

ASFA Submission to the Cooper Super System Review

Phase One: Governance

Appendices

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Association of Superannuation Funds of Australia

ASFA

Level 6
66 Clarence Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Telephone: +61 2 9264 9300
Fax: +61 2 9264 8824

Outside Sydney
1800 812 798

Website: www.superannuation.asn.au

The Association of Superannuation Funds of Australia Limited ABN 29 002 786 290 ACN 002 786 290

Please Note:

This is an abridged version of the full submission sent on October 16, 2009 to the Cooper Review panel.

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Appendix 1: Detailed responses to consultation questions

5.1 General

5.1.1 Global financial crisis:

Did the global financial crisis highlight any governance problems in our superannuation system (for example, in risk or liquidity management) and, if so, what were they?

Issues highlighted by the GFC include:

- Liquidity problems in a number of areas including the freezing of underlying managed investment schemes. This highlighted the need for trustees to undertake more robust risk management processes – for example robust stress testing/scenario analysis to better manage liquidity and understand the risks they are exposed to given their investment structure.
- The ability or otherwise of trustees to maintain the fund's investments within their pre-determined Strategic Asset Allocation (SAA) ranges.
- The need for standard definitions of assets and of investment portfolios.
- Fee structural issues – some trustees who rely predominantly on asset-based fees to cover the cost of fund operations found that as the markets (and therefore their fund's assets) dropped, the amount of fees deducted were insufficient to cover the costs of their operations.
- The unexpected cost of member protection resulting from a substantial drop in members' balances to below \$1,000 was significant for some funds.
- The funding of defined benefit funds.

Risk Management

There is an argument that the current legislative structure around risk management (in SIS – which requires audits) encourages very brief and high level risk management frameworks. That is, the current legislative structure leads to some trustees focusing only on the high level SIS risk management requirements in order to pass their annual audit, rather than focusing on building a robust and effective risk management culture within the superannuation fund. In other words, having the RMS and RMP audited encourages these documents to be very broadly drafted with little in the way of detailed risks in many cases, due to the inherent fear associated with receiving a qualified audit.

The annual audit requirement for the RMS and RMP, are an unnecessary expense for funds, given the process adds little value to trustees' risk management processes and given that APRA already review the fund's risk management practices. Having the RMS available to superannuation fund members on request appears to be of little relevance or use to members (as evidenced by the a very low incidence of members requesting a copy of the RMP). Also, this requirement is not consistent with practice in other APRA-regulated entities such as insurance companies.

ASFA supports the clarification and provision of further

guidance to trustees by APRA on sound and prudent risk management practices by way of their Prudential Practice Guide SPG 200 – Risk Management. We are currently updating our Best Practice Paper No. 19 – “A risk management framework for superannuation funds”, which aims to provide trustees with guidance around the development and implementation of a framework for effective risk management.

Recommendations:

- Remove the annual audit requirement for the RMS and RMP.
- Remove the requirement that the fund's RMP be made available to superannuation fund members on request. With the removal of the requirement to make the RMP available to members, it would be possible to merge the RMS and RMP into one document (which some funds already do) thereby removing any potential duplication and inefficiencies caused by having two separate documents.
- The industry needs to work towards a standard definition of assets and investment portfolios in order to ensure uniformity of reporting thereby driving improved consistency of what is disclosed to members in relation to their investments.
- Trustees should consider the appropriateness of their fee structures to ensure that the fund is at all times able to cover its operating expenses regardless of the economic climate. They should also consider holding reserves to provide working capital in extreme market scenarios.
- Member protection should be abolished (refer to our response to section 5.1.2 below).

5.1.2 Complexity:

Is it the case that the complexity of the superannuation system creates its own governance problems? If so, what are some examples? Are there any governance requirements that are no longer necessary or impose costs that outweigh intended benefits?

Whilst many financial industries are relatively complex, the superannuation system does have complexities specific to it, generally administrative or operational complexities. Much of the complexity is associated with the legislative requirements that trustees need to comply with/take into consideration, including the rules around benefit payments and the taxation rules together with all the grandfathering rules that go with them.

Superannuation funds currently deal with three major regulators (ASIC, APRA and the ATO) and a number of other minor regulators. Also, the structure of the superannuation legislation is very complex. There are those who believe that a single regulation and/or the centralisation of legislation would assist in reducing complexity (refer to our response to 5.3.2.2).

We make a number of recommendations for simplification as follows.

Recommendations:

- At the moment, relief from the 30-day portability requirements can only be granted by APRA in exceptional circumstances. That is, portability relief does not cater for trustees who wish to establish a new product (or investment option) with portability requirements greater than 30 days – i.e. funds with longer term investment horizons which may be “illiquid” (being investments which are not readily realisable into cash to meet redemptions in the within 30 days).
- In order to remove barriers to genuine product development, an efficient process is needed which allows trustees to develop products or investment options with a longer investment timeframe and a consequently longer required redemption period. This could be achieved either by giving trustees discretion on portability requirements rather than APRA (i.e. trustees could advise APRA after the event) or, alternatively, amending the portability relief provisions to allow APRA a broader ability to grant exemptions to trustees (i.e. not just in exceptional circumstances).
- Legacy products - there are impediments which can make product rationalisation a lengthy, complex, risky and expensive process, such as legal constraints (limited mechanisms in the current regulatory framework) and the potential adverse tax consequences for investors (eg. exposure to Stamp Duty). Legislative change is required in order to remove these impediments without diluting consumer rights, such as the introduction of a single legislative mechanism to enable financial product rationalisation and the amendment of State Stamp Duty laws to provide tax neutrality where product rationalisation has been undertaken.
- In order to facilitate the cost effective merger of funds, and protect the interests of fund members, capital gains tax and loss relief on all mergers of funds should be made permanent. ASFA has written to the government previously on this issue and is happy to provide copies of the submission and draft legislative changes required.
- Member protection is an anachronism (in that it was brought in to protect members prior to the introduction of choice of fund) and should be abolished. Member protection is a disincentive for members with balances under \$1,000 to amalgamate their accounts, which would be in everyone’s best interest. The complexity and cost now outweighs its intended benefits and the cost of this subsidy is effectively borne by other members – i.e. it is inequitable. The costs are particularly significant for industry funds with large numbers of members with low balances – anecdotally, the cost can be up to 20 basis points (possibly even higher in some cases). Also, whilst this initiative made sense when compulsory superannuation was at low rates, now SG is at 9% it is much less relevant. A person on the average annual

salary of \$60,000 would receive \$5,400 in SG during the year. As such, the \$1,000 member protection threshold (which is not subject to annual indexation) for this individual would be exceeded in just over 2 months of employment. As the average annual salary continues to increase, it is likely that ever fewer individuals will be required to be member protected going forward.

- Processing rollovers between funds – in order to promote efficiency there is a need to remove the barriers caused by privacy issues associated with funds not being able to directly deal with the ATO and other funds to gain information when rolling over. Currently much information is lost on rollovers between funds.
- Unclaimed money legislation enacted in 1999 could be removed, with the residual current requirements put into SIS.

5.1.3 Trust model for super:

Superannuation funds operate under a trustee⁴ model derived from the general law of equity. Given the nature of today’s public offer, and other large, super funds, is this model still appropriate? Does it still deliver the best outcomes for members?

The trust model possesses the following advantages, and is still appropriate for superannuation for the following reasons:

- Trusts are a traditional/classic arrangement for managing assets on behalf of others. Trustees legally hold superannuation funds monies on behalf of other people (i.e. members and beneficiaries).
- The trust structure provides strong protection for members as it places a fundamental obligation on trustees to act loyally and in the interests of the beneficiaries of the trust.
- Trusts provide an appropriate separation between the trustee’s own assets and the fund’s assets - this protects members’ funds from the trustee’s personal creditors.
- The trust structure is used in a variety of analogous situations – eg. charities, property trusts, unit trusts, housing trusts etc where the structure works well. A further example of this is the fact that custody ordinarily operates under a bare trust structure.
- Even though trusts were not initially designed for superannuation trusts, trust law has adapted to fit an evolving and changing superannuation industry.
- There is a large body of law (legislative and also well developed general law) around trusts which is well tested. A new system will not have the legal background/safeguards and may be open to legal uncertainty and challenges (and even potential misappropriation).
- Any changes to the current ownership arrangements (trust structures are an ownership arrangement) may have negative tax/stamp duty implications - requiring further government remedy/intervention.
- It is hard to envisage another viable “model” for

⁴ A trustee, in this paper, includes a person who is a trustee in a group of trustees of a fund and a person who is a director of a corporate trustee of a fund.

superannuation ownership arrangements. A contract model, as in the banking/life insurance industry, could possibly work but we would question the advantages of moving to such a model. The whole concept of trust law means that the fund's assets are specifically held on trust for the members (and not the shareholders) unlike a banking/life insurance model. Contract law would similarly need to adapt to take into account the context in which superannuation operates. This may have unintended consequences.

- Rules of trust law are principles based, as opposed to prescription or tick a box process that may be associated with a contract law approach. Trust law requires a trustee to turn their mind to the circumstances, and is guided by the over arching equitable principles.
- There would be substantial costs in replacing the current trust structure.
- The trust structure, with the separation of ownership and assets, and the duty to act in the best interest of beneficiaries, has stood the industry in good stead during the GFC.

However, there are overriding difficulties and constraints with the trust model, including:

Inflexibility of SIS

Despite the advantages of the trustee model, and that it is robust and flexible enough to continue to adequately adapt to serve the superannuation industry, the same cannot be said for the SIS legislation and its application. There is an overriding constraint in the current SIS legislation, and in its application, such that it is inflexible to the current superannuation industry.

One size does not fit all

The current superannuation regulation system, encompassing SIS, Corporations Act, and APRA and ASIC as the responsible regulators, in effect treats superannuation funds as a homogenous group i.e. it is treated as one "bucket" of one-size- fits-all members with SIS assuming (or requiring) that these members are homogenous and all have the same needs. The reality is different. Given the disparate nature of the various superannuation products/structures available in the market, and the various groups of members within a fund, SIS needs to take into account the fact that a fund does not have homogenous members and can in fact have sub-trusts or sub-groups of members with different needs.

Examples of the inflexibility of SIS include:

- SIS and APRA focus on regulation at the trust level, however parts of the industry operate at a product and portfolio level.
- SIS does not provide the flexibility to cater for sub-trusts.
- SIS does not provide the flexibility to cater for different categories of members, such as accumulation phase and retirement phase members, a situation which occurs in many superannuation funds and will be a growing issue as more funds offer retirement products.
- SIS does not provide for the difference between

members who exercise investment choice and those members who do not exercise choice and are in the default investment option).

Industry and legal opinion is that a superannuation trust, operating under trust law, can have different levels of duty for people who make active investment option choice. However, opinion is that SIS does not recognise this, and similarly the Regulators have differing, or opposing views on this situation. Tension therefore exists because the regulations and regulators do not recognise these differences that trust law does, and that trustees require in order to operate today's complex superannuation system.

Solution – Choice model, with flexibility, is required

There has been a move away from a single and simple one-size fits all superannuation model to a "choice" model offering complex products with choice of fund and choice of investments. The rise in SMSFs is testament to this and that the public clearly wants this "choice". Whatever is done with the legislative structure or framework, there is a need to recognise this market appetite for "choice", and provide a system flexible enough to satiate this appetite.

The model needs to anticipate any future changes to the superannuation industry, and regulations and regulators need to be able to adapt to accommodate current and future changes. It is felt that while the trust model supports this, SIS and the regulators do not.

There is also an issue in respect of platforms, which SIS and the trust structure do not adequately cater for.

There is a desire within parts of the industry to offer members the ability to operate a self-managed account within the trust structure. This would provide many members of funds a viable alternative to starting a self managed superannuation fund without having to take on the responsibility of being a trustee.

Recommendation:

It can be argued that the trust model is still appropriate for today's superannuation industry, and that the trust model does deliver the best outcome for most members. Even though the trust model was originally developed for estate and tax planning, trust law has adapted to different types of trusts, including superannuation trusts which have links to employment law.

As discussed above, tension exists for trustees where the SIS legislation and its interpretation and application, is a one-size-fits-all model, that is not flexible to encompass today's various superannuation industry participants and constructs.

Accordingly, what is required is that SIS be amended to reflect changes in the evolving superannuation industry. This is a complex area of law and further investigation would be required. ASFA would be happy to consult with the relevant parties to accomplish this.

5.1.4 UN Principles for Responsible Investment (UNPRI):

How should APRA-regulated super funds approach the question of becoming a signatory to the UNPRI or a similar set of principles? Should adopting such principles be mandatory? If this is not the right approach, then what would be preferable?

At the time of preparing this submission, there were approximately 22 superannuation funds that had signed up to the UNPRI principles. It is likely that more funds will continue to sign up to the UNPRI principles in the future, particularly since the links between environmental, social and corporate governance (ESG) factors and financial performance are increasingly being recognised. At this time, the commitment required of signatories is not overly prescriptive or onerous – essentially they commit to consider and incorporate ESG issues into their investment processes (including seeking disclosures on ESG issues from entities in which they invest) and generally promoting acceptance and implementation of the UNPRI principles across the broader financial community. Also, as the UNPRI is currently a self-assessed, aspirational initiative, it does not have the attributes required of a certification mechanism.

However, adopting the UNPRI or similar principles could, at some point in the future, potentially conflict with and/or compromise the ability of trustees to invest the fund's assets for the sole purpose of maximising the retirement outcomes of their members.

Whilst ASFA supports the ultimate aims of the Principles of Responsible Investment, ASFA does not support directed investments – i.e. mandated directions to invest or dis-invest in certain classes of assets. The adoption of the UNPRI or a similar set of principles should be a decision left to each trustee, to be considered in the context of managing the fund to maximise members' benefits. It should not be mandatory.

Rather, trustees should consider ESG issues as part of their broader consideration of investment/risk management issues when exercising their duty to formulate and give effect to appropriate investment strategies under section 52 of SIS. Trustees can still adhere to the principles of responsible investment if they wish, without the compliance costs associated with signing up to UNPRI. It can be argued that there are some funds that have signed up to the UNPRI principles but have done very little in the way of ESG risk assessment, whilst there are some funds that have not signed up but have in fact done a lot in this regard.

ASFA is currently drafting a new Best Practice Paper to provide guidance to superannuation trustees on ESG.

5.1.5 Public sector:

Are there governance issues specific to public sector funds? If so, what are they?

This is a very specialised area and ASFA has received divergent views from public sector funds in different states due to their different history and political environment.

ASFA supports a move towards the same regulatory structure for all superannuation funds.

5.1.6 Best practice:

What is the best way to drive best practice governance across the industry, for example, in the areas of transparency, disclosure, conflicts management, environmental, social and corporate governance and shareholder participation?

ASFA contends that, in general, Australian superannuation funds are well governed by their trustees a strong regulatory framework and effective regulators.

ASFA promotes best practice in governance and operation of super funds through our series of Best Practice Papers. The wide use of these Best Practice Papers amongst superannuation funds demonstrates that the superannuation industry takes its governance responsibilities very seriously.

ASFA also promotes good governance through a range of training courses such as Trustee Know-How and our "ASFA AIF" investment fiduciary course (which gives trustees an internationally recognised designation as an investment fiduciary).

ASFA has produced a Best Practice Paper No. 17 on Active Share Ownership Guidelines for Superannuation Trustees and is currently drafting a new Best Practice Paper to provide guidance to superannuation trustees on ESG. We do not believe that any changes to current governance practices are required in this regard.

The Corporations Act 2001 and supporting regulations contain a comprehensive disclosure regime which requires holders of Australian Financial Services (AFS) Licenses to comply with prescribed disclosure requirements. We believe these requirements adequately drive best practice around disclosure to members.

However we do have some specific recommendations for change in the areas of transparency and disclosure, and conflicts of interest as follows:

Transparency and disclosure

Recommendations:

Trustees should be required to disclose to members their policies around key governance areas, such as:

- conflicts management;
- remuneration of trustees;
- board performance reviews;
- outsourcing;
- active shareholder participation; etc.

There is currently inconsistency in the way providers describe their products – eg. what they consider to be a 'balanced' investment option. ASFA is currently undertaking a project in relation to the development of consistent disclosure (i.e. branding) requirements, particularly with respect to investments and fees/costs, since it is the branding applied to particular investment options and fees that causes confusion.

ASIC is also doing work in this area.

There needs to be a move towards managing and reporting of investments on an after-tax basis (discussed further in section 5.5.5).

Conflicts of interest or of duty

ASFA supports a principles-based, not a prescriptive approach, to the management of conflicts of interest or conflicts of duty. Where such a conflict is too great to be managed, it should be avoided.

Problem of trust law/common law responsibilities around conflicts

As superannuation funds are also governed by trust law, the trustee has a duty to avoid conflicts. This is a fundamental fiduciary duty imposed on all fiduciaries be they trustees or directors.

However, confusion exists for trustees in reconciling the law around conflict management as set out in various other sources. For example:

- trustees who are also subject to the ASIC AFSL requirements, the test is to have in place adequate arrangements for the management of conflicts;
- where a trustee is a company, the general duties of directors is to recognise and manage a conflict of their interests and fiduciary duties;
- under SIS, although conflicts are not specifically mentioned, section 52 requires a trustee to act honestly, to exercise powers and duties in the best interests of beneficiaries and to not do anything that would prevent or hinder the trustee from performing/exercising their functions and powers.

APRA requires RSE licensees to identify and manage any conflict between trustee/trustee director duties and any other commercial interests. Each of these separate tests is applied by a different regulator, and has different requirements.

Another example of the confusion is that directors of trustee entities often believe the test is simply to disclose the conflict of interest, and abstain from voting on any resolution concerning that item. The law is not necessarily that simple in some factual situations.

Clarification for trustees and directors of trustee entities is required. A common situation is that one individual is a trustee of more than one superannuation fund. This leads to the possibility of conflicts of duty.

Another common situation is that a trustee is associated with a service provider that is, or could be, used by the fund. The question in this situation is whether the trustee can manage their actual or potential conflict of interest.

Whether the trustee can manage these conflicts of duty or of interest (or alternatively whether such a conflict should be avoided) depends on the degree of the conflict.

The key questions in dealing with a conflict of interest or duty are:

- whether a trustee/trustee director who is on the board of more than one fund can fulfil their fiduciary duties;
- does the presence of that individual compromise discussion at board level? eg. whether their presence would impact on other trustees'/directors' ability or willingness to discuss issues which may be commercially sensitive or involving proprietary information; and
- what would fund members think of the presence of that individual? The perception of a conflict can be as important as the actual conflict.

As the situations are complex and varied, ASFA does not believe a prescriptive approach is appropriate in relation to whether or not an individual should be allowed to serve on multiple boards, or be allowed to have an association with a service provider to the fund. We do however believe that trustees/trustee directors must consider the various issues involved when deciding whether to appoint, or continue with the existing appointments.

We also recognise that the trustees/trustee directors sometimes do not have control over who is appointed to the board, when the individual is elected by the members or appointed by the employer (or associations representing the interests of either the members or employers).

Recommendations:

Clarification is required for Trustees (and the directors of Trustee entities), given the differences between Trust Law, Corporations Act requirements, the requirements and expectations of each of the separate regulators ASIC and APRA in relation to conflicts management, in order to drive best practice governance across the superannuation industry.

ASFA supports a principles-based, not a prescriptive approach, to the management of conflicts of interest or conflicts of duty. Where such a conflict is too great to be managed, it should be avoided.

If necessary in order to achieve this clarification, SIS and/or the Corporations Act should be amended.

ASFA further recommends that in order for fulfil its obligations and achieve best practice, Trustees should adopt the following in relation to conflict management: Trustees should have a clear and transparent policy in place to:

- manage actual and perceived conflicts; and
- avoid situations where conflicts of interest or conflicts of duty are so great that they cannot in practice be managed; and
- ensure that any conflict that does arise must be recognised by the conflicted party; and
- conflicts are promptly reported to the trustee board.

This conflicts policy should include:

- General principles to be used in managing different types of conflict. That is, the policy should include details of how to manage any conflicts, including specific conflicts, which may arise from time to time.
- For each conflict, an appropriate method of resolution must be devised and implemented.
- Both the fact of the conflict and the method of resolution should be recorded in an appropriate register.
- It is good practice for the Chair to check for conflicts at each board meeting.
- Require the disclosure of all relationships between the trustee and associated third parties and be available to fund members on the fund's website or on request.

The trustee's procedures should be regularly monitored and appropriate action taken where non-compliance is identified.

5.2 Trustees

5.2.1 Trustee duties:

Would the full or partial codification of duties to act in good faith, avoid and/or disclose real or apparent conflict of interest and not seek personal profit have a significant impact on trustee governance and the priorities given to various aspects of their operations? Would explicit provisions setting the priority of shareholder and member interests and enabling trustees to override deeds that require the trustee to invest or outsource within the corporate group help reduce trustee conflicts of interest?

The duties to act in good faith and prioritise the interests of members are currently codified in SIS, albeit there are differences between the SIS requirements and the trust law requirements. The SIS legislation in its current form is not robust enough to effectively deal with conflicts of interest. ASFA contends that, in general, Australian superannuation funds are well governed by their trustees under a strong regulatory framework and effective regulators – but this framework could do with improvements, to reflect the complex changing and adapting needs to the superannuation system and its participants.

However, we do have some specific recommendations for change in the areas of conflicts of interest which are summarised below (and discussed further in section 5.1.6).

Recommendations:

Clarification is required for trustees (and the directors of trustee entities), given the differences between Trust Law, Corporations Act requirements, the requirements and expectations of each of the separate regulators (ASIC and APRA) in relation to conflicts management, in order to drive best practice governance across the superannuation industry.

ASFA supports a principles-based approach, not a

prescriptive approach, to the management of conflicts of interest or conflicts of duty. Where such a conflict is too great to be managed, it should be avoided. If necessary in order to achieve this clarification, SIS and/or the Corporations Act should be amended.

5.2.2 Trustee knowledge, skills and training:

Are trustees adequately equipped to do their jobs? Is too much expected of trustees?

Many trustees are adequately equipped and able to properly perform their functions. Each board has their own matrix of skills as each trustee brings different areas of expertise to the collective. Many boards undertake wide ranging trustee training, often of the whole board. This includes general superannuation education such as specialised conferences, specific topic seminars, and formally assessed training courses. As an indication of specific trustee education, in the first six months of 2009, ASFA conducted formal face to face training of at least half a day's duration to 178 trustees. In the second half of 2009, ASFA launched its trustee InFocus seminars, with over 150 people at the most recent topic.

That being said, we believe there is room for improvement for those who are only reasonably equipped and there is also a need to identify and provide further training to those who are not properly equipped.

There is a difficulty in using APRA's research into trustee training published in their 2008 paper "Superannuation fund governance: Trustee policies and practices". This stated that only 49 per cent of directors have full formal trustee training, as defined by the standards (RG 146) of the Australian Securities and Investments Commission (ASIC) and only 68 per cent of funds surveyed require directors to have some formal trustee training.

The difficulty is that ASIC's RG146 requirements relate to the provision of financial advice in superannuation (whether or not they require skills assessment for personal advice) and are designed for people advising retail clients as to their superannuation investments. While RG146 compliance is required by some funds, and is a useful way of gaining an overview of superannuation from the member's perspective, we do not believe it is an appropriate measure of relevant trustee training, but rather an indication of the bare minimum standard of training required.

While a broad brush understanding of superannuation is essential, we believe that the minimum training requirement is to understand the governance role of the trustee, empowering the trustee to contribute to all of the responsibilities of the board and not just those related to their own area of expertise.

Topics that we believe are important for trustees are:

- The Regulatory Framework
- How trusts and trustee boards operate
- Trustee duties and responsibilities
- Fund governance

- Risk management
- Managing outsourcing and delegations
- Administration (from a governance perspective)
- Investment
- Communications and Disclosure
- Enquiries and disputes
- Reporting and accounts (financials)
- Strategic and business planning
- Conflicts identification, assessment and management

ASFA led the way in provision of trustee education with a course first offered in the 1990s. A specific Certificate of Trusteeship was launched in 1998. The course, Trusteeship is still being updated regularly and offered each semester as part of a Diploma of Financial Services (Superannuation).

ASFA currently also offers the following specific structured courses for trustees:

- Trustee KnowHow a workshop designed to provide individuals with the tools and techniques to assist them in becoming more effective members of the trustee board
- ASFA Accredited Investment Fiduciary (ASFA AIF) Program – the superannuation industry’s leading trustee accreditation program, which provides individuals with the skills and knowledge on how to discharge a trustee’s investment governance responsibilities.
- ASFA offers the Trustee InFocus series as a quarterly update on current issues. It is available face-to-face in Sydney, Melbourne and Perth and by print material with online quizzes.
- Advanced Trustee KnowHow Governance
- Advanced Trustee KnowHow Operations
- Advanced Trustee KnowHow Legal

Recommendations:

In ASFA’s experience with training trustees over many years, we believe there is a need for clearly articulated minimum initial competency and training standards for trustees. These standards need to relate to the role of the trustee and focuses on the trustee’s role rather than an adviser’s role.

ASFA supports the minimum ‘fitness’ requirements applying to all individual responsible officers (as outlined in APRA’s draft PPG 520 - Fitness and Propriety), including attendance at suitable induction and training programs in order to acquire the required knowledge within a reasonable period of time.

For SMSF trustees, initial competency training is required, though tailored to the specific responsibilities of the trustee.

In situations where it is not possible to train trustees before their board term commences, there should be a period of time (such as 3 – 6 months) during which the trustee can achieve these minimum initial competency and training standards.

We believe each individual trustee should be required to undertake 30 hours of Continuing Professional Development (CPD) each year as part of the ongoing improvement of their knowledge and skills, similar to the requirements of ASFA’s Professional Accreditation Program (i.e. the requirements for individuals to gain 30 CPD points per annum in order to retain their Fellow and Associate status). We recommend:

- The 30 CPD hours should not come from one source (eg. 30 hours of reading the Australian Financial Review), but should instead represent an appropriate combination of formal structured training, attendance at relevant industry seminars/functions/events, private reading etc.
- The entire 30 CPD points do not have to come from structured training, but from a variety of sources (as outlined above), however we believe at least half the 30 CPD points coming from structured training would seem to be an appropriate level.
- We recognise that each trustee brings to the board their own set of skills (eg. general business skills, accounting, investments etc). As such, we recognise that a part of their CPD could be activities relating to the financial environment or specific to the trustee’s own specialist area(s). However, ongoing CPD of trustees also needs to include activities related to the trustee’s fiduciary governance role.
- For SMSF trustees, 15 hours of CPD per year after initial competency training should be required with evidence of structured training.
- Trustee boards should consider whether higher competency standards should be placed on trustees performing specialist duties such as chairing the Audit & Compliance or the Investment committee. This is a question for boards to decide and we do not believe there should be prescription in this area.

5.2.3 Trustee performance:

How is trustee performance measured? How should it be measured? Can and do trustees adequately measure their own performance? Are there adequate benchmarks? What are, or should be, the consequences for under-performance?

Trustees need the flexibility to be able to create a board structure that is most effective for their fund and the particular circumstances, and in order to do so need discretion on the make-up of the board. To equip the board in this regard, it is important that there is a periodic review of board performance. It is not the purpose of this submission to discuss the pros and cons of board level internal performance, however objective assessment of trustees at both the individual level and at the collective group level is an important part of trustee board best practice governance.

To assist in facilitating this, it is imperative that boards:

- (a) have the ability to remove non performing board members, whether for health, conflicts, lack of

- engagement due to time constraints, or other reasons;
- (b) have the ability to appoint independent directors, and experts;
- (c) consider having limits on the number of directors, including their term / period of tenure.

In relation to (a) above, it is essential that trustee performance is measured and that underperformance is promptly detected and remedied.

There are two levels of trustee performance:

- performance on the individual trustee; and
- performance of the trustee board as a whole.

In terms of the individual trustee, it is very important that the trustee has ongoing standards which each individual must meet, and against which they are tested on a regular basis. Ongoing or consistent underperformance of an individual should lead to their replacement.

In terms of the operation of the trustee as a whole, this is difficult for the trustees to measure themselves. Some funds engage consultants to conduct regular reviews to measure board performance, however the practice is not universal.

A recent governance study by Edwards and Clough of the University of Canberra¹ discusses the findings of a range of other studies that the traditional factors used to measure corporate board performance. These factors, such as

- separation of roles of Chair and CEO
- majority non-executive directors
- small board size
- balance of director skills and competencies
- audit and other board committees
- effective board performance and evaluations
- linking CEO rewards to performance
- transparent appointment procedures, and
- adequate communication with investors

whilst easy to measure, have been shown to have a weak or even negative relationship with the strong financial performance of corporates.

This paper states there is increasing evidence of that “soft” governance factors are important for performance of corporates. These include:

- a clarity in roles, responsibilities and relationships between: CEO and chair; directors and management; directors and shareholders/stakeholders
- healthy chair/CEO interface
- directors working as a team
- culture, trust and open dissent
- right skills, competencies and characteristics, including industry/business knowledge
- a good induction process and ongoing access to training
- leadership skills of the chair
- information flows
- regular evaluation of board performance.

¹ Meredith Edwards and Robyn Clough “Corporate Governance and Performance – An Exploration of the Connection in a Public Sector Context”, University of Canberra, January 2005

Edwards and Clough state in Section 2.4 of the paper: “In summary, research conducted by those working closely with boards suggests that:

- The ‘hard attributes’ of governance such as board independence may be necessary but are not sufficient. At best they form minimal standards of good governance. More accurately, it is the interplay of these ‘hard’ but easy to measure attributes and the ‘soft’ attributes that lead to good governance.
- The ‘soft’ attributes of governance such as the chair/CEO relationship, board behaviours and board culture and critical to good governance.”

Recommendations:

There should be a requirement to conduct independent trustee board reviews on a regular (say three yearly) basis. In the intervening period between independent reviews, the board as a whole should develop processes for monitoring and measuring the performance of individual trustees against pre-determined criteria (i.e. board self assessment).

Trustee performance should be measured across the following categories:

- Fitness and propriety of individual trustees – including the implementation and maintenance of a Fit and Proper policy as part of a broader risk management framework to assist the trustee to manage the risk that responsible officers are not fit and proper. As part of their ongoing supervision of superannuation funds, APRA conducts regular reviews of trustee boards to ensure their trustee’s Fit and Proper policies are being adhered to (and takes action where this is not the case).
- Where an independent review takes place, the review process would assess the difficult-to-measure ‘soft’ attributes described above, such as culture, communication, relationships and information flow.
- Governing the Board – including the management of conflicts and the ability to act at all times in the best interest of members.
- Strategic Direction and Planning (see below).
- Resources – including the adequacy of their financial, technical and human resources;
- Outsourcing – including the due diligence processes around the selection of outsourced providers;
- Investments – including the alignment of investment assets to the time horizon of members;
- Risk management – including operational risk;
- Monitoring and supervision – including the management

of delegated functions both internally and to outsourced providers;

- Financial – including the management of taxes, capital gains and losses as well as transaction costs; and
- Running the Board – including the provision of services to members that are efficient and cost effective.

An example of the questions/requirements/benchmarks that relate to Strategic Direction and Planning could be that the board:

- Has a clear understanding of all significant external factors that could impact on their fund;
- Has a clear understanding of their fund and its membership;
- Periodically reviews whether continuing to operate their fund is the best way to meet the needs of their members;
- In consultation with management, has developed a longer term strategic plan to meet the needs of their members within the constraints of the sole purpose test;
- Rigorously reflects on and debates the efficacy of their organisation's strategic direction before endorsing it;
- Periodically reviews the strategic plan and updates it as required;
- Approves operational plans (usually annually) to implement their strategic plan; and
- Approves budgets which align with their strategic and operational plans.

5.2.4 Apprehension of personal liability:

Is trustee behaviour adversely affected by their apprehension of personal liability, thereby making fund governance more problematic, or is there an adequate balance between the duties of trustees and their potential liability in the case of a contravention?

Apprehension around personal liability can often exist where trustees (especially new trustees) are not clear about their duties and/or how to discharge them. This is particularly the case given the complexity of superannuation (refer to the issues raised in section 5.1.2). In section 5.2.2 of this submission we have provided comments around trustee training.

Once trustees build up their knowledge and have a good understanding of their governance role, there would arguably be less apprehension. That being said, it can be argued that it is beneficial for trustees to have a certain level of apprehension about failing in their duties and this apprehension in fact serves to improve their performance and should in theory provide a greater degree of comfort to members that the trustees are acting in their best interest.

However, where there is a real fear of criminal liability, this can skew trustee behaviour in unintended ways. An example of this is the inability of the industry to reduce the

length of Product Disclosure Statements (PDS). Trustees find it difficult to balance their PDS disclosure requirements with the goal of reducing PDS length due to concerns regarding criminal liability.

There is also the issue of criminal liability attaching to the non disclosure of significant events to fund members. As well as issues of criminal liability, there is also trustee apprehension about receiving a qualified audit.

Recommendation:

As a minimum, remove the criminal liability relating to PDS and significant event disclosure.

Refer to our recommendations regarding trustee knowledge, skills and training in section 5.2.2.

5.2.5 Trustee independence:

Should trustees be members of a fund of which they are a trustee so their interests are more fully aligned, or should they not have a personal interest in the fund?

It is irrelevant whether or not the trustees are members of the fund. Under trust law, they have an obligation to act in the best interests of all members. As a member of the fund, there is no guarantee that the trustee's interests will be more fully aligned with the entire membership.

There is also a low probability of any one member having enough assets to be a substantial stakeholder. As such, issues that may arise in a corporate context with a substantial stakeholder on the board are unlikely to apply to trustee boards.

We therefore do not believe any changes are required in this area.

5.2.6 Reliance on outsourcing:

In many cases, trustees engage third party experts to perform a large number of the functions of the fund. Have funds struck the right balance between internal and external expertise?

There are significant differences between trustees when it comes to the levels of outsourcing. Some trustees outsource nearly all functions whilst some trustees outsource very little. For example, retail superannuation funds are generally part of financial conglomerates where the administration, call centre and insurance are "insourced" (i.e. provided by the conglomerate) and the investments are partially insourced and partially outsourced (to other fund managers). In contrast, many industry superannuation funds outsource their administration, call centre and insurance whilst the investments are partially insourced (i.e. invested directly) and partially outsourced.

It is difficult to say whether trustees have struck the right balance between internal and external expertise. However, the outsourcing of inputs is not the relevant

factor, particularly in relation to measuring the performance of trustees. Whether or not inputs to key functions are outsourced, trustee performance should be measured on the outputs – that is, on the quality of the trustees’ decisions and the outcomes for their members.

On a conceptual basis, the system’s architecture should be based around acting in the best interests of members. Whether or not the trustee has outsourced a particular function, the relevant test should be whether the arrangement is well governed and whether the outcomes are consistent with members’ best interests.

There are a number of important matters when it comes to outsourcing:

- The trustee should be able to demonstrate that their decisions around outsourcing (including any decisions not to outsource) have been made in the best interest of its members;
- The trustee must maintain the balance of power (intellectual and economic) – the trustee must not be in a position where it can be unduly influenced by the service provider;
- There must be independence and transparency in the relationship between the trustee and service provider;
- Trustees must at all times be able to “walk away” from a service provider;
- The trustee must be able to properly understand and monitor whether the external service provider is adequately providing the services it has been contracted to provide. Issues would arise if trustees were to outsource their material business activities and completely abdicate responsibility to oversee and monitor how the external service providers are performing those activities. Trustees should be regularly monitoring the performance of their service providers, including those of related party service providers, as part of their Outsourcing policy.
- The trustee should regularly undertake appropriate benchmarking of the incumbent service provider against other providers (discussed further in section 5.2.7 below).

ASFA does not believe any changes are required in this area.

5.2.7 Conflicts in outsourcing:

In outsourcing so many functions, how do trustees who are associated with a service provider manage the conflict that arises between the interests of members and their own or associated interests? What should the rules be where a trustee has a relationship (by way of employment, directorship or ownership) with a fund service provider?

Trustees are required to have a specific outsourcing policy as well as clearly articulated processes for managing conflicts documented within their Conflict of Interest policy.

ASFA’s Best Practice Paper No. 7 Superannuation Fund Governance (currently under revision) deals with conflicts of interest and states that the trustee’s strategies for managing conflicts of interest should incorporate the following elements: Where possible, directors and staff should avoid placing

themselves in situations where conflicts of interest may result.

Any conflict that does arise must be recognised by the conflicted party, and its existence promptly reported to the trustee board.

For each conflict, an appropriate method of resolution must be devised and implemented. The strategy should include general principles to be used in managing different types of conflict.

Both the fact of the conflict and the method of resolution should be recorded in an appropriate register.

The trustee’s procedures should be regularly monitored, and appropriate action taken where non-compliance is identified (including appropriate disclosure to members).

Where the decision has been made to outsource particular key functions, the trustee should be able to demonstrate that a robust and transparent assessment has been undertaken during the tender process and that a reasonable number of parties were invited to tender.

The trustee should regularly undertake appropriate benchmarking of the incumbent service provider against other providers (for example, every 3 or 5 years). This regular benchmarking also applies to in-sourced arrangements (discussed in section 5.3.5) as well as material business activities outsourced to related parties or to third party providers. The framework for the benchmarking process should be explicitly documented and, where the benchmarking process has been undertaken by a delegate of the trustee, the results should be reported back to the board, which is ultimately responsible for making the final decision on the outsourced arrangement.

The nature and severity of the conflict can vary greatly depending on the situation. Please refer to our discussion of this issue at 5.1.6.

Conflicts of interest also occur in a range of other situations besides outsourcing – such as the situation when a trustee is on the trustee board of another superannuation fund.

5.2.8 Composition of the boards and succession planning:

Around three-quarters of all trustees are male and over 50 years old. Some trustee directors stay in office a long time and others are trustees of more than one fund. What rules should there be around qualifications, length of time in office, multiple trusteeships and selection processes for trustees?

ASFA supports a principles-based approach, not a prescriptive approach, to these issues.

Age and gender balance of boards - recommendations
Trustee boards should have a ‘balanced’ representation wherever possible. That is, ideally the make-up of trustee boards should be broadly representative of the fund’s membership demographic. However, we understand that this

is not always possible or practical (eg. where a fund has a very young age demographic), particularly given the need to have trustees with suitable experience.

We believe it would be desirable to have more women on trustee boards (and the same could be said for corporate boards) in order to remove the current gender imbalance. Trustees should conduct an objective assessment of their board's composition and, where boards do not have women represented, they should be required to disclose the reasons for this (i.e. reporting on an "if not, why not" basis). We also believe it would be desirable to have younger (suitably qualified) people with fresh ideas joining trustee boards. Trustees should consider implementing a formal succession plan to train and up-skill potential new board members (discussed further below).

We recommend that trustee boards consider whether it would be appropriate in their particular circumstances to implement either a maximum age for trustees or, alternatively, an age whereupon a trustee would be required to undergo an annual health check by a registered medical practitioner attesting to the individual's continued ability (both physically and mentally) to act in the capacity of trustee. This may be particularly relevant where a trustee board has not implemented a maximum tenure (discussed below) and, as such, may encounter greater difficulty in removing a trustee who is no longer able to exercise sound independent judgement.

Tenure on boards

ASFA suggests that best practice would be for trustee boards to consider implementing a policy which includes a maximum tenure on boards by way of fixed renewable terms (eg. a common pattern in corporate boards is to have a 5-year term with an optional additional 5-year term, with a maximum of 2 terms, but trustees could serve again after a given period of time off the board). Such a policy would be recommended but not made compulsory. It is up to each trustee to determine whether such a policy would be effective in their situation.

Whilst ASFA recognises that the imposition of maximum tenure may be an issue for some trustee boards as this could result in good trustees being lost, we believe that this potential disadvantage is balanced by the advantage of gaining fresh ideas and fresh thinking onto boards on a regular basis. Also, the introduction of maximum tenures would likely result in experienced trustees moving from one fund's board to another at the end of their tenure. This would not be an undesirable outcome since it would lead to the sharing of ideas, skills and expertise gained from previous board appointments.

This arrangement could be supported by a comprehensive succession planning process.

Multiple trusteeships

Please refer to 5.1.6 for a discussion of this issue.
Independent trustees – recommendation

ASFA's position is that there should be no requirement for trustee boards to have independent trustees, however boards should have the option of appointing them. SIS already allows independent directors (sections 89(2), 108 and definition in section 10), however these existing arrangements should be expanded to allow multiple independent directors if so desired by the trustee. That is, any impediments regarding the appointment of independent trustees should be removed, including the requirement for APRA approval to have more than one independent trustee on a board.

Selection process & succession planning

Beyond the competency standards for trustees outlined previously in this submission, the selection process should be left to the trustee board and/or the terms of the constitution. However, the selection process should be clearly disclosed to members in all instances. Trustees should have an appropriate succession plan and should consider seeking specialist skills when appointing new board members, such as legal or investment skills, where a skills gap in a given area has been identified.

It should also be recognised that in some circumstances the trustee board may have little control over who is appointed to the board – for example where a new trustee is either elected by the members of the fund, or appointed by the employer.

In addition, the succession plan should consider the training needs of new board members (relevant to the individual's base level of skills, knowledge and understanding of their duties as trustee). Since it often takes time to provide them with the necessary training to enhance their skills and knowledge to the required level, consideration should be given to providing training to new board members before they actually commence their tenure (eg. say 6 months prior to joining the board). In respect of member-elected directors, the elections could be run such that the successful candidate is determined 6 months prior to joining the board (albeit that the official appointment would take place on commencement of tenure) in order to undertake the necessary training. This approach would satisfy section 89(3) of the SIS Act which requires equal representation rules to be satisfied by filling trustee vacancies within 90 days.

Consideration should also be given to staggering the commencement of new trustees as part of the board's succession plan. For instance, rather than having all of a board's employer-appointed directors' terms expire at the same time (i.e. in the same year), the board should consider staggering the end-date of each director by one year such that there is not a sudden and dramatic drain of skills and experience from the board at given points in time. We note that some funds already do this.

Maximum size of boards – recommendation

Research has been conducted by the Melbourne Institute of Applied Economic and Social Research (The University of Melbourne) on the optimal size of boards. Results

published in their paper² indicate that, whilst empirical research on board size is relatively uncommon, two studies cited found that the average board size across a sample of 452 US firms over an eight-year period (1984-1991) was 12.25. In addition, research undertaken by Jensen (1993)³ and Lipton and Lorsch (1992)⁴ shows that as board size increases it becomes difficult for an additional director to increase value.

A larger board negatively affects the amount of time available at typical board meetings, and has a negative impact by leading to greater formality and less frankness and openness on strategic discussions. As such, a larger board may not in fact be an effective board in that it may be less cohesive and more likely to endure individuals who add little value. The authors of the abovementioned research therefore recommend limiting the sizes of boards to ten people with a preferred size of eight or nine.

However, a more recent study out of the University of Canberra⁵ suggests that there is no consensus on what the ideal board size actually is. Some examples of the inconsistencies thrown up by the various research results cited within this study include:

- i) Eight directors is cited as the upper limit, and the mean board size is 6.6⁶
- ii) Eight is described as “typical”⁷
- iii) Eight to eleven is viewed as optimal⁸
- iv) Six to nine is current good practice in the private sector (but this may differ from organisation to organisation in the public sector)⁹

One of these research studies¹⁰ suggests that there is an “inverted U” relationship between board size and performance in which, beyond a certain point (tipping point), the difficult dynamics of large board prevail over the skills/expertise advantage that additional directors might bring. However, this same study also found evidence in the Australian context that large sized boards are not necessarily impediments to good performance. Yet another study¹⁰ on company boards asserts that, for certain types of firms,

larger boards actually increase firm value.

In summary, the results of the various studies into optimal board size and the effectiveness or otherwise of larger boards as compared to smaller boards are mixed and inconclusive.

In respect of superannuation trustee boards, the number of trustees required would depend somewhat on the circumstances (i.e. complexity) of each fund. For instance, defined benefit funds might require an actuarial expert on the board and funds that self-insure might require an insurance expert. That is, trustee boards need to ensure that there is an appropriate mix of individuals on the board with the appropriate skills relevant to the needs of their fund, which could in turn impact on the number of trustees required. As such, it is difficult to prescribe an upper limit on board size that fits all circumstances.

Instead, ASFA supports guidance being provided to trustee boards regarding the advantages of having an appropriate number of trustees on their board (with the requisite skills set) relevant for their particular fund. This guidance should take the form of best practice papers rather than through prescriptive legislation. We are currently updating our ASFA Best Practice Paper No. 7 – Superannuation Fund Governance which deals with this issue.

5.2.9 Stock lending:

Should it be left to trustees to decide if it is in the interests of super fund members to have equity investments owned by the fund made available for the purposes of short-selling or hedging by third parties, or should this practice be regulated in some way

ASFA does not support directed investments – i.e. Government directions to invest or not invest in certain classes of assets (such as venture capital, infrastructure, regional development, research and development,

2 University of Melbourne (1997), Executive Remuneration, Board Structure, Corporate Strategy and Firm Performance: A Taste of the Literature

3 Jensen, M. (1993), The modern industrial revolution, exit, and the failure of internal control systems

4 Lipton, M. and Lorsch, J.W. (1992), A modest proposal for improved corporate governance

5 University of Canberra (2005), Corporate Governance and Performance: An Exploration of the Connection in a Public Sector Context

6 Kiel, G.C. and Nicholson, Gavin J (2003), Board Composition and Corporate Performance: How the Australian Experience Informs Contrasting Theories of Corporate Governance

7 Larcker, D.F., Richardson, S.A., Tuna, I. (2004), Does Corporate Governance Really Matter

8 Leblanc, R. and Gillies, J. (2004), Improving Board Decision-Making: An Inside View. Alternatives Beyond Imagination

9 Uhrig, J. (2003), Review of the Corporate Governance Arrangements of Statutory Authorities and Office Holders

10 Coles, J.L., Daniel, N.D., Naveen, L. (2003), Boards: Does one size fit all?

housing, forestry and small business) nor does it support superannuation assets being used for any purpose other than maximising retirement outcomes for members. Trustees should be free to make decisions regarding their investments based on the economic outcomes of those investments and without regulatory influences creating artificial markets for certain investments.

ASFA supports the thrust of the current sole purpose test in SIS on the basis that savings within the superannuation system should be for retirement income purposes.

ASFA believes it should be left up to each trustee to decide if securities lending is in the interests of its members and the practice should not be further regulated. However, if a decision is made to regulate this practice, ASFA's position is that regulation should only apply to naked short-selling (i.e. covered short-selling should be permitted).

5.2.10 Consolidation:

Should trustees of small funds be obliged to take steps to merge the fund in the pursuit of economies of scale in the long-term interests of members?

No. Trustees must always consider the long term viability of their own fund. Whilst it can be argued that there are currently too many funds, there will always be a place for niche providers (such as small defined benefit funds). Australians like choice and members who are unhappy with their fund can transfer their balance elsewhere under the portability rules.

In ASFA's view it is a mistake to think that bigger is always better. This is especially the case since the industry is moving towards shared infrastructure which will allow even quite small funds to run efficiently.

Compulsion is not required. Competition and regulation, as well as APRA licensing, has done much to encourage consolidation. Further consolidation will occur naturally as a result of continued competition within the industry (more meaningful league tables could also assist in this regard). In addition, benefits similar to that of consolidation can be achieved by other methods, such as economies of scale, through shared architecture, white labelling arrangements and the development of new IT architecture eg. 'Cloud technology'.

There should be transparency around any decision on whether or not to merge. For instance, if a trustee receives an approach to merge, it needs to consider the merits of the offer in full and be accountable to members for their ultimate decision.

Recommendation

There should also be full disclosure to members where a decision has been taken to merge the fund or, alternatively, trustees must inform members of the reason(s) for the trustee's decision not to merge.

5.3 Government and regulatory

5.3.1 Government policies:

Because super is concessionally taxed, compulsory and otherwise facilitated by Government, should Government:

5.3.1.1 use the system to advance other policy objectives such as sustainability, corporate social responsibility and managing climate change;

ASFA does not support directed investments – i.e. government directions to invest or not invest in certain classes of assets (such as venture capital, infrastructure, regional development, research and development, housing, forestry and small business) nor does it support superannuation assets being used for any purpose other than maximising retirement outcomes for members.

Trustees should be free to make decisions regarding their investments based on the economic outcomes of those investments and without regulatory influences creating artificial markets for certain investments.

ASFA supports the thrust of the current sole purpose test in SIS on the basis that savings within the superannuation system should be for retirement income purposes. It should be recognised that superannuation money belongs to superannuation members, not to Government. Government has given members, and trustees on their behalf, control over the investment of such money. For these reasons the superannuation system should not be used to advance other policy objectives such as sustainability, corporate responsibility and managing climate change.

5.3.1.2 be able to influence whether super funds make particular investments (eg infrastructure) either by directly mandating some level of participation (eg like a '20/30 rule') or providing strong incentives to do so; and

No. Please refer to comments in previous question. Trustees should be free to make decisions regarding their investments based on the economic outcomes of those investments and without regulatory influences creating artificial markets for certain investments.

A better way for the government to encourage investment in infrastructure (or any other area) would be via the provision of incentives. This would mean that the trustee still has the duty to decide if making the investment (taking into account the incentives) is in their members' best financial interest.

5.3.1.3 remove barriers (if any) preventing trustees investing in long-term investments, such as infrastructure? To what extent do these barriers exist? Are portability and the ability of members to switch between investment options inhibiting the ability of funds to make long-term investments? Should the Government have a role in reducing these barriers and, if so, how?

It could be argued that the most significant barrier to funds investing in long-term assets such as infrastructure is the concern around liquidity brought about by the 30-day portability requirements under SIS and member investment choice (i.e. switching).

However, APRA's argument would be that the portability/ illiquidity provisions in SIS currently allow illiquid investments if members opt out of the portability requirements. APRA's comment around this issue is that they have seen little evidence of trustees utilising the current provisions to-date.

There is also a barrier in relation to perceived risk associated with Public Private Partnerships (eg. the cross city tunnel experience). These risks include sovereign risk (such as the Government changing the terms of the contract) and valuation methodology (particularly around IRR).

Notwithstanding the concerns discussed above, good long-term investments will stand on their own merits and attract investment from trustees as part of their funds' overall investment portfolios. The issue is that there is currently a shortage of attractive long-term investment products in which funds can invest. At the moment, funds are getting together to invest in long-term investment projects.

5.3.2 APRA regulation: Should:

5.3.2.1 APRA have a prudential standard-making power or a power to give directions in relation to superannuation? If so, in relation to what prudential issues?

APRA and Treasury have considerable powers to deal with operational issues. Section 31 of SIS permits the prescribing of operating standards for superannuation funds. There are several such operating standards in the regulations (Division 4.2) on topics such as:

- Equal representation
- Investment strategies
- Investments by non-complying funds
- Roll-overs and Transfers
- Lending to members

APRA is empowered under certain sections to issue determinations. APRA also issues circulars, which are not binding but are APRA's interpretation of relevant legislation. APRA also has the power to grant exemptions and issue modifications under Part 29 of SIS.

The question of whether APRA should have a prudential standard-making power is premised on the argument that the current regime is inflexible and/or inefficient. Whilst there is no evidence to suggest that specific problems exist in the use of Section 31, ASFA supports the need for a strong and pro-active regulator.

As such, ASFA supports APRA being granted a prudential standard-making power or a power to give directions in relation to superannuation, however there would need to be appropriate checks and balances in place.

5.3.2.2 APRA's powers extend beyond prudential matters? If so, in relation to what aspects of superannuation?

The consideration of whether APRA's powers should extend beyond prudential matters can be drawn out to a question as to whether there should be a single regulator for superannuation issues.

Where can the current regime be improved?

Before contemplating this question it is necessary to consider the areas where the current regulatory regime for superannuation is not working or could be improved. In ASFA's view these areas include the following:

There are three major regulators (APRA, ASIC and the ATO) and a number of others (AUSTRAC, SCT etc). Each regulator has different goals and is implementing different legislation. No regulator has a holistic view of the entire operations of a superannuation fund. This creates sub-optimal results.

For example, one regulator may implement a change which greatly increases costs of operation of all super funds (for example, the lost members legislation implemented by the ATO) at a time when Government is telling funds to reduce their costs and become more efficient. This also means that the regulators do not see the possible detrimental impacts of changes they make (as they may impact another area / regulator) and as such cannot accurately analyse the cost/benefit of a potential change.

The legislation covering superannuation is fragmented and disjointed, situated in a number of different areas – many people find it extremely difficult to navigate around the sections and regulations in SIS plus the Tax Act, Corporations Law, Family Law, Bankruptcy Act, AML/CTF legislation and Anti-Discrimination Law (both Federal and State). To add to the complexity, there is a regular series of amendments to these Acts and Regulations that can be difficult to find. The complexity of the structure of the legislation makes it difficult for superannuation funds to remain compliant and increases reliance on specialist legal advice. This increases the costs of operation.

The financial advice regime does not work for the majority of superannuation fund members who are defaulted into a superannuation fund. This is because the financial advice regime is premised on the assumption of selling a product. That is, on the adviser having a relationship with the member, and meeting them more than once. It is premised on the adviser approaching the member not the other way round.

The disclosure regime does not work for superannuation. The regime is the same for investment and superannuation, and as such it is based on the assumption that people make an active decision to invest. That is, the majority of disclosure is geared around information provided before investment.

In superannuation, whilst a significant minority of members make an active investment decision, most members are "defaulted" into a super fund by their employer under the

compulsory SG regime. They do not receive the disclosure information until after they have “joined” the fund.

Members want information at different points of their life – such as when they change jobs, want to choose an investment or insurance options etc. The disclosure regime does not easily allow for the delivery of information at these points in time.

There is overlap between ASIC and APRA in a number of areas, including unit pricing issues, disclosure and some aspects of licensing.

Individuals can “opt out” of the majority of the regulatory regime by starting an SMSF. These funds now represent over 30% of superannuation assets. Due to the large number of such funds (more than 400,000 funds and 800,000 members/trustees) it is difficult if not impossible for the ATO to effectively regulate them. This would be an issue no matter which regulator supervises these funds. Whilst information available to ASFA indicates that the majority of SMSFs are run in a professional fashion and are for the most part compliant, in effect these funds are “outside the net”.

There are regulatory gaps under the current system – for example the police cannot effectively prosecute the illegal early release of superannuation benefits.

There are a number of ways in which issues such as the above could be solved.

Single regulator?

One suggestion is to create a single regulator who deals with all superannuation matters including disclosure and advice, supervision and prudential capital. One thing on which there is strong support is that if a single regulator is being contemplated for superannuation, that same regulator should also regulate the other related industries of ADIs, insurers and managed funds. The reason is that retail superannuation funds are already financial conglomerates that offer a range of different products and financial services, and we have already seen a trend for industry funds to offer other financial services.

We expect that over coming years, as the industry experiences further consolidation, there will be an increasing trend in this direction for the majority of superannuation funds. For a conglomerate superannuation fund to have to deal with a different regulator for the superannuation part of its business from the rest of its business would be inefficient.

Under a so-called “single regulator” model where APRA was expanded to cover disclosure and advice, supervision and prudential capital, there would still be two major regulators as ASIC would still be the financial markets regulator.

Whilst we are not recommending a single regulator, the

advantages of a single regulator for super, ADIs, insurers and managed funds include:

- Eliminates overlap between regulators
- Better co-ordination
- Specialist skills in each area
- Functional approach copes better with complex and/or new products that have elements of different “products” eg. annuity products with an insurance element
- Even though the regulator deals with a range of financial products, there could still be special rules for superannuation
- Copes better with tension between disclosure and prudential supervision
- Could have a single licensing regime.
- This regulator could also cover SMSFs (although different licensing rules would apply).
- Ability to assess broader regulatory risks.

The disadvantages of a single regulator include:

- The current three regulator system is OK – though could do with some improvements – “If it ain’t broke, don’t fix it”
- Could potentially achieve the same effect by one set of rules for super
- There would be a cost of change – especially to super fund members
- You would still need different rules for different products
- Such a change could open the door to other major reform when the system does not need it

The strengths of the ‘twin peaks’ model has been recognised as one of the reasons Australia came through the GFC so well relative to other economies.

It is arguable whether managed funds need prudential capital requirements.

The aim would be to have one prudential regulator for financial services organisations. However where such an organisation is part of a listed company (eg. a bank or life insurance company), such an organisation would still have to also deal with ASIC as the regulator for listed companies. As such for these organisations the level of simplification delivered may not be very great.

As such, we are not convinced that a single regulator would be the best approach. It does solve a number of the issues discussed above, but by no means all of them.

What is important though is that the interaction between regulators is more streamlined and effective. In particular, when matters need to be referred between regulators there is a risk of “a feeling of failure” and, as such, enforcement referrals may get delayed or even worse “buried”.

We acknowledge there are some legal impediments to information sharing and, as such, would encourage their removal.

Single piece of legislation?

It has also been suggested that superannuation legislation should be combined into one Act and set of regulations, similar to the “old” SIS Act.

Currently legislation is fragmented and disjointed - it is difficult to navigate around the sections and regulations in SIS plus the Tax Act, Corporations Law, Family Law, Bankruptcy Act, AML/CTF legislation and Anti-Discrimination Law (both Federal and State).

Some argue that it would be a far more effective approach to have a single piece of legislation to regulate superannuation funds which deals with all aspects of their operation. This would also avoid jurisdiction shopping. For example, there are many obligations which overlap SIS, the Corporations Act and common law, including conflicts and misleading and deceptive conduct, where a disgruntled member could issue proceedings under either of these Acts or fall back on the common law.

One centralised piece of legislation which is specifically tailored for, and addresses the particular nuances of, superannuation could be a more effective way to regulate the industry. For example, moving the disclosure provisions in the Corporations Act (which is poorly drafted and attempts to encompass too much in a “one size fits all” approach) so they are returned to the SIS Act would assist in the potential move to a one regulator system, thereby reducing the costs for trustees through the removal of existing duplication.

Whether it is constitutionally possible to incorporate multiple pieces of legislation into one Act for superannuation is questionable.

Also it must be recognised that as superannuation funds are increasingly moving towards offering a range of financial products, a single piece of legislation covering superannuation will not necessarily cover all of the products offered by the fund. To provide efficiency in this future scenario, perhaps we should consider a move towards a single piece of legislation that covers all financial products – which could have different provisions for different products such as super, insurance etc.

5.3.3 Sanctions and enforcement:

Is the existing sanctions and enforcement framework applying to trustees’ regulatory obligations appropriate? Should civil or criminal penalties (or both, depending on the severity) apply for breaches of the SIS Act covenants?

The existing sanctions and enforcement mechanisms in place in relation to fraud, theft or reckless indifference and civil sanctions (including banning) for gross negligence, significant/inappropriate lack of judgement (i.e. dereliction of duty) are sufficient. There is no evidence to suggest that more are needed.

ASFA does have a concern that some sanctions open to

regulators are a “blunt” instrument and, as such, the ability to change or address behaviour is limited. For example, criminal sanctions only apply to the non-reporting of significant events to members. This should be changed to enable the regulators to have a choice of regulatory tools.

Accordingly, ASFA recommends the review of penalties, particularly criminal, to ensure that the regulators has a wide variety of tools in their regulatory tool box.

5.3.4 Related party transactions:

A regulated superannuation fund is not subject to the regime governing related party transactions that applies to companies and managed investment schemes under the Corporations Act 2001. Is this a gap leading to practices that would not be permitted without member approval if the funds were subject to that regime?

Part 5C.7 of Corporations Law provides for member approval when benefits are made available to related parties, mirroring the related party requirements for public companies in Chapter 2E of Corporations Law.

The exceptions provided in Corporations Law are quite generous. Numerous transactions do not require member approval including transactions on arm’s length basis and transactions involving remuneration and reimbursement for officers or employees. Any of these transactions can occur between a registered managed investment and related party without prior member approval.

Superannuation funds are already bound by the requirements of trust law and the section 52 covenants of SIS to act in the best interests of members. There are strong common law obligations on trustees not to unduly benefit from their position. Section 109 of SIS already requires all investments to be made on an arm’s length basis and the Part 8 requirements treat practically all related party transactions as in-house assets and subject to the 5 per cent cap. Overall, the current SIS requirements are just as strong, if not stronger, than those for registered managed investments. For instance, the managed investment provider must seek member approval before making a non-arm’s length transaction, while SIS bans such transactions altogether. The provisions within SIS are likely to be better protections against agency risk.

ASFA does not support the adoption of the regime governing related party transactions that applies to companies and managed investment schemes. The existing SIS provisions provide stronger protection.

5.3.5 2007 PJC Inquiry:

In August 2007, the Parliamentary Joint Committee on Corporations and Financial Services issued a report into the structure and operation of the Australian superannuation industry. The committee made 31 recommendations. The Review proposes to examine the recommendations of the committee that fall within its terms of reference and seeks

feedback on the following recommendations relating to Governance issues:

Recommendation 4

3.35 The committee recommends that peak superannuation bodies and APRA continue to work with the Australian Accounting Standards Board with a view to forming appropriate compulsory accounting and disclosure by all funds for promotional advertising, sponsorship expenses and executive remuneration.

We support the recommendation that superannuation bodies and the regulators (both APRA and ASIC) continue to work with the Australian Accounting Standards Board (AASB) with a view to forming appropriate and consistent accounting and disclosure by all funds. ASFA, as the peak industry body, has participated in numerous consultation processes undertaken by the AASB and is in the process of providing comments in relation to Exposure Draft (ED 179): "Superannuation Plans and Approved Deposit Funds". ASFA looks forward to working closely with the AASB in the future in relation to accounting and disclosure issues. It is important that the financial statements for superannuation funds be useable and readable by members and any increased disclosure requirements in the financial statements should reflect this.

Recommendation 6

3.65 The committee recommends that trustees of superannuation funds publicly tender key service provision agreements.

ASFA does not support the recommendation that trustees should be required to publicly or privately tender for the provision of key services due to the unwarranted cost and complexity that would be involved. This should be a matter left to the professional judgement of trustees. There is no evidence that a tender would result in improved outcomes for the industry, particularly when the cost of implementing such an arrangement is weighed against any potential benefits to trustees and ultimately their members.

Instead, trustees need to have a reasonable basis for justifying their decisions. – i.e. whether to remain with the current provider (whether insourced or outsourced) or appoint a new provider. For example, where the decision has been made to outsource particular key functions, trustees should be able to demonstrate that they have a comprehensive process for selecting and/or retaining the provider (eg. a reasonable number of parties were invited to tender, an external consultant's review and recommendation or benchmarking exercise was conducted). As with the decision of whether or not to tender, the number of parties invited should not be prescribed but should instead be left to the trustee's professional judgement.

Where in-sourcing or delegating to a related party, the trustee should regularly undertake appropriate benchmarking of the incumbent service provider against

other providers (for example, every 3 or 5 years). This regular benchmarking should also apply to material business activities outsourced to related parties or to third party providers (as discussed in section 5.2.7). As a minimum, there should be a full assessment of the incumbent service provider. The framework for the benchmarking should be explicitly documented and the results of the comparison process should be reported to the trustee board, which is ultimately responsible for making the final decision on whether or not to retain the in-sourced arrangement.

5.4 Accountability to members

5.4.1 Accountability to members:

Are super funds, individually or as a class, sufficiently accountable to members? How successful has the policy committee structure (Part 9 of the SIS Act) been?

The role of the policy committee is potentially an important and valuable one in that it gives members an avenue to ask questions of the trustee, particularly around the fund's investments, operation and performance, and to express their views and concerns about the operation of the fund. However, generally the policy committee structure has not worked. It has been suggested that many policy committees exist simply to comply with the legislation but they have little to no influence on trustee decisions/fund outcomes. Further, the obligations placed on trustees of funds with greater than 49 members to "take all reasonable steps" to ensure that a policy committee is formed are ambiguous – what constitutes "all reasonable steps"? In many cases, substantial expenses have been incurred in an attempt by trustees to comply with Part 3 of the SIS Regulations, often with few committees ultimately established.

We believe that the establishment and ongoing operation of policy committees is an ineffective use of the fund's financial resources, particularly when the cost is weighed against the outcomes generated in many cases.

Recommendation

ASFA recommends that the requirement for trustees to form policy committees should be abolished.

Do super fund members need a body or association that just represents them and advocates their issues?

We do not believe members need another body or association that represents them and advocates their issues. Members have access to external dispute resolution bodies, regulator compliant mechanisms, consumer groups, local parliamentarians as well as a Federal Minister for Superannuation. Superannuation funds are also heavily prudentially regulated. This we believe differentiates the super industry from say normal corporate enterprises.

ASFA, as the peak superannuation industry body, also

plays a significant part in fulfilling this role. One of ASFA's major objectives, as outlined in our constitution, is to protect, promote and advance the interest of funds, their trustees and their members.

ASFA works closely with Government and regulators to ensure the messages of the superannuation industry and the wider financial services industry are heard. Our approach is to work closely with our political, regulatory and government agency stakeholders behind the scenes where we can influence more directly to improve outcomes for the industry and, ultimately, for members.

In these critical times for the superannuation industry, ASFA offers a clear point of difference in representing the industry and members' issues. Through ASFA's unique combination of leadership, lobbying, advocacy, education and consultation, members are represented regardless of which industry sector their superannuation fund belongs.

In addition, ASFA's suite of Best Practice Papers are a vital resource and sets the standard for the industry. They provide guidance to trustees and encourage best practice in relation to a number of areas, which ultimately benefit members. Our Best Practice Papers are continually updated as a result of industry developments and new papers are prepared as issues arise.

ASFA also delivers comprehensive industry information through our ASFA Action (online newsletter), Superfunds magazine, Policy Roadshows and other segmented and focused events across the country. We continually receive and respond to queries from fund members, who look to ASFA to provide guidance to the industry and act as the Voice of Super through public policy that is in the best interests of members.

Also, members lack an annual general meeting equivalent. Should larger funds host, for example, online AGMs?

The use of annual general meetings is not something new for superannuation funds in Australia. Some funds have chosen to stage annual meetings for members but more for information sharing and communication purposes. However attendance has been low. One major industry fund with an active membership, for example, notes attendance at such meetings of 300-400 out of a membership of 10,000. A review of selected international comparisons notes that compulsory member meetings are very rare within superannuation/pension fund regulatory regimes.

There are obvious pros and cons for annual meetings. Annual meetings do afford exposure of trustees to members and where the trustees would be expected to explain their decisions of particular issues raised at any such meeting. Meetings could also be useful in providing members with an opportunity to become more involved in their fund and in developing a greater sense of ownership and belonging to a fund.

There are also many negatives to requiring meetings.

1. Member meetings will generate additional costs – which will likely be borne by all fund members. Costs become an even more worrisome issue for multi-employer funds and single employer funds that are multi-site. The logistics of organising a meeting would prove difficult for some. For a large multi-employer fund, the costs could run into the millions of dollars per meeting. One multi-employer fund estimates inviting members to an annual meeting would cost \$400,000. Even online AGMs would impose substantial costs for funds.

2. A mandatory meeting does not sit well with the concept of a trust, as members are beneficiaries of the trust. As well, SIS restricts the ability of trustees to be directed by other persons. There is a genuine concern in the industry that trustees may be more likely to take a short term investment focus if they are pressured by a vocal (but small) group of members.

3. The threshold question remains as to what powers members can exercise at these meetings. This is particularly important as members are beneficiaries of a trust arrangement and do not have ownership the same way a "shareholders" do. Are members granted the power to publicly ask questions of the trustees (and maybe the auditor and actuary) about material provided? Or are members granted the power to select / remove / replace trustees and/or appoint the auditor, actuary or any other service provider? Invoking a power to call or requirement to hold meetings will also require considerable legislative work on which (if any) types of funds are exempted from this requirements; what is the appropriate unit of members; voting rights; notice; bringing of motions; minutes; quorums and so forth. Another issue that would need to be considered if any such proposal is to work properly is whether members would be granted paid time off work to attend meetings, as is required in Quebec.

SIS already provides members with significant rights to be involved in their fund, importantly through member representative trustees. Further, SIS requirements regarding voting ensure that neither employer-appointed nor member representative trustees are able to dominate a properly constituted and operating fund.

Individual members also have other significant rights under SIS including:

- Right to receive information on their benefit and the fund on an annual basis.
- Right to request further information, such as full set of accounts and recent actuarial reports.
- Right to be notified of surplus repatriation.
- Funds must also have a mechanism for responding to member complaints and queries and to respond within particular timeframes. Members must be told at entry and annually about this facility. Members (and others) also have the right to take certain complaints to the Superannuation Complaints Tribunal (SCT). Importantly, trustees are required to act in the best interest of members under the section 52 covenants.

In conclusion, ASFA does not believe that AGMs (either mandatory annual meeting or meetings called by members) are appropriate in the current SIS regime. Encouraging member involvement could be better done through voluntary information meetings (eg. member seminars or briefing sessions), improved communication material and use of electronic delivery mechanisms for inquiries and information (eg. online queries page or email drop boxes).

5.4.2 Corporate governance of underlying investments:

There is currently no formal connection between the views of super fund members and the exercise of votes on equity investments held by the fund. As members of superannuation funds are collectively substantial owners of capital, should they have a say on who represents their interests in corporate board rooms? How could this be achieved?

We support trustees being active shareholders and having the fund's interests represented in corporate board rooms. ASFA has issued its Best Practice Paper No. 17 on Active share ownership guidelines for superannuation fund trustees.

That being said, notwithstanding the fact that members are collectively substantial owners of capital, we cannot envisage trustees taking into account their members' opinions as part of this process. There are a number of issues that would make this difficult, including:

- Evidence suggests that, on the whole, members are insufficiently engaged with their fund for this to be a worthwhile exercise.
- There are practicality and cost issues related to trustees canvassing their membership's opinion in relation to the exercising of votes. What would they do where there are competing groups of members with different opinions?
- Timing is also an issue – it is difficult enough for trustees to make decisions and communicate to their custodians in the time allowed. Apart from the cost issues discussed above, consulting members would require significant time.
- Trustees have the ultimate responsibility for making decisions about the investment of their fund's assets.

For these reasons, we do not believe trustees should be required to canvass the fund's membership with respect to the exercising of votes on equity investments held by the fund. It should be left to trustees to act in accordance with the law and in the best interests of members.

5.4.3 Responsibility for investments:

How do superannuation trustees decide what choices to offer members? How much responsibility should be placed on trustees for individual investment strategies when members make investment choices either with or without separate advice? Is it appropriate to allow fund members to direct a trustee to follow any investment strategy a member chooses from the trustee's available investment options?

Trustees are generally required to provide a default option for those members who fail to make an investment choice. Trustees are also able to offer members a menu of investment options under the member investment choice (MIC) regime.

However, there is a disconnect between the setting of investment menus and the responsibilities of trustees with respect to members who actively make a choice. Some would argue that the responsibility of the trustee rests solely in formulating appropriate investment options having regard to the circumstances of the fund (including those outlined in section 52(2) of the SIS Act). However, the counter-argument is that trustees have a responsibility in providing a 'suitable' number of investment options and that, in some instances, members are offered too much (or inappropriate) choice. With the introduction of MIC, it is difficult to see how trustees can comply with section 52(2) (f) when members are effectively given the power to select their own investment strategy.

There is also the issue that the trustee does not have a full view of the member's financial situation – eg. in relation to other superannuation accounts or investments outside superannuation. It is therefore difficult for the trustee to determine whether a particular investment option is appropriate for that member.

ASFA's position is that members should be allowed to direct a trustee to follow the investment strategy a member chooses from the investment menu available, however there needs to be a two tiered regime:

1. If members do not exercise a choice they should be invested in a default option (the issues around defaults will be discussed in our submission to Phase Two: Operation and Efficiency). In this situation the trustee has the fiduciary obligations currently enshrined in SIS and common law – in relation to asset diversification.
2. However, if a member actively makes an investment choice (including actively choosing the default option), they are in effect taking control of their own investment in the superannuation fund and thereby 'opting out' of the default option system. In such circumstances, the trustee would no longer be obliged to satisfy the broader fiduciary obligations of, for example, asset diversification.

Notwithstanding the above, trustees should consider:

- The full extent of their menu to determine whether the number and type of options is suitable for their membership – for example is the choice broad enough? Is it too broad?
- Their product design and any restrictions around the investment choice offered to members – for example, is there a limit to the proportion that can be invested in a narrowly invested sector option? Should retirees be able to draw income from a narrow sector option that could become illiquid?

These considerations are part of a trustee's fiduciary duty and do not need further prescription.

The inclusion of members who actively choose the default option in the 'opt out' regime will require trustees to be able to differentiate which members are in the default option because they have not made a choice and those that have actively chosen to be invested there. Whilst this might place an additional obligation on trustees, we would argue that this is an important piece of information trustees should have in order to fully understand their fund's membership.

In respect of the second scenario, where a member makes an active investment choice there would need to be protection around the member 'opting out' of the default option system. Examples of these could include:

- Trustees properly communicating the consequences of making an investment choice – including appropriate disclosure in the fund's PDS, switching forms, etc.
- Clear standards (across the industry) in relation to the risk level of the portfolio.
- Disclosure documents containing clear asset allocation and other disclosures that provide the members with all relevant information to enable an active investment choice.
- The development of standards to enable "true to label reporting".
- Members being strongly encouraged to seek personal financial advice that is tailored to their own personal circumstances prior to making a valid investment choice.
- Written acknowledgement and certification from the member that they fully understand the consequence of making an active investment choice, including the limited protection and potential for recourse. For example, if members obtain personal financial advice, they would provide written acknowledgement and certification to the trustee that they have received and understood the advice regarding the consequences of 'opting out' of the default option system.

The essential point under the 'opt out' scenario is that, if members are empowered to choose their own investments, then members must also assume responsibility for that choice, good or bad. If the trustee meets its obligations to develop the various options for MIC, offering an appropriate cross section of choices for members, provides sufficient information to assist its members in determining which choice to make in relation to risk etc, then the trustee should be seen as having met its obligations and have access to the statutory defence, should a member make a bad choice or the investment markets experience a downturn.

We would envisage that the fiduciary obligations under the 'opt out' regime would still be catered for under the trust structure, however we note that an amendment to the legislation would be required to implement this change.

We recognise that this would require amending section 52(2) (f) of SIS as well as APRA revisiting its position in its Circular on Member Investment Choice, which suggests that the trustee remains liable to set the investment strategies for the

individual investment options in which members can direct their monies to be invested.

5.5 Operational

5.5.1 Investment Time Horizon:

It is often said that superannuation funds and investment managers are too focused on short-term performance. Is this criticism valid and, if so, what are the factors driving short-termism and what, if anything, could be done to encourage a longer-term horizon?

Yes, we believe the criticism is valid. There are a number of issues that lead to funds and managers focusing too heavily on short-term performance, including:

- Investment switching and portability are major factors contributing to the industry's short-term investment performance focus.
- Short-term is how the industry is assessed – monthly/quarterly performance statistics are published by the media and ratings agencies which focus funds and members on short-term performance.
- Investment managers competing with each other to produce the highest short-term results (since these statistics are published and often used as a basis of comparison of the managers' performance), which often leads to funds/managers taking greater risks to produce higher returns. Managers are quick to publicise good short-term results but tend to go silent when results are bad – perhaps consideration could be given as to whether this should be legislatively dealt with?
- Disconnect between what members receive in the way of their fund's investment performance and statistics published in the media or by ratings agencies. By the time members receive their annual statements (which show the fund's year-end or six-monthly returns), the fund has usually already released more up-to-date performance statistics for publication. With the recent volatility in the market, this disconnect has been further accentuated.

This issue is not only relevant for the superannuation industry. Arguably the real economy is also subject to too great a focus on short term performance, which often leads to outcomes that are not in the long term interests of stakeholders.

There is no easy answer to encourage a greater focus on longer-term horizon. Better education and advice are clear solutions, particularly around understanding the investment time horizon associated with superannuation as well as volatility and risk. Funds should better communicate to members that volatility and market movements do not always occur in a smooth line, and provide warnings about the consequences of investment switching (particularly frequent switching) as a result of considering short-term results.

There is evidence to suggest that members who switch more than once a year do so to their own detriment since it is often difficult to time the market.

Funds should be required to include projections on members'

annual statements which encourage a focus on longer term performance. However, we recognise that this would require careful and consistent wording around the assumptions used in the projections, warnings that the outcomes should not be relied upon to make financial/investment decisions, seeking personal advice etc. ASIC are already doing work in this space.

It will be important for ASIC to develop the assumptions to be used and standard strong warnings around relying on these projections.

There is also a need for meaningful and consistent league tables to measure funds on a like with like basis in terms of their long term investment performance and other key metrics.

5.5.2 Tilt towards equities:

Australian super funds seem to have had a bias towards equities in their portfolios (around 57 per cent before the global financial crisis, compared with an average of 36 per cent in 20 OECD countries where data are available). This meant that Australians' superannuation savings were more vulnerable to the global market turmoil, but equally are likely to benefit from a market recovery. Is this tilt towards equities justified? Should the Government impose restrictions to enforce more diversification to other asset classes or allow trustees to decide?

It is neither relevant nor appropriate to compare Australia's retirement income system with that of the other OECD countries since the majority of their superannuation or pension systems are publicly funded.

What is absolutely vital is that members' time horizon and their ability to achieve growth are viewed in the longer term. Recent research undertaken (by Mercer) has shown that the equivalent of 28% growth in members' superannuation balances occurs before retirement. Post retirement the figure is 60%. Under the current system, the only way the majority of Australians can hope to retire with an adequate income to support a dignified standard of living in retirement is by ensuring that a substantial proportion of their assets are invested in growth securities whilst working and also in retirement. The stock market has a 40 year history of being the top performing asset sector over the longer term, because it actually invests in the real economy.

ASFA does not support restrictions being imposed to enforce more diversification to other asset classes, nor any directed investments – i.e. Government directions to invest or not invest in certain classes of assets (such as venture capital, infrastructure, regional development, research and development, housing, forestry and small business). It should be left up to each trustee to decide the extent to which their portfolios are exposed to equities as part of the formulation and giving effect to appropriate investment strategies under section 52 of SIS.

5.5.3 Portfolio rebalancing:

How rigorously do super funds adhere to their portfolio rebalancing policies? What are members told about this? Should there be clearer rules about how far out of balance familiar types of portfolios (eg balanced, growth) can go before some action has to be taken; for example, some prescribed ranges?

Strategic asset allocation ranges (SAAs) already exist and trustees should be monitoring their exposure to the various asset classes against those ranges. Whilst we recognise that in times of high volatility there may be tactical reasons for moving outside asset allocation ranges, trustees should never be forced sellers or buyers, but should actively monitor their exposures against their SAAs on a regular basis.

They should take a particularly disciplined approach in doing so during periods of strong market volatility. Where ranges are breached in periods of rapid market movement, trustees should carefully consider what action they need to take, proactively engage with the regulators and make sure members are adequately informed of the circumstances as well as the action being taken by the trustee to address the situation.

Recommendation

Trustees should be obliged to disclose their asset allocation monitoring and rebalancing methodologies to members on joining (within the PDS) and on an ongoing basis (on the fund's website).

5.5.4 Leverage:

Are the current exceptions to the borrowing prohibition suitable? Should superannuation funds be permitted to make investments that can result in investment losses beyond the initial capital outlay (such as instalment receipts or contracts for difference) even if they do not involve borrowing?

Trustees of superannuation funds, including SMSFs, should not be allowed to borrow except perhaps in limited circumstances for operational purposes – but not for leverage or speculation.

Covered derivative positions should be allowed.

Deliberately uncovered or leveraged derivatives should not be allowed. Thus, there may be the potential to lose more than what was invested but this will be covered by physical cash or securities – in accordance with the trustee's derivative strategy.

Trustees should fully understand the exposure of all their investments. Every investment should go through an appropriate due diligence process (this can be delegated to the fund's investment committee but must be fully understood by the trustee).

5.5.5 Tax governance:

To what extent do trustees take an interest in the taxation of the underlying portfolio and, for example, the amount of capital gains tax being incurred? Crystallising capital gains in the accumulation phase can be adverse to members' interests, but will be unavoidable in certain circumstances and for certain types of funds. What are members (or their professional advisers) told about the tax governance policies of the fund? Is mandating an across the board obligation to have regard only to after-tax returns (e.g. in rewarding managers) a solution?

Trustees in general take a very keen interest in the taxation of the underlying portfolio, and it is part of their fiduciary duty to do so. Trustees should be instructing their investment managers to be managing their investments on an after-tax basis, however an across the board obligation to have regard to after-tax returns should not be mandated but should instead form part of a reporting standard.

ASFA has recently partnered with FTSE to create the FTSE ASFA Australia Index Series, the first Australian index series with after-tax benchmarks, to better align investment decisions with tax decisions (as some investment decisions can be attractive on a pre-tax basis but less attractive on an after-tax basis).

Institutional investors in Australia, including superannuation funds, rely on indices to benchmark their fund's performance, communicate this to their members, and to assess the performance of their fund managers. The FTSE ASFA Australia Index Series uses varying tax rates to calculate after-tax performance and offers all types of investors a more accurate representation of performance. We recognise that having regard to after-tax returns is not the only solution in relation to rewarding managers, however trustees should be strongly encouraged to do so in order to ensure there is no misalignment between superannuation funds and fund managers.

Members and their professional advisers should be fully informed about the fund's tax governance policies. For consistency and transparency purposes, information on the trustee's tax governance policies should be disclosed to members (either in the PDS or on the fund's website).

Appendix Two: ASFA Superannuation Fund Governance Framework

The following is a further discussion and explanation of the framework.

Full versions of the diagrams are included at the end of this section.

Overview

1. Diagram 1 illustrates the functional environment in which the trustee operates, and the functions which the super funds should undertake. It illustrates the trustee's oversight obligations in respect of the functional aspect of the superannuation fund.
2. The detailed diagram 2 is structural; illustrating the way the trustee should establish itself and the fund to satisfy its governance obligation.
3. The ASFA Governance framework is structured to clearly distinguish, and reinforce that there is a clear distinction between the trustee and management. Of necessity there is a clear separation of the functions that they each undertake, and of their responsibilities and obligations. Those obligations and responsibilities can be put simply as:
 - a. The Trustee governs and directs.
 - b. Management manages.
4. The trustee should not cross the boundary between directing and managing, rather they are charged with the setting of the strategy for the fund and, then, necessary oversight of functions.
5. On the other hand, Management is charged with the day to day functioning and administration of the fund. – via a chain of delegations from the Trustee/Board.
6. Management is charged with the day to day functioning and administration of the fund – via a chain of delegations from the Trustee/Board. The Trustee should not cross the boundary between governing and directing which are their responsibilities, and that boundary which delineates the obligations of management to manage.

The Trustee

7. The Trustee is solely responsible for superannuation fund governance.
8. The cornerstone of this "sole responsibility" obligation is that the Trustee is charged with the ultimate responsibility for the sound and prudent management of the superannuation fund. It is the Trustee that has sole responsibility for, and is accountable for all governance obligations of the superannuation fund and its members. Accordingly, it is the Trustee that must ensure that that an appropriate governance system exists and that it operates.
9. Where corporate governance is the system whereby an entity pursues the 'purpose' for which it was established, then the guiding principle for superannuation fund governance is that its purpose is to operate in the best interests of the members of the superannuation fund.

This, along with certain other trust duties, is in a manner codified in section 52 of the SIS Act. Trust Law also operates to regulate the Trustee, along with various other laws and regulators, which regulate the functions and actions of not just the Trustee, but also of the Fund itself.

10. Though the interests of other stakeholders are taken into account, the ultimate interest is emphasis is given to the interests of members.
11. Ensuring that this system exists and operates effectively is to be undertaken with the aim that improved governance links to improved performance, in both the corporate sense and the financial sense.

The Board and its Committees

12. The Trustee is a separate entity, and typically, though not always, takes the form of a company with a Board. In such a case, the Board should be supported by a secretariat function.
13. The effectiveness of the Board should be enhanced by the establishment of board committees to add specialist expertise where required and to assist with board workload. These committees play key roles in enabling the board to properly discharge its responsibilities.
14. The most common permanent committees are: Audit, Compliance & Risk Management, Benefit Claims, and Investment. Further committees and sub-committees should be established, on a permanent or as needs be basis, to support the necessary functions to be undertaken for the fund.
15. Qualifications – Fit and Proper: While a diversity of skills and backgrounds of the Trustee Board can be effective, it is important to ensure minimum standards and expertise of all directors, for their personal protection as well as for the benefit of fun members. The participants must be suitably qualified. The Trustee and those carrying out functions on behalf of the Trustee must have the necessary skills, qualifications expertise, and be provided with continuing training in order to perform.

Management

16. Reflecting the separation of ownership and management typical of corporate entities, there is a clear distinction between the Trustee and Management. There is therefore the clear separation of the functions that they each undertake, and of their responsibilities and obligations.
17. Identification, acknowledgment, and understanding of the separation of roles and functions, will assist in the identification and managing of any conflict of interests.
18. The Trustee should not cross the boundary between directing and managing. The Trustee is charged with the setting of the strategy for the fund, and then necessary oversight of functions.
19. Management is charged with the day to day functioning and administration of the fund – via a chain of delegations from the Trustee/Board.
20. A CEO should be appointed to undertake and represent Management, and be the liaison to the Trustee. The

CEO should not be the chairman of the Board of the Trustee in order to ensure that appropriate checks and balances exist. The CEO is supported by the necessary group executives / managers and their staff in order to undertake the necessary functions for the fund.

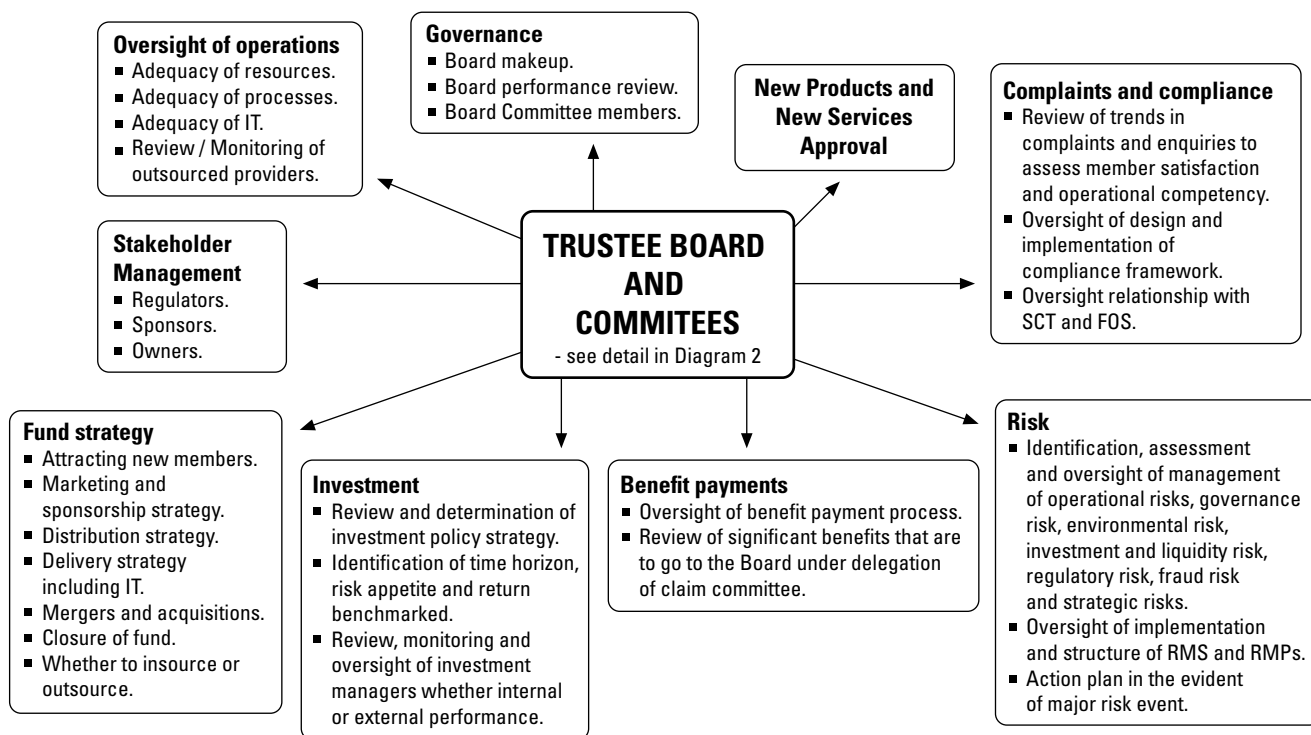
21. The Framework lists out necessary functions that the must be undertaken (subject to the funds particular circumstances) for the proper operation of the fund. Adequate resources must be available to the Trustee in order for the functions to be carried out. The Trustee must determine who is to carry out what functions, and which functions are in-sourced or out-sourced.

Reporting, Monitoring, Supervision, Assessment & Evaluation

22. Review, and assessment of all aspects, and all participants, is a critical function.
23. There must be regular and sufficient checks and balances, by way of audit, monitoring, supervision, performance measurement and assessment, to ensure that all relevant parts of the fund are in fact operating and functioning. There must be regular and sufficient reporting between all relevant parts for them to operate.
24. There should be regular and sufficient Trustee evaluation including an assessment of whether the Trustee / Board / its Directors have the necessary diversity of skills, experiences, and expertise appropriate to the Trustee and the superfund's ongoing needs. Similarly of service providers.
25. Risk Management must be embedded into the culture of the fund.

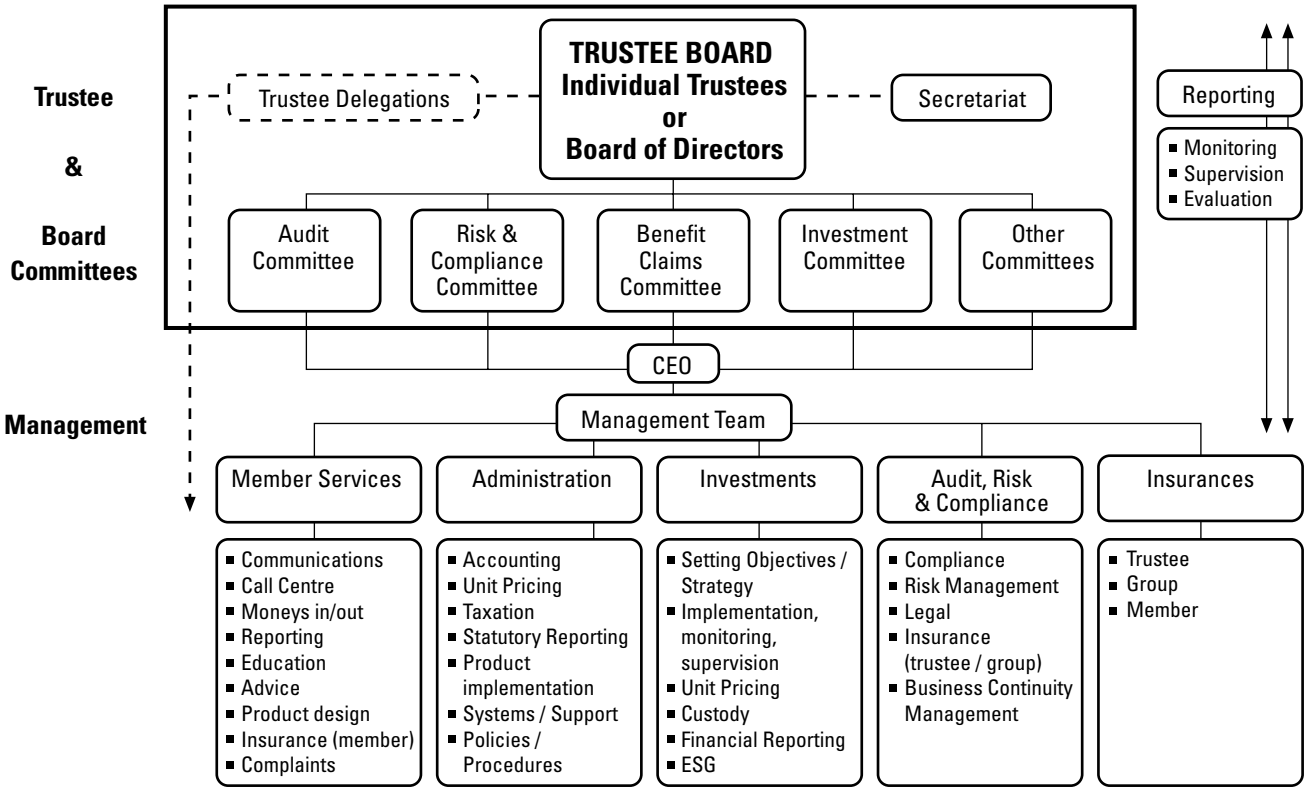
Diagram 1:

ASFA GOVERNANCE MAP



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Diagram 2:



ASFA Framework for Superannuation Fund Governance

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