 510 will be aligned with equivalent provisions applying to authorised deposit taking institutions and insurers under Prudential Standard CPS 510 <i>Governance</i>. • APRA will require RSE licensees to put in place a formal governance framework, which must include a formal policy regarding board size and composition and nomination, appointment and removal processes. • At least one third of the members of both the Board Audit Committee and Board Remuneration Committee must be independent directors. • The chair of both the Board Audit Committee and Board Remuneration Committee must be an independent director. The chair of the Board cannot also act as the chair of the Audit Committee. • The Board's independence is to be assessed annually.
SPG 510 <i>Governance</i>	<ul style="list-style-type: none"> • Expands on existing guidance relating to board renewal, and provides guidance related to the nomination, appointment and removal of directors. • Considerations for RSE licensees seeking to appoint new directors, including their independence and fit and proper policies.
SPS 512 <i>Governance Transition</i>	<ul style="list-style-type: none"> • That all RSE licensees undertake a preliminary assessment of the extent to which their governance arrangements comply with the new governance requirements. • To notify APRA whether the RSE licensee complies, intends to comply or intends to cease operating by the end of the transition period. • To develop a transition plan to address the key changes required to the RSE licensee's governance and risk management frameworks to ensure compliance by the end of the transition period.
SPG 512 <i>Governance Transition</i>	<ul style="list-style-type: none"> • SPG 512 expands on the types of actions that a transitioning RSE licensee may need to undertake in order to comply with the new governance requirements by the end of the transition period, including some examples of the types of impediments that an RSE licensee may face.

in favour of independent directors; two, the current representative model is working well...three, there are governance safeguards in place already; four, the proposed changes are overly prescriptive; and, five, the amendments will cost millions of dollars for fund members.'

- 'When it comes to no evidence for independence, the Government has not been able to stack up the claim that maintaining independent directors on not-for-profit superannuation funds would improve fund performance.'

It is unclear whether the government has the numbers in the Senate to secure passage of the bill. Industry groups are increasingly rejecting the government's approach of black-letter law reform to superannuation governance, instead preferring a principles-based, industry-

led, approach, similar to the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*.

Unless the government is able to obtain the support of the minor parties in the Senate, not to mention the broad support of industry groups, it is doubtful whether these reforms will be successfully implemented. However, it remains to be seen whether APRA, in the absence of government reforms, will nevertheless press ahead with its own reform of trustee governance. With APRA targeting an 'end-2015' for implementation of its own reforms, further developments from APRA could present an interesting quagmire for the government and industry. Amendments to superannuation governance will certainly be a theme to watch in 2016. ■

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