The Association of Superannuation Funds of Australia Limited
ABN 29 002 786 290 I ACN 002 786 290
Level 6, 66 Clarence Street, Sydney NSW 2000
PO Box 1485, Sydney NSW 2001
T 02 9264 9300 I F 1300 926 484 I W www.superannuation.asn.au

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31 July 2015

Pat Brennan
General Manager, Policy Development
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Email: superannuation.policy@apra.gov.au

Dear Mr Brennan,

Governance requirements for RSE licensees: proposed amendments

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the letter from the Australian Prudential Regulation Authority (APRA) to all RSE licensees dated 26 June 2015 regarding the regulator's proposed changes to the prudential framework following the Government's release of *Superannuation Legislation Amendment (Governance) Bill 2015* (the Bill) and *Superannuation Legislation Amendment (Governance) Regulation 2015* (the Regulation) proposing new governance arrangements for APRA-regulated superannuation funds.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90 per cent of the 12 million Australians with superannuation.

General comments

ASFA provided a submission to Treasury on 24 July 2015 in response to the release of the Bill and the Regulation. We would be happy to provide you with a copy of this submission.

As stated in the above-mentioned submission to Treasury, ASFA supports the introduction of new section 86 of Part 9 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) which requires RSE licensees of all APRA-regulated superannuation funds to have at least one-third independent directors, with one of these directors serving as an independent chair.

However, ASFA does not support the proposed requirement that a majority of both the Board Audit Committee (BAC) and Board Remuneration Committee (BRC) be independent directors. In ASFA's view, while it is reasonable to require at least one independent director to be appointed to the BAC and BRC, beyond this, it should be up to each RSE licensee to decide how best to structure their committees.

Similarly, we do not support the requirement that the chair of the BAC and BRC must be an independent director. In our view, these committees should be chaired by the director who is most suited to that role, regardless of whether or not they are an independent director.

In addition, we have concerns with APRA's proposed timeframe for RSE licensees to prepare and approve a transition plan. In our view, and confirmed by feedback from our members, the industry needs 12 months from the finalisation of the requirements (including the prudential standards) to fully consider and prepare a transition plan that will ensure an orderly and timely adoption of such significant changes. As such, ASFA recommends that RSE licensees be given until 31 December 2016 to prepare their transition plan and have it approved by the board.

Our submission discusses issues regarding some limbs of the definition of 'independent', including what constitutes a 'material relationship'.

We have also provided some initial recommendations around APRA's proposal to update existing guidance in certain areas to support sound governance practices by RSE licensees. We look forward to providing further feedback to APRA as part of its consultation with industry in relation to updating the prudential standard on governance (SPS 510) and the development of the new transition prudential standard (SPS 512).

* * * *

We would be pleased to meet with you to discuss our submission.

If you have any queries or comments regarding the contents of our submission, please contact ASFA's Chief Policy Officer, Glen McCrea, on (02) 8079 0808 or by email gmccrea@superannuation.asn.au.

Yours sincerely

Pauline Vamos
Chief Executive Officer

asfa
the voice of super

Submission

APRA letter to all RSE licensees: Proposed amendments to governance requirements for RSE licensees

31 July 2015

The Association of Superannuation Funds of Australia (ASFA)

Contents

Executive summary

ASFA has consulted with our members on the proposed prudential requirements outlined in APRA's letter to all RSE licensees dated 26 June 2015, as well as the legislative requirements outlined in the Bill and the Regulation, in relation to the new governance arrangements for APRA-regulated superannuation funds.

Below is a summary of ASFA's recommendations in relation to the proposed changes to the prudential framework on governance-related matters. We recognise that a number of these (in particular, recommendations 2, 5 and 6) are actions for Treasury/government rather than APRA, but we have included them in this submission as we believe they are relevant considerations for the regulator, particularly given the coordinated approach being undertaken by Treasury and APRA in relation to the establishment of the new governance arrangements.

Definition of independence

Recommendation 1

ASFA supports the definition of 'material relationship' being addressed in the prudential standards.

We support APRA's intention to supplement the definition of 'independent' by setting out in SPS 510 the circumstances which the regulator considers to be a material relationship. ASFA will be working closely with APRA to ensure that the definition of 'material relationship' that will be included in SPS 510 is both robust and flexible and does not give rise to any unintended or impracticable consequences.

Recommendation 2

The power to determine whether a specific individual is or is not independent should be used by APRA sparingly. In order to provide reasonable boundaries for the use of the power to determine whether a specific individual is independent, ASFA has recommended to Treasury that:

- the Bill includes a power providing for regulations to be made prescribing the criteria that should be considered by APRA in any application of its power to determine whether a person is, or is not, independent; and
- the Regulation sets out those prescribed criteria.

Recommendation 3

ASFA recommends that it be made clear in the APRA prudential standard dealing with the transition arrangements (SPS 512) that RSE licensees are able to reclassify current directors as independent directors if they satisfy the new definition.

That is, being a current director should not preclude the director from being reclassified as independent, as long as they do not have any other material relationship with the RSE licensee that would preclude such a reclassification.

Recommendation 4

A person should not be precluded from being an independent director simply by virtue of having been nominated by a body that has the right to appoint a person, so long as the nominee meets all other independence requirements.

We recommend that APRA take this into account in the course of updating SPS 510 and the associated Prudential Practice Guide SPG 510.

Recommendation 5

ASFA recommends that the definition of 'independent' should not contain a prescribed three-year exclusion period for a person who has ceased to be employed by a supplier at an executive or director level. The ability of such individuals to be considered 'independent' should be determined by the RSE licensee on a case by case basis, with regard to prudential requirements in respect of the identification and management of conflicts of interest.

Recommendation 6

ASFA recommends that current employees, executive officers and directors of firms that are suppliers to the RSE licensee, but who themselves have had no previous dealings with the RSE licensee, should be allowed to be appointed as an independent director.

ASFA considers that such situations can be adequately addressed as part of the RSE licensee's conflicts management policy and procedures.

Independence on board committees

Recommendation 7

ASFA does not support the proposed requirement that a majority of both the Board Audit Committee (BAC) and the Board Remuneration Committee (BRC) be independent directors.

ASFA considers that it is reasonable to require at least one independent director to be appointed to the BAC and BRC. However, beyond this, it should be up to each trustee board to decide how best to structure their committees.

Recommendation 8

ASFA supports the introduction of new section 86 of Part 9 which requires RSE licensees of APRA-regulated superannuation funds to have an independent chair.

However, we do not support APRA's proposed requirement that the chair of the BAC and BRC must be an independent director.

Transition requirements

Recommendation 9

ASFA recommends that RSE licensees be given an additional six months (that is, until 31 December 2016) to prepare their transition plan and have it approved by their board.

This proposed extension recognises the fact that the prudential framework underpinning the transition to the new governance arrangements will not be finalised until the end of 2015. The additional timeframe will also give RSE licensees sufficient time to fully consider and implement these significant changes in the most effective manner possible with minimum upheaval for funds and their members.

Recommendation 10

ASFA recommends that SPS 512 should expressly permit RSE licensees to move toward compliance with the one-third independent director requirement during the transition period, even where that would constitute a technical breach of the equal representation rules prescribed by Part 9 (as in effect during the transition period).

Updates to guidance

Recommendation 11

ASFA supports APRA requiring RSE licensees to have policies in place that address such issues as: the size of RSE licensee boards, renewal and appointment processes, setting director tenure limits, the management of conflicts of interest (particularly where multiple directorships are held) and the role of board committees, in particular nomination and risk committees.

However, it should be up to each RSE licensee to determine how best to implement these requirements. In ASFA's view, it may be more appropriate for guidance on these matters to be provided from within the industry - to ensure that the impact on all current structures are considered - rather than by the regulator.

Recommendation 12

In ASFA's view, RSE licensee boards need the flexibility to be able to create a structure that is most effective for their fund and its particular circumstances. In order to do so, RSE licensee boards need discretion on their size.

ASFA supports guidance being provided by APRA in relation to what the regulator considers to be good practice in relation to the size of RSE licensee boards. ASFA looks forward to providing input into the draft guidance in this area.

Recommendation 13

Every trustee director should be nominated and appointed through a formal and transparent process based on competency. The individual should meet certain minimum standards set by the trustee board prior to being appointed, and the trustee board should be actively involved in the nomination/appointment process to ensure that the new director has the relevant experience and skill set required by the board.

Depending on the circumstances of a fund and how it is constituted, a variety of processes for identification of independent directors and their appointment should be allowed.

Recommendation 14

ASFA recommends that RSE licensees should be required to implement a policy which includes a maximum appointment term for its directors. ASFA considers that an appropriate maximum appointment term for trustee directors could fall somewhere in the range of 9 to 12 years.

The requirement to set a policy on maximum tenure should be introduced by way of an APRA prudential standard rather than being enshrined in legislation, with appropriate guidance provided by the regulator.

Recommendation 15

ASFA supports APRA's intention to review, and potentially extend, the existing guidance in Prudential Practice Guides SPG 510 (Governance) and SPG 521 (Conflicts of Interest) to ensure that they continue to support sound governance by RSE licensees, particularly around the management of conflicts of interest.

In ASFA's view, there are a number of other measures that could also strengthen the conflict of interest regime, including a requirement for RSE licensees to consider the appropriateness of multiple trustee board directorships (where they exist for their fund).

Each of the recommendations outlined above are discussed in greater detail in the subsequent sections of this submission.

Section 1: Definition of independence

1.1 Location of key definitions – legislation versus prudential standards

In previous submissions, including to the Financial System Inquiry (FSI) Final Report and our response to the Treasury discussion paper: *Better regulation and governance, enhanced transparency and improved competition in superannuation*, ASFA recommended that the definition of 'independent' should be removed from the SIS Act and instead be included in the prudential standards, on the basis that the standards relating to governance are constantly evolving and prudential standards are easier to change/update than legislation. In addition, prudential standards are more flexible instruments in that, although the requirements in the prudential standards are legally binding, there is scope for trustee boards to lodge an application to APRA for an adjustment or exclusion from specific requirements in the prudential standards.

We recognise that a decision has been taken to keep the definition of 'independent' in the SIS Act. Having considered the rationale for this, including arguments around simplicity and the relative ease of drafting the definition in the legislation vis-à-vis the prudential standards (in the time that remains prior to the proposed commencement of the new governance regime), ASFA is not uncomfortable with this decision.

However, ASFA supports the definition of 'material relationship' being addressed in the prudential standards for the reasons discussed above regarding flexibility (and recognising the difficulty in incorporating all the possible circumstances in which a person should be deemed to have a material relationship into the definition in the legislation in sufficient time for the start of the new governance regime).

We support APRA's intention to supplement the definition of 'independent' by setting out in SPS 510 the circumstances which the regulator considers to be a material relationship. The importance of getting the definition of 'material relationship' in the prudential standards right cannot be overstated.

We note that APRA has advised that it proposes to amend SPS 510 to include the following as material relationships:

- material professional advisers or consultants
- suppliers.

In addition, APRA has indicated that it will revise its existing guidance to address a range of matters, including the size of RSE licensee boards, setting director tenure limits, and the management of conflicts of interest, particularly where multiple directorships are held.

ASFA is consulting broadly with our membership and other industry stakeholders on these issues. We will work closely with APRA to ensure that the definition of 'material relationship' that will be included in SPS 510, and elaborated upon in the guidance material, is sufficiently robust and does not give rise to any unintended consequences. That is, that the persons captured by this definition are only those whose relationship with the RSE licensee is sufficiently material to impact their capacity to be classified as an independent director.

Recommendation 1

ASFA supports the definition of 'material relationship' being addressed in the prudential standards.

We support APRA's intention to supplement the definition of 'independent' by setting out in SPS 510 the circumstances which the regulator considers to be a material relationship. ASFA will be working closely with APRA to ensure that the definition of 'material relationship' that will be included in SPS 510 is both robust and flexible and does not give rise to any unintended or impracticable consequences.

1.2 APRA power to determine a director's independence

As noted in section 1.1, the draft legislation proposes that the basic definition of 'independent' be included in the legislation while at the same time providing APRA with the power to set out in prudential standards what constitutes a 'material relationship' for the purposes of determining whether an individual is independent.

It is also proposed that APRA be given the power to determine whether a specific individual is, or is not, independent. We note that APRA has indicated that its intention would be to exercise such a power sparingly.

ASFA agrees that such a power should be used sparingly, as frequent use would have the potential, in effect, to replace the operation of the primary provisions in the legislation and prudential standards. In order to provide reasonable boundaries for the use of the power to determine whether a specific individual is independent, ASFA has recently recommended to Treasury that the Regulation should set out the criteria to be considered by APRA in any application of that power. To facilitate this, we have recommended that the Bill should include an appropriate regulation-making power.

Recommendation 2

The power to determine whether a specific individual is, or is not, independent should be used by APRA sparingly. In order to provide reasonable boundaries for the use of the power to determine whether a specific individual is independent, ASFA has recommended to Treasury that:

- the Bill includes a power providing for regulations to be made prescribing the criteria that should be considered by APRA in any application of its power to determine whether a person is, or is not, independent; and
- the Regulation sets out those prescribed criteria.

1.3 Reclassification of current trustee directors

APRA has indicated that, as part of the transition arrangements, RSE licensees will be required to prepare and lodge a transition plan that includes, among other matters, a list of current directors and whether they can be considered independent under the new definition.

In the course of undertaking the required assessment of which of their directors satisfy the new definition of independent, and can therefore be considered independent directors, some RSE licensees will be looking to reclassify existing employer representative and member-representative directors as independent directors.

We are aware of a number of funds that have directors on their boards who they consider to be experienced and on all measures also independent of the RSE licensee even though they have been nominated by sponsors. As such, these RSE licensees will be looking to reclassify these directors as independent on the basis that they satisfy the proposed definition.

ASFA contends that, being a current director of the RSE licensee, in and of itself, should not preclude the director from being reclassified as independent (as long as they do not have any other material relationship with the RSE licensee that would preclude such a reclassification).

This is particularly an issue for smaller non-public offer funds where the increase in cost associated with not being able to reclassify directors as independent would be significant and potentially detrimental. It is likely that the members of these funds will have to bear the cost of employing additional independent directors if current directors are unable to be reclassified as independent, and the cost impact for smaller non-public offer funds is likely to be greater than for larger funds.

The ability for RSE licensees to reclassify current directors as independent should be explicitly stated in the APRA prudential standard that deals with the transition arrangements (SPS 512) in order to avoid any confusion.

Recommendation 3

ASFA recommends that it be made clear in the APRA prudential standard dealing with the transition arrangements (SPS 512) that RSE licensees are able to reclassify current directors as independent directors if they satisfy the new definition.

That is, being a current director should not preclude the director from be reclassified as independent, as long as they do not have any other material relationship with the RSE licensee that would preclude such a reclassification.

1.4 Source of nomination of directors

As outlined in the Explanatory Guide to the Bill, 'material relationships' will likely include relationships between the RSE licensee and the following:

- parent companies
- standard employer-sponsors
- bodies with the right to nominate potential directors.

With respect to the third bullet point, ASFA considers that, where a person who is being nominated as a potential director is in some way associated with the nominating body, it is appropriate that this be treated as a material relationship with the RSE licensee and that person be precluded from being classified as an independent director.

However, if the person being nominated has no association with the nominating body, and meets all the other requirements of the new definition, ASFA is of the view that they should not be precluded by either the legislation or by a Prudential Standard from being an independent director simply by virtue of having been nominated by a body that has the right to nominate (but not appoint) a person. That is, the identity of a party nominating a person as a potential director should not, in and of itself, be a determining factor if the nominee is completely independent of the nominating body and the RSE licensee.

In this regard, the proposed legislation does not require RSEs to change the method by which directors are appointed. The trust deed over-ride provision in the Bill only applies if an RSE licensee is forced to change the trust deed, but the legislation would not force such changes.

As a result, it may be difficult or impossible for an RSE itself to change a director appointment process when that is embedded in a trustee company constitution and/or trust deed. Shareholders and/or the bodies who set up the trust would need to agree to such a change. In many or most instances the existing board of directors of an RSE will not have the capacity to set up a nominating committee or to appoint a new or replacement director as this power will reside with shareholders or other identified entities.

In any event, as explained above, the test should be whether a director is independent rather than how a director is appointed.

Unless and until legislation requires new appointment processes to replace the existing powers for directors to be appointed by specified bodies, for both practical and policy reasons ASFA considers that the tests for independence in both the legislation and the relevant Prudential Standards should focus on the characteristics of the director rather than how they are appointed. The variety of existing processes for identification of independent directors and their appointment should be allowed for in the drafting of the Prudential Standards and Prudential Practice Guides.

Recommendation 4

A person should not be precluded from being an independent director simply by virtue of having been nominated by a body that has the right to appoint a person, so long as the nominee meets all other independence requirements.

We recommend that APRA take this into account in the course of updating SPS 510 and the associated Prudential Practice Guide SPG 510.

1.5 Exclusion period for ex-employees of suppliers

APRA has advised that it proposes to include suppliers as having a material relationship with the RSE licensee when it updates SPS 510 to set out the circumstances which the regulator considers to be a material relationship. In particular, APRA has indicated that it proposes to include 'material professional advisors, consultants or suppliers' as examples of material relationships.

Based on feedback from our members, ASFA considers that the proposed exclusion of a person who has been an executive officer or director of a supplier in the last three years is too wide in scope and may reduce the pool of potential candidates for independent director appointments.

For example, we note that the concept of 'material relationship' proposed in APRA's letter of 26 June 2015 appears wide enough to exclude from consideration, as a potential independent director, all former partners of an accounting firm which provides (or has, within the last three years, provided) audit services in respect of a fund. This is so even where an individual former partner was not personally involved in the provision of those services.

For some funds, recently retired employees and executive level officers of suppliers are likely to be one of their best sources of skilled independent directors - particularly in the areas of investments, law and accounting. Given the difficulty that some funds might face in identifying and appointing sufficient candidates of appropriately skilled and qualified independent directors, ASFA considers that this is an area where some latitude might be given.

We acknowledge that in some circumstances, the appointment of a former director or executive officer of a supplier might raise a perceived or actual conflict of interest. However, we consider that this can be adequately addressed by the RSE licensee applying its conflict management framework, taking into account appropriate guidance from APRA.

The potential conflict may in some cases be so material that it cannot be effectively managed, and must instead be avoided. That is, the RSE licensee may determine that the conflict is so material that the appointment of a potential candidate would be inappropriate. One such example might involve an individual who was, in the immediate past, a partner in a professional services firm who was directly responsible for the fund's audit engagement. In this example, ASFA believes it would be inappropriate for the audit partner to resign from the professional services firm and shortly thereafter be appointed to the fund's trustee board as an independent director.

We note that APRA's letter of 26 June 2015 indicates that it intends to revise and update its existing guidance, and in some cases its existing prudential standards, to reflect the proposed reforms. We anticipate that these revisions will address conflict management issues in relation to the appointment of independent directors, and will engage with APRA as part of that process.

Recommendation 5

ASFA recommends that the definition of 'independent' should not contain a prescribed three-year exclusion period for a person who has ceased to be employed by a supplier at an executive or director level. The ability of such individuals to be considered 'independent' should be determined by the RSE licensee on a case-by-case basis, with regard to prudential requirements in respect of the identification and management of conflicts of interest.

1.6 Current employees of suppliers

It is critical that those entrusted with looking after the retirement incomes of Australians have the required level of skills and experience needed by RSE licensees to achieve and maintain high levels of governance over Australia's superannuation pool.

To this end, ASFA considers that a case can be made to allow current employees of companies that are suppliers/consultants/professional advisers to an RSE licensee, but have no dealings with the RSE licensee or the fund, to be classified as independent directors.

For example, where a firm provides audit, legal or consulting services to an RSE licensee, we support the position that a current employee, executive officer or director that has direct dealings with the RSE licensee should not be able to be appointed as a director of the RSE licensee. However, another employee, executive officer or director in the same firm (that is, one who has had no previous dealings with the RSE licensee) should, in ASFA's view, be allowed to be appointed as an independent director of the RSE licensee.

Otherwise, too many people with important skills needed by RSE licensees (such as business acumen, investment experience, audit and legal skills) would be effectively ruled out of being appointed to trustee boards, which could potentially (and in ASFA's view, unnecessarily) compromise the ability of RSE licensees to supplement the overall skills and experience of the board and achieve the best retirement outcomes for fund members.

This is particularly an issue for larger funds who may for example utilise the services of each of the four largest accounting/professional services firms.

Where the person is appointed as a director of the RSE licensee and remains employed by a firm that is a current supplier (but the person themselves has had no previous dealings with the RSE licensee), ASFA considers that this situation can be adequately addressed as part of the RSE licensee's conflict management policy and procedures.

Recommendation 6

ASFA recommends that current employees, executive officers and directors of firms that are suppliers to the RSE licensee, but who themselves have had no previous dealings with the RSE licensee, should be allowed to be appointed as an independent director.

ASFA considers that such situations can be adequately addressed as part of the RSE licensee's conflict management policy and procedures.

Section 2: Independence on board committees

2.1 Requirement for committees to have a majority of independent directors

As discussed in our submission to Treasury following the release of the Bill and the Regulation, ASFA supports the government's announcement on 26 June 2015 that at least one-third of the directors on superannuation boards should be independent.

However, ASFA considers that the mandated number/proportion of independent directors should be restricted to the board level.

We note that APRA proposes to amend Prudential Standard SPS 510 to require that a majority of both the Board Audit Committee (BAC) and the Board Remuneration Committee (BRC) be independent directors, and for the chair of the BAC and BRC to be independent.

In ASFA's view, it is reasonable to require at least one independent director to be appointed to the BAC and BRC. Beyond this, ASFA considers that it should be up to each trustee board (which will comprise at least one-third independent directors going forward) to decide how best to structure their committees.

We also note that it could be difficult for some funds to comply with APRA's proposed requirement.

Take for example a fund whose trustee board consists of nine directors, three of whom are independent under the new requirements, with the remaining six directors being non-independent. APRA's proposed requirement would effectively limit the size of both the BAC and BRC to five committee members. Further, in such circumstances, all three independent directors would have to serve on both the BAC and BRC in order for the fund to comply with the majority independent requirement for the committees - that is, it would be impossible for the BAC and BRC to have six or more members.

As well, trustee boards could be forced to remove non-independent committee members with audit and remuneration experience from the BAC and BRC and replace them with directors who, while independent, have little or no experience in these areas.

Alternatively, trustee boards may be forced to appoint more independent directors simply in order to comply with the requirement to have a majority of independent directors on committees. This would result in the formation of unnecessarily large boards that add little to no benefit to the overall performance of the RSE licensee and, more importantly, to the outcomes for fund members.

Recommendation 7

ASFA does not support the proposed requirement that a majority of both the BAC and the BRC be independent directors.

ASFA considers that it is reasonable to require at least one independent director to be appointed to the BAC and BRC. However, beyond this, it should be up to each trustee board to decide how best to structure their committees.

2.2 Requirement for committees to have an independent chair

ASFA supports the requirement for trustee boards to appoint an independent chair. This recommendation is consistent with contemporary governance standards and with requirements of other prudentially regulated entities, including banks and insurance companies under *Prudential Standard CPS 510 – Governance*.

We note that APRA has advised that it will amend SPS 510 to:

- require the chair of the BAC and BRC to be independent
- permit the chair of the board to also be the chair of the BRC
- remove the existing provision allowing the chair of the board to also chair the BAC where the chair is the only independent on the board.

ASFA does not support the proposed requirement that the BAC and the BRC be chaired by independent directors. In our view, the BAC and BRC should be chaired by the director who is most suited to that role, regardless of whether they are an 'independent' director.

Recommendation 8

ASFA supports the introduction of new section 86 of Part 9 which requires RSE licensees of APRA-regulated superannuation funds to have an independent chair.

However, we do not support APRA's proposed requirement that the chair of the BAC and BRC must be an independent director.

Section 3: Transition requirements

3.1 Three-year transition period

The Bill provides that the new governance regime will apply from 1 July 2016. Where an APRA-regulated superannuation fund is established after 1 July 2016, the RSE licensee of that fund will need to adhere to the new governance arrangements from the time it is established. Similarly, RSE licensees authorised on or after 1 July 2016 will need to comply with the new regime.

However, APRA-regulated funds and RSE licensees established before 1 July 2016 will have three years to transition to the new arrangements, from the time the legislation receives Royal Assent.

ASFA supports a three-year transition period for RSE licensees to move to the new governance regime. In previous submissions, including our response to the Treasury discussion paper: *Better regulation and governance, enhanced transparency and improved competition in superannuation* (February 2014) and our response to the FSI Final Report (March 2015), ASFA has recommended that a minimum transition timeframe of three years is necessary to implement such significant changes, including any new requirements regarding the minimum number/proportion of independent directors and the appointment of an independent chair.

We have also recommended that the transition period for any significant changes of this nature should not commence until the relevant requirements are finalised (that is, until the legislation receives Royal Assent and the prudential standards are finalised).

In our view, it would make sense to allow directors to serve out their existing terms (which could be up to three or four years). A three-year transition period would give funds time to carefully consider the impact of the new requirements, particularly given the number of funds and the time it can take to find suitable candidates, and establish and implement a plan to transition to the new regime in the most effective manner possible and with minimum upheaval.

For this reason, in our response to Treasury following the government's release of the Bill and the Regulation, ASFA has recommended that the three-year transition period should commence on 1 July 2016 and end on 30 June 2019 or three years after the legislation receives Royal Assent, whichever is later.

Although not specifically relevant to APRA's proposed changes to the prudential framework, we believe it is important that APRA is aware of the industry's concerns on this matter.

3.2 Timeframe for preparing transition plan

Although the Bill proposes a three-year period for RSE licensees to transition to the new governance regime, APRA has stated in its letter to all RSE licensees dated 26 June 2015 that it intends to require RSE licensees to formulate and implement a transition plan to support 'the orderly and timely adoption of changes required to meet the new requirements'.

Further, APRA will require the transition plan to be prepared and approved by the board by no later than 1 July 2016. This is despite the fact that the relevant prudential standards (amended SPS 510 and new SPS 512) will be released for industry consultation later this year, with the final versions not likely to be released until the end of 2015.

ASFA has received feedback from a number of RSE licensees expressing concern regarding the truncated timeframe available to develop their detailed transition plans and have it approved by their board (effectively six months from the release of the final prudential standards).

ASFA considers the proposed deadline of 1 July 2016 to be tight for a couple of reasons. Firstly, as outlined above, the updated and new prudential standards (as well as any guidance to support the standards) will unlikely be published until the end of the year. The feedback we have received from our members is that RSE licensees will not be able to complete the transition plan until all these details are known.

Secondly, and perhaps more importantly, the introduction of the new standards will have significant impact on existing board rules as well as the processes and Constitutions of the RSE entities. These issues will require careful consideration and preparation, not only from the technical perspective of complying with the new law and APRA guidance, but also in terms of ensuring that the required changes are introduced in the most effective manner possible and with minimum upheaval for funds.

ASFA's view is that the industry needs 12 months to fully consider and prepare a transition plan that will support the effective functioning of the board during the transition period and the orderly and timely adoption of the changes required to meet the new requirements.

As stated in section 3.1, the transition period for significant changes of this nature should not commence until the relevant requirements are finalised (that is, until the legislation receives Royal Assent and the prudential standards are finalised).

Therefore, given the fact that the prudential standards are not likely to be finalised until around the end of 2015, ASFA recommends that RSE licensees be given until 31 December 2016 to prepare their transition plan and have it approved by the board.

Recommendation 9

ASFA recommends that RSE licensees be given an additional six months (that is, until 31 December 2016) to prepare their transition plan and have it approved by their board.

This proposed extension recognises the fact that the prudential framework underpinning the transition to the new governance arrangements will not be finalised until the end of 2015. The additional timeframe will also give RSE licensees sufficient time to fully consider and implement these significant changes in the most effective manner possible with minimum upheaval for funds and their members.

3.3 Pre-existing RSE licensees transitioning to the new regime

We note that some ASFA members have expressed concern regarding the manner in which the proposed transition provision in Part 3 of the Bill may impact on an RSE licensee that is the trustee of a standard employer-sponsored fund immediately before 1 July 2016.

We note that paragraph (b) requires an RSE licensee which is trustee of a standard employer-sponsored fund to comply with 'any requirements of Part 9, as in force immediately before 1 July 2016, **to the extent that they did not cover matters dealt with** by the requirements referred to in paragraph (a)' – namely, 'any requirements of the prudential standards **relating to the transition of RSE licensees**' to the new regime (our emphasis).

In the absence of detailed information about the transition requirements proposed to be included in SPS 512, it is difficult to assess the potential operation of the transition provision.

In particular, it is unclear whether the intention is that SPS 512 will expressly permit RSE licensees to move toward compliance with the one-third independent director requirement during the transition period, even where that would constitute a technical breach of the equal representation rules prescribed by Part 9 (as in effect during the transition period).

ASFA strongly recommends that RSE licensees who are trustees of standard employer-sponsored funds be given the flexibility to bring independent directors onto the board as they are appointed, as part of an orderly transition process. The alternative position - that such RSE licensees are required to maintain strict compliance with the equal representation rules until the end of the transition period - might require a substantial turnover of trustee directors simultaneously at the end of the transition period. This would not, in ASFA's view, be an optimal outcome.

However, ASFA is concerned that providing for such flexibility through the prudential standards may be legally ineffective, on the basis that it would purport to give priority to a prudential standard over the explicit requirements of the legislation.

ASFA has therefore recommended to Treasury that the current wording of the transition provision in the Bill be revised to clarify the transition arrangements for RSE licensees that are trustees of standard employer-sponsored funds and, in particular, to make it clear that such RSE licensees are permitted to move toward compliance with the one-third independent director requirement throughout the transition period.

In conjunction with this recommendation, ASFA considers that SPS 512 should expressly permit RSE licensees to move toward compliance with the one-third independent director requirement during the transition period.

Recommendation 10

ASFA recommends that SPS 512 should expressly permit RSE licensees to move toward compliance with the one-third independent director requirement during the transition period, even where that would constitute a technical breach of the equal representation rules prescribed by Part 9 (as in effect during the transition period).

Section 4: Updates to guidance

In its letter to all RSE licensees dated 26 June 2015, APRA has stated that it will provide additional guidance in respect of a number of issues including:

- the size of RSE licensee boards
- renewal and appointment processes
- setting director tenure limits
- the management of conflicts of interest, particularly where multiple directorships are held
- the role of board committees, in particular nomination and risk committees.

ASFA supports APRA requiring RSE licensees to have policies in place that address the above issues. We discuss a number of these matters in the remainder of this submission.

We also recognise the need for further guidance on these matters in order to ensure that the spirit of the reforms is not compromised by arrangements such as the appointment of additional directors to achieve the one-third independent threshold without consideration of the ultimate size of the RSE licensee's board.

However, in our view, RSE licensees need maximum flexibility on how best to implement any requirements in these areas. We believe the content of these policies should as much as possible be left up to each RSE licensee - that is, the requirements should recognise that a 'one size fits all' approach is not appropriate - and any guidance provided to RSE licensees should reflect this.

We therefore believe it may be more appropriate for guidance on these matters to be provided from within the industry - to ensure that the impact on all current structures are considered - rather than by the regulator. To this end, ASFA is in the process of updating its Best Practice Paper on *Superannuation Fund Governance* which provides superannuation trustees, funds and their service providers with recommended practices to achieve good governance in a number of areas, including those outlined above.

Recommendation 11

ASFA supports APRA requiring RSE licensees to have policies in place that address such issues as: the size of RSE licensee boards, renewal and appointment processes, setting director tenure limits, the management of conflicts of interest (particularly where multiple directorships are held) and the role of board committees, in particular nomination and risk committees.

However, it should be up to each RSE licensee to determine how best to implement these requirements. In ASFA's view, it may be more appropriate for guidance on these matters to be provided from within the industry - to ensure that the impact on all current structures are considered - rather than by the regulator.

4.1 Size of RSE licensee boards

In ASFA's view, RSE licensee boards need the flexibility to be able to create a structure that is most effective for their fund and its particular circumstances. In order to do so, RSE licensee boards need discretion on their size.

ASFA endorses the ASX Corporate Governance Principles and Recommendations (ASX Principles) but recognises that funds need the flexibility to determine that a larger number of directors may be necessary given their specific circumstances. In particular, RSE licensee boards need to have a sufficient number of members to enable the effective operation of a trustee board's committee structure and to ensure that the required skills and a variety of perspectives are incorporated into the RSE licensee board.

Recommendation 12

In ASFA's view, RSE licensee boards need the flexibility to be able to create a structure that is most effective for their fund and its particular circumstances. In order to do so, RSE licensee boards need discretion on their size.

ASFA supports guidance being provided by APRA in relation to what the regulator considers to be good practice in relation to the size of RSE licensee boards. ASFA looks forward to providing input into the draft guidance in this area.

4.2 Director appointment and removal processes

The manner in which independent directors are appointed to trustee boards is critical to ensuring good governance and the effective operation of the trustee board. In order to be considered independent, the individual must be nominated and appointed through a formal and transparent process based on competency - that is, the person should meet certain minimum standards (skills, experience etc) set by the trustee board. Knowledge, skills and experience in regard to superannuation and fund-related matters should be the primary qualification for a trustee director no matter under what process the director is appointed.

ASFA's view is that every trustee director should be nominated and appointed through a formal and transparent process based on competency. The individual should meet certain minimum standards set by the trustee board prior to being appointed, and the trustee board should be actively involved in the nomination/appointment process to ensure that the new director has the relevant experience and skill set required by the board.

As stated in section 1.4 of this submission, it may be difficult or impossible for an RSE itself to change a director appointment process when that is embedded in a trustee company constitution and/or trust deed.

Unless and until legislation requires new appointment processes replacing existing powers to appoint by specified bodies, ASFA considers that the tests for independence should focus on the characteristics of the director rather than how they are appointed. Depending on the circumstances of a fund and how it is constituted, a variety of processes for identification of independent directors and their appointment should be allowed.

Recommendation 13

Every trustee director should be nominated and appointed through a formal and transparent process based on competency. The individual should meet certain minimum standards set by the trustee board prior to being appointed, and the trustee board should be actively involved in the nomination/appointment process to ensure that the new director has the relevant experience and skill set required by the board.

Depending on the circumstances of a fund and how it is constituted, a variety of processes for identification of independent directors and their appointment should be allowed.

4.3 Setting director tenure limits

In ASFA's view, trustee boards should be required to implement a policy which includes a maximum appointment term for its directors. ASFA considers that an appropriate maximum appointment term for trustee directors could fall somewhere in the range of 9 to 12 years.

While ASFA recognises that the imposition of a maximum appointment term may be an issue for some RSE licensees, we believe that the advantages resulting from the regular replenishment of board members and the introduction of fresh ideas and thinking outweigh the disadvantages.

There is also the issue of board control/influence that needs to be considered - that is, generally speaking, long-serving directors tend to exert greater influence on, or control over, the board, often at the expense of newer/less experienced directors. Unlike shareholders of a company, members of a superannuation fund do not have the capacity to remove trustee directors.

ASFA therefore considers that trustee boards should be required to implement a policy which includes a maximum appointment term for its directors. This could be done by setting maximum fixed renewable terms. For example, a common approach in corporate boards is to have a four-year term with an optional additional four-year term, with a maximum of two terms, but directors could serve again after a given period of time off the board. Another approach is to have multiples of three-year terms up to a maximum of, say, three or four terms.

Such arrangements could be supported by a comprehensive succession planning process, including staggering the end of director's terms in order to avoid a major loss of experienced directors from the board all at once.

Although the ASX Principles do not specifically set a maximum tenure for listed company directors, they do state that 'Board renewal is critical to performance, and directors should be conscious of the duration of each director's tenure in succession planning. The nomination committee should consider whether succession plans are in place to maintain an appropriate mix of skills, experience, expertise and diversity on the board'.

There is also research in the listed company space, based on a sample of S&P 1500 firms, which suggests that there is an 'inverted U' shape relationship between board tenure and firm value resulting from board decisions[1]. Empirically, this research suggests that 'the highest firm value is reached at a board tenure of around nine years. For firms with greater advisory needs or with less entrenchment costs, firm value could increase up to 12 years.'

Given the results of the research discussed above, ASFA considers that requiring RSE licensees to implement a policy on maximum appointment term for its directors somewhere in the range of 9 to 12 years would be appropriate.

In terms of implementation, the requirement to set a policy on maximum tenure should be introduced by way of an APRA prudential standard rather than being enshrined in legislation. APRA should also provide guidance to trustee boards on the setting of an appropriate maximum appointment term for directors.

Recommendation 14

ASFA recommends that RSE licensees should be required to implement a policy which includes a maximum appointment term for its directors. ASFA considers that an appropriate maximum appointment term for trustee directors could fall somewhere in the range of 9 to 12 years.

The requirement to set a policy on maximum tenure should be introduced by way of an APRA prudential standard rather than being enshrined in legislation, with appropriate guidance provided by the regulator.

[1] Research by Huang, S. (July 2013) – *Board Tenure and Firm Performance*.

4.4 Management of conflicts of interest

ASFA supports the view that robust management of conflicts of interest is required within superannuation. As such, ASFA supports APRA's intention to review, and potentially extend, the existing guidance in Prudential Practice Guides SPG 510 (Governance) and SPG 521 (Conflicts of Interest) to ensure that they continue to support sound governance by RSE licensees, particularly around the management of conflicts of interest.

An RSE licensee has a fiduciary duty to ensure that the decisions of trustee board members are not compromised or biased by conflict. Superannuation trustee boards in any part of the system must have the flexibility to appoint the right people, with the right skills, knowledge and experience to deliver the best outcomes for fund members.

As stated in our response to the FSI Final Report, ASFA sees merit in the recommendation that each board member must acknowledge when a board member adds an interest to the board's register of director interests. That is, each board member's interests should be deemed to have been disclosed only when acknowledged by all other board members.

In ASFA's view, there are a number of other measures that could also strengthen the conflict of interest regime. These measures include:

(i) Pre-appointment disclosure of potential conflicts of interest or duty at the time an individual is nominated for appointment or election to the trustee board
(ii) Ongoing disclosure of potential conflicts of interest and duty in the fund's annual report
(iii) A requirement for trustee directors to excuse themselves from all board meeting agenda items, discussions, communications and decisions relating to matters where a conflict of interest or duty exists
(iv) A requirement for trustee boards to consider the appropriateness of multiple trustee board directorships (where they exist for their fund).

With respect to item (iv) above, ASFA's view is that, as a minimum, trustee boards should be required (as part of their conflict management policy) to consider whether the risks and conflicts associated with a director on their board serving on the board of one or more other APRA-regulated superannuation funds can be adequately managed.

Recommendation 15

ASFA supports APRA's intention to review, and potentially extend, the existing guidance in Prudential Practice Guides SPG 510 (Governance) and SPG 521 (Conflicts of Interest) to ensure that they continue to support sound governance by RSE licensees, particularly around the management of conflicts of interest.

In ASFA's view, there are a number of other measures that could also strengthen the conflict of interest regime, including a requirement for RSE licensees to consider the appropriateness of multiple trustee board directorships (where they exist for their fund).

The Association of Superannuation Funds of Australia Limited
PO Box 1485, Sydney NSW 2001
T +61 2 9264 9300 or 1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au
ABN 29 002 786 290 ACN 002 786 290

asfa
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