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24 July 2015

Manager
Insurance and Superannuation Unit
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: superannuationgovernance@treasury.gov.au

Dear Sir/Madam,

Superannuation Legislation Amendment (Governance) Bill and Regulation: Governance arrangements for APRA-regulated superannuation funds

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the release of *Superannuation Legislation Amendment (Governance) Bill 2015* (the Bill) and *Superannuation Legislation Amendment (Governance) Regulation 2015* (the Regulation) regarding proposed changes 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 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.

This support should not be seen as a criticism of current governance structures, but instead recognises changing community expectations, increased complexity and risk in running superannuation businesses, and significantly higher regulatory standards and liability.

It should also be recognised that there are many different structures and sizes across the sector and a 'one size fits all' approach may have unintended consequences. As such, we urge both the final legislation and APRA prudential standards to be principles based.

While ASFA supports the introduction of a three-year transition period for existing funds to comply with the new requirements, we are of the view this 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.

In addition, we have concerns with APRA's proposed timeframe for RSE licensees to prepare and approve a transition plan. We have articulated these in this submission and will also provide feedback to APRA directly.

ASFA does not support the proposed requirement for RSE licensees to disclose on their annual report (on an 'if not, why not' basis) whether they have a majority of independent directors. We are also of the view that there are some unintended and potentially detrimental impacts.

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

A number of ASFA members have raised concerns with us regarding the uncertainty caused by the absence of the prudential standards. In particular, our members have advised ASFA that they have found it difficult to provide comprehensive comments on the impact of the Bill and the Regulation without knowing exactly how a number of matters, particularly around the circumstances which APRA considers will constitute a material relationship, will be addressed in the prudential standards and guidance.

As you are aware, the legislative and prudential frameworks in relation to the new governance regime are intrinsically linked. We understand that APRA intends to consult on the updating of the prudential standard on governance (SPS 510) and the new transition prudential standard (SPS 512). We strongly support the proposed industry consultation and the development of worked examples.

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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

Draft legislation and regulation: Governance arrangements for APRA-regulated superannuation funds

July 2015

The Association of Superannuation Funds of Australia (ASFA)

Contents

Executive summary

A sound governance framework for superannuation funds is essential in order to ensure the performance of the trustee board in carrying out its trust and fiduciary duties is both optimal and transparent.

In a compulsory and concessionally taxed system, it is critical that those entrusted with looking after the retirement incomes of Australians are required to achieve and maintain high levels of effective governance. This is particularly important given the size of Australia's superannuation pool continues to grow and the increasingly important role trustee boards play in delivering comfortable retirement incomes, as well as investing in the economy in an efficient and cost-effective manner.

Over the past few years ASFA has consulted with our members on a number of governance-related matters, including those addressed within the draft legislation, culminating in the development of ASFA policy on, among other things, the number/proportion of independent directors, and the appointment of an independent chair.

Below is a summary of ASFA's recommendations in relation to the proposed changes to the governance arrangements for APRA-regulated superannuation funds outlined in the Bill and the Regulation:

One-third independent directors and independent chair

Recommendation 1

ASFA supports the introduction of new section 86 of Part 9 which requires RSE licensees of APRA-regulated superannuation funds to have at least one-third independent directors (or at least one third independent trustees in the case of a group of individual trustees).

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

Recommendation 2

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 requirement that the chair of the Board Audit Committee and Board Remuneration Committee must be an independent director.

Three-year transition period

Recommendation 3

ASFA supports the introduction of a three-year transition period for RSE licensees to move to the new governance requirements. However, this 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.

Recommendation 4

ASFA recommends that the transition provision in the Bill be revised to clarify its operation in relation to standard employer-sponsored funds, and that the Bill specifically permits RSE licensees that are trustees of standard employer-sponsored funds to move toward compliance with the one-third independent director requirement throughout the transition period.

Disclosing whether the RSE licensee consists of a majority of independent directors

Recommendation 5

ASFA does not support the proposed requirement for RSE licensees to publicly disclose (on an 'if not, why not' basis) in the annual report whether they have a majority of independent directors.

We strongly recommend that this requirement be removed.

Definition of 'independent' and 'material relationship'

Recommendation 6

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 7

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 recommends 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 8

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 9

ASFA notes that paragraph (a) of the definition of independent, regarding substantial holdings in the RSE licensee, will be problematic for funds with certain legal structures. We recommend that paragraph (a) be amended so that a director with a substantial shareholding in a corporation, that is an RSE licensee acting as trustee of an (industry or corporate) APRA-regulated fund, is not precluded from being independent where the shares are of a nominal value and are held on trust.

Recommendation 10

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.

Recommendation 11

ASFA recommends 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 12

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.

Recommendation 13

ASFA is supportive of the definition of independent and material relationship not excluding a person from being classified as an independent director purely as a result of being a member of the fund, where the person does not have any other material relationship with the RSE licensee.

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

Section 1

Requirement to have at least one-third independent directors

The Bill provides that all boards of RSE licensees acting as trustees of APRA-regulated superannuation funds, including standard employer-sponsored superannuation funds, are required to have a minimum of one-third independent directors. Where the RSE licensee consists of a group of individual trustees, one-third of these individuals must be independent.

There are strong views in relation to the merits, or otherwise, of having independent directors on trustee boards and mandating a minimum number/proportion of independent directors. Some have argued that having independent directors has the potential to add significant value to the decision-making process and improve the overall performance of the trustee board. However, others have argued that forcing boards to have a certain number, or proportion, of independent directors could, if anything, result in less discursive boards and, ultimately, potentially inferior decision-making.[1]

On balance though, and in recognition of changing consumer attitudes, ASFA supports increasing the number of independent directors on the boards of superannuation funds and recognises that over the past few years many trustee boards have already taken the opportunity to supplement their skills and have appointed independent directors.

While there is no conclusive research on the appropriate proportion, ASFA supports the Government's announcement on 26 June 2015 that at least one-third of the directors on superannuation boards should be independent.

In ASFA's view, the right independent directors are able to offer diversity of thought and the benefit of experience outside traditional superannuation and financial services. Such directors may be useful in filling any gaps that may exist or arise in the overall skills and experience of the board.

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. We also consider it appropriate that the chair of the Board be precluded from chairing 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 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.

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[1]Professor Sally Wheeler, Professor in the Faculty of Law, Queen's University Belfast – presentation to ASFA Sydney and Melbourne luncheon series, August 2013.

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 trustee and, more importantly, to the outcomes for fund members.

We note that the composition of board committees is not a matter that is specifically raised in the Bill and Regulation. However, in ASFA's view, the requirements that may be prescribed by APRA in this respect are intrinsically relevant in any consideration of the one-third independent director requirement. ASFA will be discussing the industry's concerns on this matter directly with APRA as part of our response to their letter dated 26 June 2015.

Recommendation 1

ASFA supports the introduction of new section 86 of Part 9 which requires RSE licensees of APRA-regulated superannuation funds to have at least one-third independent directors (or at least one third independent trustees in the case of a group of individual trustees).

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.

Section 2

Requirement to appoint an independent chair

The Bill provides that all boards of RSE licensees acting as trustees of APRA regulated superannuation funds, including standard employer-sponsored superannuation funds, are required to have an independent chair.

The Explanatory Guide to the Bill makes it clear that the independent chair may be counted towards the minimum one-third independent director requirement (that is, funds do not have to have at least one-third independent directors **plus** an additional 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*.

The importance of the role played by the chair in ensuring the effectiveness of a trustee board cannot be overstated. This role includes guiding the board and CEO to focus on the right strategic priorities, make difficult decisions and ensure all fiduciary duties are met. The trustee board therefore should consider the characteristics it seeks in a chair and devise suitable procedures for the chair's appointment.

In addition, from a good governance perspective, the roles of the chair and chief executive officer should not be held by the same individual. However, such a prohibition, if introduced, should be addressed in the APRA Prudential Standards rather than through legislated requirements.

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.

As indicated in section 1 above, 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. ASFA also does not consider it appropriate to have a common chair for the board and the BRC.

We will address these issues in more detail in our response to APRA's letter dated 26 June 2015.

Recommendation 2

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 requirement that the chair of the BAC and BRC must be an independent director.

Section 3

Transition arrangements

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 Financial System Inquiry (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). For this reason, ASFA considers that the transition provision in the Bill should be amended so that the transition period commences on 1 July 2016 and ends on 30 June 2019, or three years after the legislation receives Royal Assent, whichever is later.

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 amend their internal processes and procedures to comply with the new requirements, particularly given the number of funds and the time it can take to find suitable candidates.

ASFA has developed an accreditation program that will enable trustee boards to apply a clearer strategy when appointing trustee directors. The ASFA Trustee Director Accreditation Program will help to create a pool of highly-skilled trustee director candidates to fulfil the independent director requirements by providing current and future trustee directors with the training they need to develop, improve and maintain their knowledge and skills.

Recommendation 3

ASFA supports the introduction of a three-year transition period for RSE licensees to move to the new governance requirements. However, this 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 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 APRA will only be releasing the relevant prudential standards (amended SPS 510 and new SPS 512) 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).

Although not specifically relevant to the Bill and Regulation, we want to flag that we will be raising the industry's concerns directly with APRA as part of our response to its letter dated 26 June 2015.

3.2 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.

Firstly, we note that paragraph (b) of the proposed transition provision refers to an RSE licensee which "was, immediately before 1 July 2016, a standard employer-sponsored fund". In order to distinguish correctly between the RSE licensee and the RSE of which it is trustee, this paragraph should, in our view, be redrafted to refer to an RSE licensee which "was, immediately before 1 July 2016, **the trustee of** a standard employer-sponsored fund" (our emphasis).

More significantly, 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 therefore recommends that the current wording of the transition provision 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.

Recommendation 4

ASFA recommends that the transition provision in the Bill be revised to clarify its operation in relation to standard employer-sponsored funds, and that the Bill specifically permits RSE licensees that are trustees of standard employer-sponsored funds to move toward compliance with the one-third independent director requirement throughout the transition period.

Section 4

Requirement to disclose majority of independent directors

The Explanatory Guide states that RSE licensees acting as trustees of all APRA-regulated superannuation funds will be required to publicly disclose (on an 'if not, why not' basis) in the annual report whether they have a majority of independent directors commencing 1 July 2019. This requirement will be implemented through changes to the *Corporations Regulations 2001*. However, we note that the Regulation itself does not contain any commencement or application provisions in relation to the reporting requirement.

The proposed changes to the SIS Act provide that trustee boards will be required to have a minimum of one-third independent directors, which reflects the broader policy and public debate on the issue. The Bill does not propose that funds should be required to have a majority of independent directors.

ASFA considers that it is inappropriate to create an obligation to report on a 'if not, why not' basis if funds do not have a majority of independent directors – given there is no legislative (or other) requirement to have such a majority.

Having to report an absence of a majority of independent directors implies that having less than a majority of independents is somehow less than fully compliant, which clearly is not the case given the new SIS Act requirements only mandate a minimum of one-third independent directors. This may, in our view, cause confusion to members, increase regulatory burden and impose unnecessary costs on RSE licensees.

We urge the government to reconsider and remove this requirement on the basis that it is inconsistent with the proposed board composition requirement.

Recommendation 5

ASFA does not support the proposed requirement for RSE licensees to publicly disclose (on an 'if not, why not' basis) in the annual report whether they have a majority of independent directors.

We strongly recommend that this requirement be removed.

Section 5

Definition of 'independent' and 'material relationship'

The Bill provides a definition of 'independent'. It includes, among others, persons who are not substantial shareholders of the RSE licensee or do not have or have not had within the last three years a 'material relationship' with the RSE licensee, including through their employer. In addition, APRA may make prudential standards setting out further requirements a person must meet in order to be independent.

Below we discuss issues with respect to the definition of 'independent' and 'material relationship' that have been raised by our members.

5.1 Location of key definitions – legislation versus prudential standards

In previous submissions, including to the 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.

Retaining the definition of 'independent' in the SIS Act also addresses concerns that have been expressed with respect to the extent of APRA's power to adjudicate on who is, or is not, independent, and whether this is consistent with the doctrine of separation of powers between the political arm of government (which makes the law) and the executive arm (which administers and enforces it).

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 advisors or consultants
- suppliers.

In addition, APRA has indicated that it 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 intends to consult 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 6

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.

5.2 APRA power to determine a director's independence

As noted above in Section 5.1, 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. 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 recommends that Regulation sets out the criteria that should be considered by APRA in any application of that power. To facilitate this, it will be necessary for the Bill to include an appropriate regulation-making power.

Recommendation 7

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 recommends 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.

5.3 Reclassification of current trustee directors

The Bill specifically requires RSE licensees to comply with the transition requirements in the new transition prudential standard SPS 512. 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 8

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.

5.4 Substantial holding

Sub-paragraph (a) of the definition of 'independent' states that a person is independent provided that they do not have a substantial holding in the RSE licensee or directly associated with a person who has such an interest.

Under the *Corporations Act 2001* a substantial shareholding is defined as a holding of more than five per cent of the issued shares.

There are a number of superannuation funds, typically corporate and industry funds, whose constitutions provide that each director holds one share in the trustee company for as long as they remain a director of the company. Often this shareholding is held in trust for a third party – generally the members of the fund. These shares are often of a nominal value, such as one dollar, which does not change over time.

For such funds, apart from the exceptional circumstances where there are 20 or more directors on the board of the trustee company, subparagraph (a) would render all directors as substantial shareholders and, as such, preclude them from being treated as independent.

In ASFA's view, a director having a substantial shareholding in such circumstances does not, in any way, represent a conflict of interest that should disqualify the director from being treated as independent.

This can be contrasted with a director of a publicly-listed company who owns, or is directly associated with a person who owns, a substantial shareholding. In that circumstance, there is a potential conflict of interest that would preclude the director from being treated as independent, as any decision made has the potential to materially affect the value of their shareholding.

In determining whether a person could be considered to be independent, it is critical to identify whether any perceived potential for a conflict of interest does, as a question of fact, present a conflict of interest such that the director should not be considered to be independent. We would submit that a director with a substantial shareholding in a corporate trustee, where the shares are of a nominal value and are being held on trust, is an example where there is, in fact, no conflict of interest precluding the director from being regarded as independent.

Recommendation 9

ASFA notes that paragraph (a) of the definition of independent regarding substantial holdings in the RSE licensee will be problematic for funds with certain legal structures. We recommend that paragraph (a) be amended so that a director with a substantial shareholding in a corporation that is an RSE licensee acting as trustee of an (industry or corporate) APRA-regulated fund is not precluded from being independent where the shares are of a nominal value and are held on trust.

5.5 Source of nomination of directors

As outlined in the Explanatory Guide, '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 as having a material relationship with the RSE licensee, if that person 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 the person is 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 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 and it might be difficult in any event to draft such a requirement. 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. Any sanctions which are proposed relate to those cases where an RSE licensee does not have the required number of directors who meet the tests for independence, rather than to what is in the trust deed, and the sanctions relate to the capacity to accept future contributions.

As a result, it may be difficult or impossible for an RSE itself to change a director appointment process when that is imbedded 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.

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 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.

Accordingly, ASFA considers that the legislation should recognise that, on an ongoing basis, various entities which have a material relationship may be entitled to appoint a director. As noted above, what is important is not the method of appointment – which could be by employer sponsors, bodies with a right to nominate potential directors, or even through a vote of fund members – but the independence of the director concerned.

Recommendation 10

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.

5.6 Exclusion period for ex-employees of suppliers

As stated previously, 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 conflicts management framework.

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.

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 conflicts management issues in relation to the appointment of independent directors, and will engage with APRA as it part of that process.

Recommendation 11

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.

5.7 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 advisors 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 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 conflicts management policy and procedures.

Recommendation 12

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.

5.8 Fund members allowed to be classified as independent

ASFA is supportive of the definition of 'independent' not excluding persons who are members of the fund, but have no other material relationship with RSE licensee (or have not had such a material relationship in the past three years), from being independent directors.

In ASFA's view, being a member of the fund may in fact represent an alignment of interest, rather than a conflict.

Recommendation 13

ASFA is supportive of the definition of independent and material relationship not excluding persons from being classified as an independent director purely as a result of them being a member of the fund, where the person has no other material relationship with the RSE licensee.

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