



**Australian Government**

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**The Treasury**

# **Regulation Impact Statement: Superannuation Governance**

September 2015

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ISBN 978-0-642-74992-5

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## BACKGROUND

The size of the superannuation savings pool in Australia is currently \$2.05 trillion<sup>1</sup> and is expected to grow to approximately [\$9] trillion by 2040.<sup>2</sup> While compulsory superannuation has been in existence since 1992, its significance in Australia's financial system has increased rapidly in recent years as the pool of savings continues to grow and questions about its efficiency are raised in broader economic discussions.

The Australian Prudential Regulation Authority (APRA) has prudential oversight of the superannuation system along with the Australian Securities and Investments Commission (ASIC) which regulates the conduct and disclosure obligations of financial services providers (including superannuation trustees that hold an Australian financial services licence). The Australian Taxation Office has responsibility for the oversight of self managed superannuation funds (SMSFs).

In its superannuation statistical data, APRA groups superannuation funds into several categories: corporate (38 funds), retail (147 funds), public sector (19 funds), industry (not-for-profit) (44 funds) and small (550,706 funds).<sup>3</sup> Superannuation funds are generally regulated by both the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and the *Corporations Act 2001* (and related regulations, along with APRA prudential standards).<sup>4</sup>

In 2009, a review was commissioned to examine and analyse the governance, efficiency, structure and operation of Australia's superannuation system, which was led by Jeremy Cooper (the Cooper Review). It specifically examined both compulsory and voluntary aspects of superannuation and the governance, efficiency, structure and operation of the system. The Cooper Review was aimed at boosting the retirement savings of all Australians by increasing efficiencies, reducing costs and fees and in turn lifting long-term rates of return.

The Cooper Review recommended that the SIS Act be amended so that it is no longer mandatory for trustee boards to maintain equal representation in selecting its directors. The Cooper Review also noted that the presence of independent directors on boards is best practice in corporate governance.<sup>5</sup>

In September 2013, the then Opposition committed to improve governance in superannuation through the appropriate provision of independent directors on superannuation trustee boards.<sup>6</sup>

In 2014, the Financial System Inquiry (the Murray Inquiry) in its Final Report recommended mandating a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair.

The Murray Inquiry noted that 'including independent directors on boards is consistent with international best practice' and that independent directors 'improve decision making by bringing an objective perspective to issues' and 'hold other directors accountable for their conduct'.

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1 APRA Quarterly Superannuation Performance March 2015.

2 The Financial System Inquiry, p 2-84 July 2014.

3 Small funds include self-managed superannuation funds. APRA Quarterly Superannuation Performance March 2015.

4 The Australian Taxation Office also plays a role in the administration of self-managed superannuation funds.

5 Cooper Review, p 55.

6 In general terms, governance refers to the system of rules, practices and processes by which a company is directed and controlled.

# 1. THE PROBLEM

The Government is seeking to deliver on its superannuation governance election commitment (election commitment) to align governance in superannuation more closely with the corporate governance principles applicable to ASX listed companies. In particular, the government is seeking to increase the level of independence in superannuation funds to ensure improved member outcomes, while minimising the costs to the superannuation industry.

The Cooper Report and the Murray Inquiry into the Financial System both concluded after their consultations with the superannuation industry representatives that superannuation funds would benefit from having independent directors. In particular, the Murray Inquiry identified overseas research, which suggested, “good governance adds one percentage point to pension fund returns.”<sup>7</sup> The superannuation industry representative have also indicated that stronger board performance, which could be achieved through increased independence, can have a direct impact on the returns superannuation funds achieve for their members.

Currently, it is estimated that of only 49 per cent of industry, corporate and public sector funds have one or more independent directors (leaving 51 per cent of funds without any independent directors). Considering the current average board size of these particular funds is estimated to be nine members it can be concluded that independence is lacking across these superannuation funds.

In a 2015 report by Australian Institute of Company Directors, which considered the views of 100 Chairs covering organisations in the publicly listed, private, not-for-profit and public sectors, consideration was given to the factors that were required for good governance. The report indicated that the past focus on structural aspects of governance has not helped reduce the occurrence of corporate errors, omissions and malfeasance. Instead it was considered that the critical factors required for ensuring good governance were trust; independence of mind; and diversity of worldview.

In this regard, independence of mind and responsibility are at the core of the case for independence. Current APRA guidance references a number of key principles underpinning a sound and effective governance framework for superannuation boards one of which is ‘responsibility – the board of directors is ultimately responsible and accountable for the decisions and actions taken by an RSE licensee’.

Included among the SIS Act covenants required to be included in the governing rules of superannuation trustees, are covenants to:

- perform the trustee’s duties and exercise the trustee’s powers in the best interests of the members;
- exercise the same degree of care, skill and diligence as a prudent superannuation trustee (or prudent superannuation entity director) would exercise in relation to an entity of which it is the trustee and on behalf of the members;
- act fairly in dealing with classes (or members in a class) of members; and
- act honestly in all matters concerning the entity.

These covenants are aimed at ensuring superannuation boards and directors act responsibly.

Historically, superannuation boards have generally acted in the best interests of their members in line the above covenants, irrespective of whether they have one or more independent directors. However,

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<sup>7</sup> Financial System Inquiry Final Report, Chapter Two; Governance of Superannuation Funds

this is not always the case. In this regard, in 2009, Trio Capital collapsed, leaving around 6,100 investors with losses amounting to \$176 million. The majority of the loss was due to the failure to not fully investigate the accuracy of falsified valuations and fictitious returns in overseas hedge funds, as well as failure to adequately investigate the risks associated with the investment. APRA reviewed governance failings within Trio Capital, and identified a lack of independent directors in the Trio Capital funds, which were APRA regulated superannuation funds.

The liquidator of the failed Trio Capital entities concluded that the directors did not take reasonable steps to ensure that Trio was complying with its obligations as responsible entity, did not exercise appropriate duty of care as officers, did not act in the best interests of [the managed investment scheme into which the Trio Capital superannuation funds had invested], and did not comply with statutory and fiduciary responsibilities to avoid conflicts of interest.

It is also important to note that APRA has on occasion disqualified directors under section 120A(2) of the SIS Act.. Some of the decisions to disqualify directors have been made because APRA formed the view that the director failed to exercise a reasonable degree of care and diligence in ensuring that RSE licensee carried out its duties under the SIS Act.

On 25 August 2015, in an Australian Financial Review article the link between improved independence and improved decision making through the context of the Murray Inquiry was clearly captured.

*Financial system inquiry head David Murray said independent directors were "more likely to ask the right questions" if a board needed to pit hard-nosed economic decisions against ideology... funds should have a majority of independent directors and an independent chair. "The point about independent directors is that they can examine in a dispassionate way if policies are in the interests of members or for other reasons,"... "That is very helpful. Independent directors are more likely to ask the right questions of where the interests of members lie, if there are enough of them."<sup>8</sup>*

Increasing independence can also be seen to bring diversity in worldview to a board's decision making processes. A diverse worldview enables the decision making processes of superannuation boards to be tested and challenged in a way that achieves beneficial member outcomes and feeds back into the above covenants.

However, the current equal representation model, which has existed since 1993, significantly affects the current the level of independence of mind and diversity of worldview obtained through the inclusion of definition of an independent director as currently defined in section 10 of the SIS Act.

Section 10 provides that an "independent director " , in relation to a corporate trustee of a fund, means a director of the corporate trustee who:

- is not a member of the fund; and
- is neither an employer-sponsor of the fund nor an associate of such an employer-sponsor; and
- is neither an employee of an employer-sponsor of the fund nor an employee of an associate of such an employer-sponsor; and
- is not, in any capacity, a representative of a trade union, or other organisation, representing the interests of one or more members of the fund; and

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<sup>8</sup> Australian Financial Review, Australia, Joanna Mather and Sally Patten, 25 Aug 2015.

- is not, in any capacity, a representative of an organisation representing the interests of one or more employer-sponsors of the fund.

Equal representation as currently contained in the SIS Act prevents changes to the number of independent directors on some superannuation trustee boards.<sup>9</sup> Under the SIS Act, funds operating under the equal representation model are only able to appoint one independent director. In practice however, funds have the ability to apply to APRA to appoint more than one independent director.<sup>10</sup> Not-for-profit funds and corporate funds typically operate under equal representation arrangements, although some have an independent director on the Board.

In contrast to directors representing employers or employees under the equal representation model independent directors are free of the types of conflicts that may cause them to deliberately or unconsciously serve the interests of a related party or a subset of members, rather than the fund's entire membership.

Independent directors of superannuation funds are not influenced by:

- parent companies, such as an insurance company or bank;
- sponsoring organisations, such as a union or employer organisation;
- service providers, such as an administrator; or
- subsets of the membership of the fund, such as those fund members who are also a member of the sponsoring union.

The Murray Inquiry also indicated that the equal representation model is less relevant in the current superannuation system, which predominantly consists of public offer accumulation funds and funds less focused on single employers.

*'fund members exercise choice, directors appointed by employer and employee groups are less likely to represent the broader membership of public offer funds (see Recommendation 12: Choice of fund). Given the diversity of fund membership, it is more important for directors to be independent, skilled and accountable than representative.'*

Given the importance of independence of mind and diversity of worldview as expressed by Chairs, under the SIS Act and eminent academics, increasing independence is key to improving governance in the superannuation system, thus improving member outcomes.

## **THE SITUATION THE GOVERNMENT'S ELECTION COMMITMENT IS ADDRESSING**

Superannuation funds regulated by APRA are structured with trustee arrangements—there is a separation between members and trustees, with trustees managing funds on behalf of members.

A longstanding feature of the superannuation governance framework is the requirement for some superannuation trustee boards to have equal representation (typically not-for-profit and corporate

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<sup>9</sup> At June 2013, 68 per cent (103 of 151) of registrable superannuation entity (RSE) licensees had an equal representation board structure.

<sup>10</sup> For example, the Industry Super Australia submission noted that out of a sample of 26 industry superannuation funds, 16 of the funds already have at least one independent director on their board. Of these, the majority of funds (11) had one independent director and the remaining five more than one independent director.

funds).<sup>11</sup> This reflects the position adopted with the commencement of occupational superannuation, that members should have a greater voice through representation on non - public offer funds (industry, corporate and public sector). Equal representation allowed both stakeholder groups (employers and employees) to have oversight and responsibility for funds' operations.

Most APRA-regulated funds are public offer funds, which also receive contributions from standard employer sponsors; that is, some members may choose to join the fund by direct arrangement with the trustee, while others join because of an arrangement between their employer and the trustee. In those cases, there may be an independent trustee, but for certain groups of members drawn from a single employer, the trustee must have in place advisory policy committees that must comprise equal representation of the both the employer sponsor and that group of members. Policy committees are not required in cases where the trustee board has equal representation.

The Cooper Review examined the equal representation model and found that although it was an important part of the governance structure twenty years ago, 'changes in the industry over time and certain implementation practices mean that equal representation no longer seems to achieve its original ... objective'.<sup>12</sup> In addition, the Cooper Review articulated the issues with governance in superannuation in these terms:

*'Trustee governance structures have not kept up with developments in the industry. There have also been difficulties for trustees and their trustee-directors in understanding what is expected of them and, as the industry consolidates, conflicts of interest and conflicts of duty arise regularly. Good trustee governance is fundamental to enhancing members' retirement incomes.'*<sup>13</sup>

The Cooper Review recommended that the SIS Act be amended so that it is no longer mandatory for trustee boards to maintain equal representation in selecting its directors. The Cooper Review also noted that the presence of independent directors on boards is best practice in corporate governance.<sup>14</sup>

In 2014, the Murray Inquiry, in its Final Report, recommended mandating a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair. The Murray Inquiry noted that 'including independent directors on boards is consistent with international best practice' and that independent directors 'improve decision making by bringing an objective perspective to issues' and 'hold other directors accountable for their conduct'<sup>15</sup>.

In addition, there is currently an inconsistency in the governance frameworks (including self-governing guidelines) on the number of independent directors and the definitions of independence between retail and not-for-profit superannuation fund boards.

For example, Financial Services Council (FSC) member entities (retail funds) have no restrictions in appointing independent directors and from 1 July 2014, are required, under FSC's self-governing standard, to have a majority of independent directors and an independent chair.

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11 Not-for-profit funds include industry, corporate and public sector funds. These funds are generally affiliated with either the public sector, individual corporations, trade unions or employer representatives and have an equal number of employer and employee representatives on a trustee board. Retail funds are generally run for profit and are affiliated with banks or other financial institutions. Retail funds have significantly more choice investment options than non-retail funds. In general terms, equal representation means that the board of a corporate trustee must consist of equal numbers of employer representatives and member representatives.

12 Cooper Review, p 53.

13 Cooper Review, p 43.

14 Cooper Review, p 55.

15 Financial System Inquiry, page 134 of the Final Report, November 2014



## 2. THE CASE FOR GOVERNMENT ACTION

Given superannuation funds are expected to increase in significance and size, Australia's superannuation governance framework must be strengthened to ensure a stable and efficient system that improves the wellbeing of all Australians.

In this regard, strong governance arrangements ensure that fund members' interests are paramount in the minds of trustees. The trustee (and its directors) has fiduciary obligations to members and beneficiaries, which require taking ultimate responsibility for the fund and an obligation to manage the assets of the fund with competence, diligence, prudence and honesty.

In September 2013, the then Opposition published *The Coalition's Policy for Superannuation* in which it committed to improving standards and better management of conflicts of interest by aligning corporate governance in superannuation more closely with the corporate governance principles applicable to ASX listed companies. The Coalition committed to improving superannuation governance by ensuring that there is an appropriate provision for independent directors on superannuation fund boards. The Coalition also noted that the Cooper Review questioned the financial expertise and professionalism of union and employer trustees appointed to superannuation boards through the 'equal representation model.'

The Government's election commitment seeks to build on recent reforms, which were designed to ensure that the superannuation system is primarily focused on operating in members' best interests.<sup>16</sup>

On 28 November 2013, the Government released the *Better regulation and governance, enhanced transparency and improved competition in superannuation* discussion paper to consult on its superannuation election commitments. The discussion paper provided stakeholders with an opportunity to comment on possible reforms to governance regulations and the outcomes of that consultation are reflected in the analysis of options in this statement.

The analysis in this statement is mindful of the need for an appropriate regulatory framework for the superannuation system as a whole, one that protects the interests of members, supports the efficient allocation of savings and one that is not overly burdensome and costly to administer.

### OBJECTIVES OF GOVERNMENT ACTION

The Government through its election commitment is seeking to ensure that superannuation fund boards have increased levels of independence, as having appropriate provision of independent directors on superannuation trustee boards is seen as a vital step towards strengthening the superannuation system.

In particular, the Government considers that independent directors provide an external, dispassionate perspective, enabling boards to benefit from a diversity of views and provide a check on management

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<sup>16</sup> 'Best interests' are defined by the sole purpose test in the *Superannuation Industry (Supervision) Act 1993*, which focuses on maximising post-retirement benefits. The trustee's ability to form a fund strategy that generates good long-term returns, while operating within reasonable risk bounds, is a critical element in serving members' best interests. In general, a trustee is a person or company (corporate trustee) appointed under the terms of the trust deed to hold the trust property for the beneficiaries and to make sure that the plan is operated in accordance with the trust deed. Generally, trustees owe a fiduciary duty to the beneficiaries. Superannuation trustees must also comply with certain legislative duties.

recommendations. By being free from relationships that could materially interfere with their judgment, they can provide an objective assessment of issues.

The objective of the Government's election commitment is to:

- set a minimum standard, in terms of the number of independent directors on superannuation trustee boards, to promote good governance through the broadening a superannuation fund board's pool of experience and expertise. In addition, independent directors allow for an increased accountability of decisions made by other directors who may have conflicting interests.
  - A 2010 Regnan Research Report notes that the 'empirical research from Australia and overseas lends support to the hypothesis that board independence and diversity ... translate into better business performance'.<sup>17</sup>
- have a common definition of 'independence' to minimise any ambiguity for the superannuation industry by ensuring that all APRA-regulated superannuation funds have the same requirements for determining whether a director is independent. The intent is for the definition of independence to be based on ASX principles, but adapted to the superannuation context.

The Government's election commitment of ensuring appropriate provision of independent directors on superannuation trustee boards is consistent with both the Cooper Review's and Murray Inquiry's recommendations (noting that the proposed Government action is not as far reaching as proposed by the Murray Inquiry) on corporate governance frameworks and international best practice.

- Both the Cooper Review and the Murray Inquiry have recommended increasing independent directors on super fund boards. APRA requires a majority of independent directors for its other regulated entities banks and life insurance companies.
- The ASX Corporate Governance Council's Corporate Governance Principles recommend, on an 'if not, why not' basis, that Australian listed companies have a majority of independent directors and an independent chair.

To progress the Government's election commitments and provide the superannuation industry with the necessary certainty and sufficient time to implement the new requirements, the Government is working towards introducing legislation into Parliament in the 2015 Spring sittings.

## International comparisons

In Canada, it is recommended that the board of directors of every corporation should be constituted with a majority of individuals who qualify as unrelated directors.<sup>18</sup> In addition, the United Kingdom Corporate Governance Code recommends that at least half the board should comprise non-executive directors determined by the board to be independent.<sup>19</sup> As a result, 48 per cent of United Kingdom pension schemes have at least one independent trustee.<sup>20</sup>

In addition, from 6 April 2015, firms in the UK that operate group personal pension schemes or group stakeholder pension schemes have been required to set up an Independent Governance Committee (IGC) (or equivalent). It is intended that IGCs will raise an independent challenge to the providers of schemes on value for money issues. The UK Government sees this as a complement to its automatic

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<sup>17</sup> October 2010 [http://www.regnan.com.au/documents/Regnan Research Report.pdf](http://www.regnan.com.au/documents/Regnan%20Research%20Report.pdf)

<sup>18</sup> Toronto Stock Exchange: *Corporate governance — A guide to good disclosure*.

<sup>19</sup> Financial Reporting Council (September 2012): *The UK Corporate Governance Code*.

<sup>20</sup> Pensions Governance Survey 2013 (Mercer).

enrolment policy of employees into workplace pension schemes, which began in July 2012.

In New Zealand, an independent trustee is a requirement for some KiwiSaver Funds (i.e. non-default KiwiSaver schemes). Amongst other things, independence requires that the trustee is not connected with a promoter of the scheme. The New Zealand *Superannuation Schemes Act 1989* does not have this independent trustee requirement and, therefore, non-KiwiSaver superannuation schemes (including complying schemes) have no qualification requirements attached to the role of the trustee.

KiwiSaver was regulated differently from other superannuation funds and managed funds because KiwiSaver was intended to be a long-term savings vehicle, with funds locked in until (in most cases) the age of eligibility for NZ superannuation.

In summary:

- In Canada, multi-employer plans established pursuant to a collective agreement are governed by a board of trustees composed in accordance with the plan or collective agreement (typically equal representation – that is, that the board of a corporate trustee must consist of equal numbers of employer representatives and member representatives).
- In the United States, multi-employer (Taft-Hartley) funds must have equal representation of employers and employees.
- In the United Kingdom, at least one third of trustees must be member-nominated.

It is worth noting that a corollary of the Australian Government's policy still allows representation of employer and employee groups on superannuation boards. The composition of superannuation trustee boards, beyond the one-third independent directors prescribed, will remain at the discretion of the board (subject to any requirements set out in the constitution of the trustee and to the overarching legal requirement that board members are fit and proper and that boards have an appropriate skill mix).

This leaves open the ability for trustees to choose to enshrine equal representation (or voting rules in their constitutions). This outcome is consistent with representation on superannuation boards across Canada, the United States and the United Kingdom.

## **3. POLICY OPTIONS**

### **3.1. SUMMARY OF THE RECOMMENDED OPTIONS**

In recognition of the extensive work undertaken in the Cooper Review and the Murray Inquiry, as outlined above, the following two options were considered to best implement the Government's election commitment to ensure the appropriate provision of independent directors on superannuation trustee boards:

- Option 1: Legislate for a minimum one-third of directors to be 'independent' with an independent chair, with funds reporting whether they have a majority of independent directors and if they do not, disclosing why not (that is, on an 'if not, why not' reporting basis). This option includes a three-year transitional period; or
- Option 2: Legislate for a majority of independent directors with an independent chair, with a five year transitional period (consistent with the Murray Inquiry).

As a result of the cost implications of legislating for a majority of independent directors, the Government has decided that legislating one-third independent directors, including an independent chair, strikes an appropriate balance while still substantially strengthening governance arrangements.

### **3.2. DETAILED DISCUSSION OF THE OPTIONS TO DELIVER ON THE GOVERNMENT'S ELECTION COMMITMENT**

*Option 1 (Proposed): Legislate for a minimum one third of directors to be 'independent' with an independent chair, with funds reporting whether they have a majority of independent directors and if they do not, disclosing why not (that is, on an 'if not, why not' reporting basis). This option includes a three-year transitional period.*

This option involves mandating that a minimum one third of directors on superannuation fund boards be 'independent' with an independent chair, with an aim for a majority independent directors on an 'if not, why not' reporting basis (funds must disclose why they do not have a majority of independent directors). The 'if not, why not' basis is consistent with the approach adopted in the ASX principles for listed companies.

This option would allow the equal representation model to continue in a modified form. Boards could have the remaining two thirds split between member and employer representatives. This may result in some superannuation trustee boards incurring costs and increasing in size slightly. Costs associated with appointing at least one third of independent directors include search and ongoing remuneration costs, as well as requirements to change trust deeds. There would also likely be increased compliance costs associated with appointing and remunerating the additional independent directors.

A transitional period of three years would minimise compliance costs, allowing existing directors to leave and new directors be appointed in an orderly fashion. Typical board appointments are for terms of three years. Given that compliance costs increase with the number of independent directors, this option is the preferred option in meeting the Government's objective of improving superannuation governance.

Some submissions to the Government's discussion paper *Better regulation and governance, enhanced transparency and improved competition in superannuation* considered that an option that required up to one-third of independent directors over an appropriate transition period would meet the Government's objective of improving governance while considering the compliance costs on superannuation funds. The recommended governance option is estimated to cost the superannuation industry \$12.3 million per year in ongoing costs and \$8.5 million in start-up costs.

*Option 2: Legislate for a majority of independent directors with an independent chair, with a five year transitional period.*

This option involves mandating that a majority of directors be independent, which is consistent with the requirement imposed on the banking and insurance industries by the APRA. This option is stronger than the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations (ASX principles), which recommend a majority of independent directors on an 'if not, why not' basis. This option is also consistent with, but broader than, the Murray Inquiry's recommendation mandating a majority of independent directors and an independent chair on the board of corporate trustees of public offer superannuation funds only.

Compared to option 1, a longer transitional period of five years would help reduce compliance costs and allow existing directors to leave and new directors be appointed in a more orderly manner.

The Murray Inquiry recommended mandating a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair. This option

is consistent with the Inquiry's recommendation. The Inquiry notes in its Final Report (page 134) that 'including independent directors on boards is consistent with international best practice' and that independent directors 'improve decision making by bringing an objective perspective to issues' and 'hold other directors accountable for their conduct'.

However, this option would result in some superannuation funds (not for profit funds) being required to change their board composition markedly. There would be compliance costs associated with appointing a majority of independent directors (including search and ongoing remuneration costs, as well as requirements to change trust deeds). This option could likely result in an overall increase in the size of boards for many funds with increased compliance costs associated with appointing and remunerating the additional independent directors.

Some submissions, particularly from the retail superannuation fund sector, considered a requirement for a majority of independent directors over an appropriate transition period would meet the Government's objective of improving governance while considering the compliance costs on superannuation funds. One submission noted that a requirement for majority independent directors was inevitable for superannuation given this is the standard for other APRA-regulated entities in the finance and insurance sector. The ongoing costs per year for option 2 are estimated to be around \$23.3 million per year and start-up costs are estimated to be around \$ 10.5 million.

**THE OPTIONS FOR IMPROVEMENTS TO SUPERANNUATION GOVERNANCE WERE FORMULATED TO CONSIDER THE FOLLOWING ISSUES:**

*What is the appropriate number of directors on superannuation trustee boards?*

The provision of independent directors on superannuation trustee boards is aimed at promoting board diversity and ensuring members' best interests are front and centre. Increasing the number of independent directors on superannuation trustee boards is an issue that requires careful consideration.

Feedback from consultation (mainly from not-for-profit funds) indicated continued support for the equal representation model and opposed any requirement to mandate a proportion of independent directors.

Other submissions considered that up to one-third independent directors could be achievable with an appropriate transition period. Finally, some submissions supported a requirement for a majority of independent directors. However, the costs associated with a majority of independent directors were recognised as a potential hurdle for the superannuation industry.

The number of directors on superannuation trustee boards is not being legislated. Allowing each trustee to determine the optimal size of its board provides boards with the flexibility to appoint the directors needed to ensure the right mix of skills and experience to best serve member interests.

*What should be the appropriate transition period to increase the number of independent directors on superannuation trustee boards?*

Another consideration in implementing a new governance regime concerns transitional impacts on existing and new board appointments.

Feedback from submissions suggested that the transition period should differ depending on the number of independent directors required. For instance, the greater the proportion of independent directors on superannuation trustee boards, the longer the transition period should be to minimise compliance costs.

*What is an appropriate definition of independence?*

In considering how to improve governance in the superannuation industry through increasing the number of independent directors on superannuation trustee boards, a key issue that needs consideration is what is meant by 'independent directors'? This is critical given the potential impacts the definition may have on the pool of independent directors. For instance, a tighter definition of independence may limit the pool of candidates, whereas a more flexible definition may widen it.

Feedback from a number of submissions indicated that if a member of a fund is a director, this gives them 'skin in the game' and therefore does not result in a conflict of interest. This is consistent with limited liability companies where directors can have a non-material shareholding and still be independent.

Other submissions argued that in order to achieve improvements to governance, it is important that independent directors are at arm's length from the fund.

## 4. IMPACT ANALYSIS

### 4.1 IMPACT ON INDUSTRY AND CONSUMERS

The proposed enhancements to superannuation governance seek to improve the superannuation system while ensuring compliance costs do not outweigh potential benefits to the market and to consumers.

The proposed options are aimed at improving superannuation governance, which in turn is expected to provide benefits to fund members. In this regard, as discussed in the Problem section, the importance of independence in the decision making process can be seen through both the comments of Chairs, the SIS Act and eminent academics. However, it is recognised that while the requirement for increased independence in superannuation funds is fundamental to improving governance, and thus improving member outcomes, the full benefit of the proposed options will only be identified over the longer term. The Government's election commitment is aimed at ensuring that the best interests of superannuation fund members are front and centre in trustees' decision making processes.

In addition, as the vast majority of trustees of APRA-regulated superannuation funds are companies (and it is the board of trustee directors who are responsible for the trustee's decisions and actions), these APRA-regulated superannuation funds will benefit by having a more diverse and skilled board.<sup>21</sup>

Community organisations and individuals more broadly are less likely to be affected directly by the governance reforms. However, all members of superannuation funds would benefit from improved governance.

The main groups affected are industry, corporate and public sector superannuation funds. These funds are the funds that will be required to restructure their boards to comply with any new independence requirements. The changes do not apply to SMSFs.

The overall compliance cost to the superannuation industry in start-up costs is estimated to be \$8.5 million compared to maintaining the status quo. The overall compliance cost to the superannuation industry in ongoing costs is estimated to be around \$12.3 million per year compared to maintaining the status quo. This will result in a compliance cost impact of \$20.8 million in the first year and \$12.3 million in subsequent years.

How superannuation funds choose to respond to the proposed reforms will depend on the individual funds. The choice of passing on costs to members or absorbing them will be made by each fund, taking into account their particular business situation and strategy.

A detailed breakdown of the cost estimate inputs cannot be publicly released as some of the data was provided on an in-confidence basis.

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<sup>21</sup> A regulated superannuation fund is one which: elects to comply with the SIS legislation; has either a corporate trustee or pays retirement benefits as pensions; is a superannuation, pension, provident or benefit fund that is indefinitely continuing.

## Governance

Governance	Minimum of one-third independent directors and an independent chair.	Majority of independent directors and an independent chair.
<b>Start-up costs</b>	<b>\$8.5 million</b>	<b>\$10.5 million</b>
<b>Ongoing costs</b> (all funds, per year)	<b>\$12.3 million</b>	<b>\$23.3 million</b>
<b>Board changes</b>	Independent Director remuneration: \$75,000 per annum. Change from current Director to Independent Director \$20,000 30 per cent of boards (31 RSEs) will likely increase in size to meet the new requirements	Independent Director remuneration: \$75,000 per annum. Change from current Director to Independent Director \$20,000 30 per cent of boards (31 RSEs) will likely increase in size to meet the new requirements
<b>Search costs</b>	Newspaper advertisement: \$28,000 for 20 per cent of impacted RSE licensees. Executive search firm: \$53,000 per director for 80 per cent of impacted RSE licensees.	
<b>Constitution, Governance rules, Trust deed and legal document changes</b>	\$14,000 x 101 RSE licensees	\$14,000 x 101 RSE licensees

Notes:

1. A transitional period of three years would minimise compliance costs and allow existing directors to leave and new directors be appointed in an organised fashion (potentially consistent with a fund's existing board renewal strategy).
2. Current board size is estimated to be on average between 7 to 10
3. Additional remuneration costs associated with a Chair (if any) are in addition to a Directors normal remuneration. As such, having an independent chair will not increase costs as the appointment of a chair and the associated costs are business as usual actions.
4. The development of a traditional plan will align with current obligations on RSEs as such; the costs associated with a traditional plan are captured through business as usual practices.
5. Currently, 49 per cent of the affected categories have no independent directors. As such, it is estimated that on average three independent directors will be required to be appointed. However, it is estimated that 40 per cent of the affected categories will replace existing directors with new independent directors. In this regard, it is recognised that some current directors may not be currently remunerated; as such it is estimated that 50 per cent of the existing directors will have cost impact as hiring new directors.
6. Currently, 51 per cent of the affected categories have between one and two independent directors. As such, it is estimated that on average one independent director will be required to be appointed. However, it is estimated that 40 per cent of the affected categories will replace existing directors with new independent directors. In this regard, it is recognised that some current directors may not be currently remunerated; as such it is estimated that 50 per cent of the existing directors will have cost impact as hiring new directors.

## Methodology

- The primary costs incurred relate to increased remuneration costs associated with complying with the proposed independent director requirement. Other significant costs include search and engagement costs, legal costs (changes to constitutions, trust deeds etc.).
- The two proposed options were costed:
  - A legislated majority of independents on superannuation trustee boards after a five-year transition period; and
  - A legislated minimum one-third of independent directors with an independent chair on superannuation trustee boards with a three year transition period.

Data used in the determination of the cost impact of the proposed options was obtained from the public and private sectors and both the retail and industry funds sector through direct consultation and through the two public consultation processes.



**The following assumptions were made:**

- 101 RSE licensees with an equal representation board structure (corporate, industry and public sector funds) will be affected by the requirement to have independent directors.<sup>22</sup>
  - In some cases this may result in a change in the composition of boards over time (with the same board size) and in others, it may result in an increase in board size.
  - Remuneration expenses increase when boards increase their size and/or restructure to meet the new requirements.

The changes in board sizes are estimated using the current average range of board sizes in the affected groups, which is between 7 and 10. The calculation for remuneration of directors was estimated to be \$75,000 per annum for an independent director and an increase of approximately \$20,000 when a current director is reclassified or replaced with an independent director.

The process for finding new independent directors is normally undertaken through executive search firms or newspaper advertising (with an additional due diligence process).

- Based on data from the superannuation industry, it is estimated that using an executive search firm will cost \$53,000 per director for each fund. It is estimated the majority of funds will undertake this process (80 per cent).
- Based on data from the superannuation industry, it is estimated that newspaper advertising will cost \$28,000 (which includes costs associated with due diligence) for each fund to fully implement the reforms. It is estimated that a smaller proportion of funds will undertake this process (20 per cent).

To ensure compliance with the new requirements superannuation funds will be required to amend their Constitutions, Governance rules and Trust deeds to reflect the new independent director requirements.<sup>23</sup> Additionally, other legal documentation including product disclosure statements will also need to be updated to reflect the changes to broad compositions. Based on industry data, it is estimated these changes will have an initial cost of \$14,000 per superannuation fund.

It is recognised that new directors may also require additional training in order to understand and comply with the RSE's governance structure and procedures in addition to other legal requirements, it is superannuation funds indicated that this training can range from \$10,000 to \$15,000. As such, it is estimated that affected RSE's will face additional compliance costs of \$12,500 for all new directors.

In the development of the costing in this RIS consultation was undertaken with key industry stakeholders. In this context, one submission received through the consultation process, indicated that the costs currently outlined in this RIS did not capture the full impact of the proposed changes in

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<sup>22</sup> RSE licensee is the holder of an RSE licence. An RSE licence is the licence granted by APRA to trustees of APRA regulated superannuation entities and with which the holder can act as the trustee of an RSE. Trustees of self-managed superannuation funds (SMSFs) and public sector superannuation schemes are not required to hold an RSE licence. There are two classes of RSE trustee licences: Public offer entity licence; and non-public offer licence. To hold a public offer entity licence the trustee must be a body corporate that is a constitutional corporation.

<sup>23</sup> A trust deed is a document, which sets out the rules for the establishment and operation of a fund. A superannuation trust deed includes provisions covering such issues as: who can be appointed and the processes involved in appointing trustees; who will be admitted as members of the fund; the process for receiving and investing contributions; discretionary powers of trustees; and the payment of benefits to members.

Option 1. The submission indicated that the costs outlined were significantly understated. In particular, the submission indicated that:

- The remuneration costs associated with independent chairs were significantly higher than normal chairs, contrary to the assumption used in the costing in this RIS. This assumption was tested with other stakeholders and these stakeholders considered that the current assumption used in this RIS was more appropriate.
- The definition adopted to determine who is considered independent would have a significant impact on the number of directors required to be appointed, thus compromising the assumptions outlined in this RIS. Further, the definition of independence adopted would also influence the pool of potential directors from which appointments may be made, thus resulting in increased remuneration costs for independent appointees. These statements are considered correct in principle. However, when tested with other stakeholders, it was indicated that it was unlikely the definition of independence if it was broadly in line with the current definition in section 10 of the SIS Act would result in a significant change in the assumptions outlined in this RIS.

### Summary - Governance

In summary, option 1 is the preferred option, as it will give effect to the Government’s election commitment while minimising the cost impact on the superannuation industry.

**Table 1: Regulatory burden and cost offset estimate table**

Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$13.154	\$	\$	\$13.154
Cost offset (\$ million)	Business	Community organisations	Individuals	Total, by source
Treasury	\$13.154	\$	\$	\$13.154
Are all new costs offset?				
<input checked="" type="checkbox"/> Yes, costs are offset <input type="checkbox"/> No, costs are not offset <input type="checkbox"/> Deregulatory—no offsets required				
Total (Change in costs – Cost offset) (\$ million) = \$0				

- Note: where the identified offsets are obtained from outside the agency bringing forward the proposal, extra rows need to be inserted into this table identifying those offsets obtained from within the portfolio (other than from the agency bringing forward the proposal) and those obtained outside the portfolio, as well as a total row.

### 4.2 SPECIFIC IMPACT ON SMALL BUSINESSES

There are 2,428 small APRA funds as at March 2015 that will be affected by the governance regime. Small APRA funds typically outsource their trusteeships to ‘trustees for hire’.<sup>24</sup> These trustees will need to meet the independent director obligations.

However, as these trustees frequently act for a large number of funds, the effect on individual funds should be minimal.

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<sup>24</sup> Trustees of small APRA funds are usually professional trustee companies.

Self-managed superannuation funds are regulated by the Australian Taxation Office and not included in the new governance regime.

### **4.3 IMPACT ON GOVERNMENT**

The impact on Government will be relatively small and non-ongoing. In the short-term, implementation costs will be incurred to draft the legislation for the proposed amendments, and to make changes to the regulations. The financial impact on APRA and ASIC of these proposals was addressed in 2010 as part of the previous government's superannuation reforms arising from the Cooper Review.

## **5. CONSULTATION**

Soon after the 2013 election, the Government decided to progress its superannuation governance election commitment in a variety of ways, including the issuing of a public discussion paper and exposure draft legislation. To ensure the consultation process covered all relevant persons, the Government consulted in the public domain. Due to some more technical aspects of the Government's policy, the Government also conducted targeted consultation with stakeholders.

On 28 November 2013, the Government released a discussion paper seeking industry's views on the status of reforms covering governance and transparency. The paper was entitled '*Better regulation and governance, enhanced transparency and improved competition in superannuation*'. Amongst other things, the discussion paper canvassed improving trustee board governance through having independent directors on superannuation trustee boards.

A total of 90 submissions were received, including 23 confidential submissions. Consultation involved meetings, including around 14 meetings with representatives from across the superannuation sector. This consultation informed the assessment of compliance costs. Stakeholders were also engaged in further direct consultation to assist with assessment of the cost implications of the policy options.

The main themes raised by submissions were:

- both support and concern over proposed board governance changes; and
- the need for appropriate time to implement any legislative changes.

A number of submissions, mainly from industry funds, indicated continued support for the equal representation model and opposed the proposed requirement to mandate a proportion of independent directors. A number of industry fund submissions, including Industry Super Australia (ISA), argued that not only is Australia's representative trustee arrangements consistent internationally, but that equal representation helps ensure that member interests come first and at the same time has delivered higher average returns and lower fees than retail funds.

In particular, the ISA opposed any requirement to have a specified proportion of independent directors on boards. ISA said that there should only be a positive obligation on boards to consider if appointing an independent chair and/or independent directors (up to one third of total board membership) may be in the best interests of fund members.

On the other hand, the Association of Superannuation Funds of Australia (ASFA) supported some independence on boards and said that if a requirement for independent directors is mandated, at least

one-third of the directors on superannuation boards should be independent with an independent chair.

Another key consideration in the discussion paper was the appropriate transition period to implement the new governance regime. Submissions suggested that the transition period should differ depending on the number of independent directors required. For instance, the greater the proportion of independent directors on superannuation trustee boards, the longer the transition period should be to minimise compliance costs. In particular, there was a range of views ranging from three years (for example, ASFA) to five years (for example, the Australian Institute of Superannuation Trustees (AIST)).

An early assessment stage RIS (OBPR ID 16729) was prepared for consideration prior to the development of exposure draft the legislation.

On 26 June 2015, the Government released draft legislation to require one-third independent directors on superannuation trustee boards. Consultation closed on 23 July 2015. Thirty-one written submissions were received in response to this consultation, of which two were confidential.

In the week beginning 27 July 2015, officials from Treasury met with a wide range of stakeholders in Melbourne and Sydney to seek views on any technical issues and unintended consequences with the draft legislation.

The policy issue of independent directors is a threshold issue for some parts of the industry, with views split to some extent between retail and industry funds. For example in their submission, the ISA said, "the approach adopted in this draft Bill will not strengthen the governance of superannuation funds. It is misdirected, imposes rigid and inflexible regulation, intrudes into the private affairs of a corporation without a rational or compelling basis, and will undermine the representative trustee system." The AIST submitted that the changes "will impose significant costs and introduce risks to the industry for no good reason. The changes also take Australia in the opposite direction to the rest of the world by removing member representation from boards of occupational-based retirement savings funds."

Australian Super continued to raise strong reservations on the benefits of moving away from the current governance requirements, "the prevailing governance arrangements for industry funds have produced very strong results for fund members. The case for a mandatory proportion of independent directors has not been made on merit grounds. Indeed the empirically-based grounds for maintaining the currently successful equal representation model are very strong."

However, a number of stakeholders did support the Government's policy of a minimum one-third independent directors. For example, the Association of Superannuation Funds of Australia said that it "supports increasing the number of independent directors on the boards of superannuation funds and recognises that over the past few years many trustee boards have already taken the opportunity to supplement their skills and have appointed independent directors." The Financial Services Council said a "requirement to have independent directors and an independent chair on the boards of superannuation trustees is consistent with international best practice for corporate governance and is in the best interest of consumers. It is consistent with recommendations from the Super System Review and the Financial System Inquiry." Catholic Super said the "Government rightly considers independent directors on superannuation trustee boards as a way of strengthening the current superannuation system". The consultations helped to refine the draft legislation to superannuation governance and informed the final assessment of compliance costs.

## 6. CONCLUSION

A strong and stable superannuation system is an important part of the Government's policy program to build a stronger and more prosperous economy.

These reforms deliver on the Government's intention to align governance structures in the superannuation system more closely with corporate governance principles applicable to ASX listed companies. Consultations revealed that while stakeholders remain polarised on the overarching policy question of whether or not independent directors should be mandated by law, the majority of parties consulted were able to move beyond this point and provide very useful views on ways to improve the robustness of the draft legislation.

The main issues arising from consultation on the draft legislation were:

- a preference for realigning the split between the law and the powers given to the Regulator (APRA) by including more provisions in the Bill to provide greater certainty to stakeholders;
- certainty that the length of the transition period will be three years;
- a preference for retaining the equal representation rules contained in the current Part 9 of the Superannuation (Industry) Supervision Act and the two-thirds voting rule; and
- a number of technical drafting issues that will clarify the intent of the law.

These issues have been taken into account in redrafting the final Bill.

We confirm our view that option 1 is the best policy option. In contrast to option 2, that a board should have a majority of independent directors, we believe that proceeding now with one-third independent directors, including an independent chair, strikes an appropriate balance while still substantially strengthening governance arrangements. The Government is also mindful of the scale of change that would be required if a majority of independent directors was mandated.

## 7. IMPLEMENTATION AND REVIEW

The Government intends to implement option 1 by introducing legislation into Parliament in the Spring Sittings with a commencement date of Royal Assent.

Success will be measured by how quickly superannuation trustee boards move to a minimum one-third independent directors. However, the ultimate yardstick will be at the end of the three year transition period to assess how many trustees are compliant with the requirements. Another measurement will be how many trustees may need to use the potential relief on offer from the Australian Prudential Regulation Authority, where a bona fide effort has been made throughout transition and a compliant transition plan been lodged with APRA.

Some parties have indicated that there could be difficulties in finding sufficient number of independent trustees; however the Australian Institute of Company Directors maintains a large data base of members who are seeking board positions, many of whom would be suitable. Funds who currently have independent directors commented that they have not had any problems in finding suitable candidates.