

23 July 2015

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

Dear Sir/Madam

Superannuation Legislation Amendment (Governance) Bill 2015:
Governance Arrangements for APRA regulated superannuation funds
(Exposure Draft)

Thank you for the opportunity to comment on the Exposure Draft.

Mercer supports, in principle, the Government's proposal to require a minimum of one third independent directors and an independent chair on the boards of APRA regulated superannuation trustees. Mercer also commends the Government for its flexibility in allowing trustees to choose whether to comply with the one third minimum (and disclose why in its annual report) or to have a majority of independent directors. This flexibility will enable trustee boards to determine their own size and composition, based on the competencies required for their individual funds.

We take this opportunity, however, to raise some issues we have identified with the current Exposure Draft.

Concept of independence

Proposed section 86 of the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* will require at least one third of an RSE Licensee's directors and the chair of the board of

directors to be *independent from the RSE Licensee*. Proposed section 87 then provides the meaning of this concept.

Under section 87(1), a person will be independent from the RSE Licensee if the person:

No substantial shareholding:	does not have, and is not directly associated with a person who has, a substantial shareholding in the RSE Licensee or in another entity that is a member of the same group as the RSE Licensee
No material relationship (either personally or via employer):	does not have a material relationship with, and is not employed by an entity that has a material relationship with, the RSE Licensee
Not within past 3 years an executive officer or director of a company in a material relationship within past 3 years:	has not at any time in the last 3 years been an executive officer or director of a body corporate that has, or has at any time in the last 3 years had a material relationship with the RSE Licensee.

Issues Identified

1. Substantial shareholding

‘Substantial shareholding’ is defined by reference to the *Corporations Act 2001* (**Corporations Act**) and would preclude a person who holds 5% or more of the shares in the RSE Licensee from being an independent director. The substantial shareholding restriction would therefore preclude the independence of directors of a ‘not for profit’ corporate trustee who may, as a condition of office, nominally hold one share in the RSE Licensee for the term of their directorship, but without any right to personal profit - because typically the Constitution would preclude the distribution of profits.¹ Therefore their nominal shareholding would **not** affect their independent judgment and objectivity and would **not** present them with any conflict of interest.

We recommend that a concept other than ‘substantial shareholding’ be used to denote only those circumstances where a person’s shareholding in the RSE Licensee or a related entity is expected to generate profits for that person and therefore **could** affect their independent judgment and objectivity. For example, instead of using the term

¹ For example, if there are 10 directors each holding one share, each director would hold 10% of the company’s issued shares.

'substantial shareholding', the legislation could refer to the person having a 5% or more shareholding interest in the RSE Licensee or a related company that is expected to generate profits for the director (or for a person directly associated with or related to the director).

2. Material relationship

The proposed restriction on a person having a material relationship with the RSE Licensee (either personally or via the person's employer) does not have any 'look back' period of 3 years. This differs from the proposed restriction on a person being an executive officer or director of a body corporate that has a material relationship with the RSE Licensee, which does have a 'look back' period of 3 years.

We query whether this difference is intentional, since in principle we do not see a basis for the distinction.

3. APRA Powers

The proposed legislation does not define the concept of 'material relationship'. Instead it is envisaged that APRA may make prudential standards setting out the meaning of this expression. The explanatory guide to the proposed legislation states that examples of bodies in a material relationship with the RSE Licensee could include parent companies, standard employer sponsors and bodies with the right to nominate potential directors.

While we agree that it is helpful for APRA to have power to elucidate this concept, for legal certainty, it would be preferable for the legislation to define the fundamental principles of the 'material relationship' concept, so that any subordinate instrument such as a prudential standard would need to be consistent with it. Otherwise APRA is effectively being expected to make law. For example, a material relationship could be defined as one that might reasonably be expected to have an influence on the independent judgment or objectivity of the director.

Proposed section 87(3) also gives APRA the power to make determinations as to whether a person is, or is not, independent. We assume that such powers could only be used prospectively.

4. Independent of whom?

It is curious that the definition of independence is expressed by reference to independence from the RSE Licensee itself, but does not expressly preclude an

independent director from currently being an executive officer or employee of the RSE Licensee or a related body corporate.²

Overseas jurisdictions have focused on directors being independent from management³ and independent from service providers.⁴

We also consider that independence from third party stakeholders, such as employer sponsors, employer organisations and employee organisations, would be appropriate in the Australian context.

We therefore recommend that a more comprehensive definition of independence be formulated to proscribe:

- An independent director having a 5% or more shareholding interest in the RSE Licensee or a related company that is expected to generate profits for the director (or for a person directly associated with or related to the director)
- An independent director being an executive officer or employee of the RSE Licensee or a director, executive officer or employee of a related company, either currently or within the past 3 years
- An independent director being a material service provider or professional adviser to the RSE Licensee, either currently or within the past 3 years
- An independent director being a director or executive officer of, or a member of a partnership that is, a material service provider or professional adviser to the RSE Licensee, either currently or within the past 3 years
- An independent director being a director, executive officer or employee of an employer sponsor, an employer organisation for employer sponsors to the fund or an employee organisation for members of the fund, either currently or within the past 3 years.

Defining independence in this way would be more consistent with the approach taken to 'external directors' under Chapter 5C of the Corporations Act.

² It is not clear whether an employment relationship with the RSE Licensee itself is intended to be a 'material relationship'.

³ For example, in the listed company space

⁴ For example, the recent pension governance reforms in the United Kingdom

Effect of vacancies

Proposed section 91 requires a vacancy in the membership of individual trustees or the board of a corporate trustee to be filled within 90 days. This is the period currently required under the equal representation rules.

Issue identified

In practice, replacing an independent director or trustee may take longer than replacing a member representative or employer representative director or trustee, particularly in a competitive market. The recruitment process typically takes longer than 90 days and can depend on the availability of suitable candidates. Even where a candidate can be recruited within 90 days, the candidate may need to resign other positions, which could impact the timing of the appointment.

We therefore suggest a period of 120 days and that APRA should be given power to determine, on application by the RSE Licensee, a longer period for filling a vacancy arising for an independent director or trustee.

Overriding effect of Part 9

Proposed section 95 suggests that the new governance requirements will override the governing rules of the fund.

Issue identified

The composition of an RSE Licensee's board will more often be governed by the RSE Licensee's Constitution, rather than by the governing rules of the fund. Under the Corporations Act, the amendment of a company's constitution requires a special resolution. A special resolution requires at least 21 days' notice and at least 75% of shareholders voting in favour of the change. This may be difficult to achieve since the shareholders may not be subject to APRA regulation. Therefore we suggest that the provisions of the RSE Licensee's Constitution be included in proposed section 95.

Transition Period

Part 3 of the Exposure Draft proposes a transition period beginning on 1 July 2016 and ending on the third anniversary of the day on which the legislation received Royal Assent.

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Submission to Treasury

Issue Identified

If the legislation receives Royal Assent **before** 1 July 2016, there will be a transition period of less than three years. Given that the new governance requirements will require the majority of APRA regulated funds to source independent directors for their boards, we query if the transition period is long enough to facilitate an orderly transition to the new regime. We suggest a minimum period of three years i.e. from the **later** of 1 July 2016 and the date the legislation receives Royal Assent.

We would be happy to discuss the issues we have identified if Treasury would like to do so. Please contact Pamela McAlister on (03) 9623 5040 in the first instance.

Yours faithfully,



Partner