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Phase One: Governance

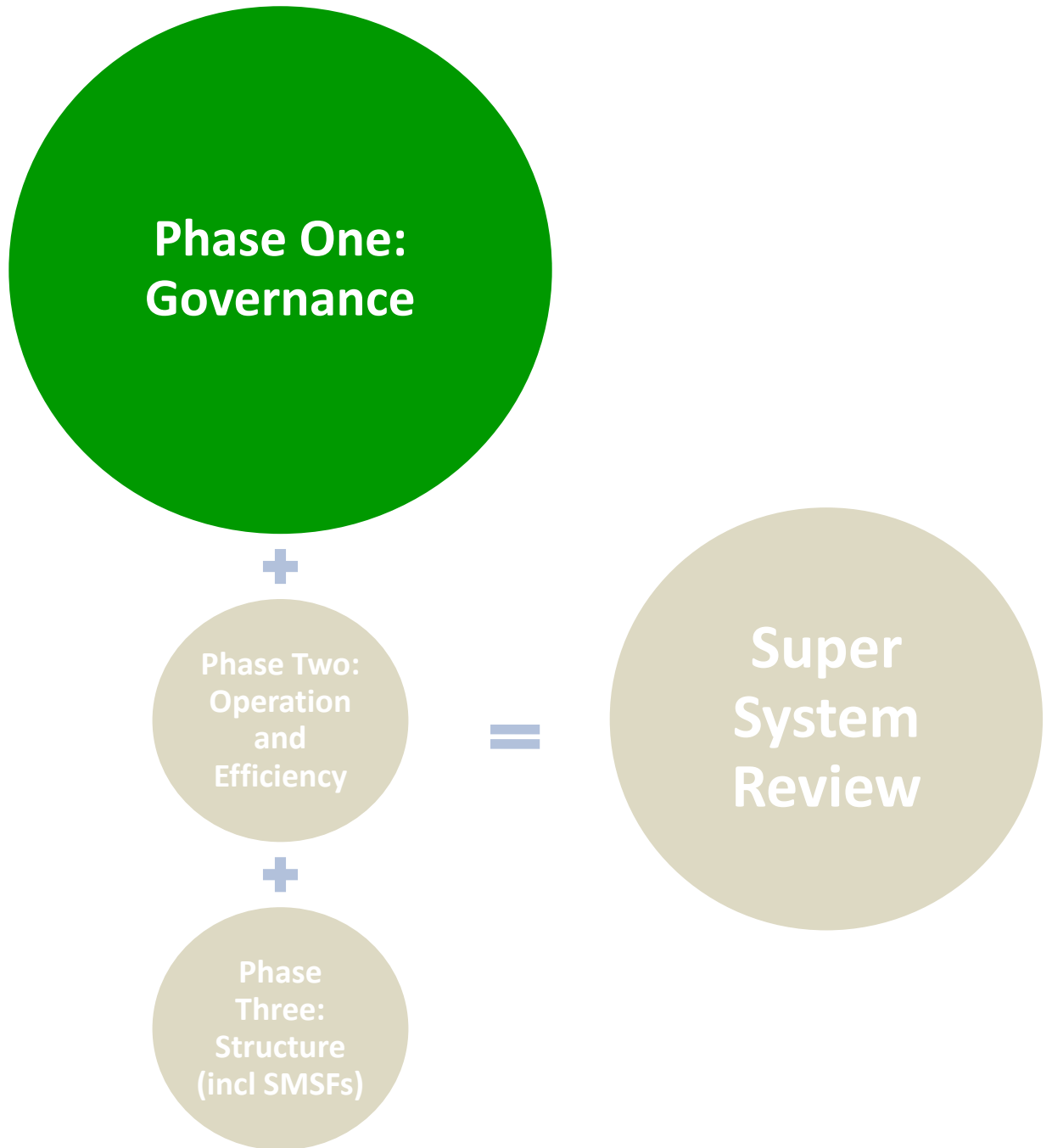


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1 INTRODUCTION

On 29 May 2009, the Government announced a comprehensive review of Australia's superannuation system: the Super System Review (**Review**).

The Review has broad [terms of reference](#).¹ It has been charged with examining and analysing the governance, efficiency, structure and operation of Australia's superannuation system. The Review is focused on achieving an outcome that is in the best interests of members and which maximises retirement incomes for Australians.

The Chair of the Review is Jeremy Cooper, a former Deputy Chairman of the Australian Securities and Investments Commission (**ASIC**). Jeremy is supported by a Panel of seven part-time members: Mr Kevin Casey, Mr Greg Evans, Mr Sandy Grant, Dr David Gruen, Ms Meg Heffron, Mr Ian Martin and Mr Brian Wilson. Short [biographies](#) for each of the Panellists are on the Review website.²

2 SCOPE OF THE REVIEW

The Scoping Paper entitled 'The Scope of the Review – a three phased consultation', released on 25 August 2009 and available at www.supersystemreview.gov.au, explains the scope of the Review.

3 THREE-PHASED CONSULTATION PROCESS

The Review will be divided into three phases of consultation under the following themes:

- Phase One – Governance
- Phase Two – Operation and Efficiency
- Phase Three – Structure (including SMSFs)

This Issues Paper deals with the first phase: Governance.

Key dates for Phase One: Governance

Phase One: Governance		
Release of Issues Paper <i>25 August 2009</i>	Closing date for submissions <i>16 October 2009</i>	Release of preliminary recommendations <i>Early December 2009</i>

Submissions for this phase of the Review close on 16 October 2009. Section 7 explains how to make a submission.

1 http://www.supersystemreview.gov.au/content/terms_of_reference.aspx

2 http://www.supersystemreview.gov.au/content/the_review_panel.aspx

4 BACKGROUND

4.1 Introduction

Governance broadly refers to the ideas, laws, processes and systems by which organisations are operated, regulated and controlled for the benefit of their relevant stakeholders. Governance is particularly important in the superannuation sector because people typically rely on trustees of superannuation funds to manage their retirement savings, and also frequently rely on the advice of other key agents to make choices about their superannuation options.

Good governance assists in ensuring that the interests of the various stakeholders in the system are aligned as closely as possible, such that funds are managed in the best interests of members, minimising conflicts of duties and interests and loss to the fund through carelessness or fraud.

Superannuation funds operate under a trustee model derived from the general law of equity. That is, a corporate trustee, or a group of individual trustees, controls the fund's assets and operates them solely for the benefit of its members and beneficiaries. Each trustee has a fiduciary obligation to the members and beneficiaries, which involves taking ultimate responsibility for the entity, and an obligation to manage the assets of the entity with competence, diligence, prudence and honesty.

The *Superannuation Industry (Supervision) Act 1993 (SIS Act)* also specifies obligations of trustees that automatically form part of the governing rules of all superannuation funds. Many of the obligations in the SIS Act embody duties already imposed on trustees by trust law. This does not include the fundamental duties of trustees to avoid or disclose actual or potential conflicts of interest, although the *Corporations Act 2001* conflicts regime³ will apply if the trust entity has an ASIC-issued Australian financial services licence.

To ensure a consistently high standard of governance across the superannuation industry, it is important for trustees' duties to be clearly understood, set at an appropriately high level and expressed in a way that is sufficiently flexible and robust to continue to accommodate developments in the size, structure and practices of the superannuation industry.

4.2 Prudential regulation

Closely tied to governance is prudential regulation. Prudential regulation helps ensure that funds deliver on their long-term financial promises. Important features of the superannuation fund prudential framework include:

- the 'sole purpose test', designed to ensure superannuation funds are maintained solely for retirement income purposes (and a limited range of ancillary purposes, including the provision of death and disability insurance);
- licensing of participants through the registrable superannuation entities concept;
- enforcement powers for the Australian Prudential Regulation Authority (**APRA**), including powers to investigate trustees and funds, issue directions and disqualify trustees; and

3 Section 912A(1)(aa) and RG 181: Licensing: Managing conflicts of interest (see <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Regulatory%20guides#181>)

- compensation provisions allowing trustees of APRA-regulated funds to apply for a grant of financial assistance where the fund has suffered loss as a result of fraudulent conduct or theft.

APRA is responsible for the prudential regulation of all regulated superannuation funds other than SMSFs, which the ATO supervises. APRA licenses superannuation trustees and can impose penalties on trustees that breach their responsibilities under the SIS Act. APRA requires that trustees operating APRA-regulated superannuation funds, among other things, demonstrate that they meet minimum standards of fitness and propriety and have in place appropriate risk management mechanisms to identify, measure and manage risks to the trustee and to the fund. However, unlike with authorised deposit-taking institutions and life offices, APRA does not have a prudential standard-making power in relation to superannuation funds. Rather, superannuation funds are subject to operating standards of the SIS Act and the *Superannuation Industry (Supervision) Regulations 1994*.

4.3 Investment strategy

An important aspect of the prudential framework relates to the investment of superannuation assets. Rather than the Government mandating or proscribing certain investments, trustees have a duty to formulate and give effect to an investment strategy that gives consideration to, among other things, appropriate diversification, expected cash-flow requirements, the liquidity of the investments and the need to balance risk and return in the best interests of members. However, members can direct a trustee to follow an individual investment strategy where a fund offers an investment option designed to allow members to invest in accordance with that strategy (eg international shares).

The SIS Act prohibits or limits certain investment practices that would expose superannuation funds to excessive risk. This includes a prohibition against borrowing, subject to limited exceptions allowing trustees to borrow up to prescribed limits to address short-term liquidity issues and to borrow on a limited-recourse basis for the purpose of investing. However, superannuation funds are not prohibited from investing in derivatives that do not involve a borrowing, but can result in losses beyond the initial capital outlay of the investment.

5 ISSUES – APRA-REGULATED FUNDS

These issues are not intended to be exhaustive and do not limit submissions to the issues raised. The Review may or may not make recommendations on all of them.

5.1 General

- 5.1.1 **Global financial crisis:** Did the global financial crisis highlight any governance problems in our superannuation system (for example, in risk or liquidity management) and, if so, what were they?
- 5.1.2 **Complexity:** Is it the case that the complexity of the superannuation system creates its own governance problems? If so, what are some examples? Are there any governance requirements that are no longer necessary or impose costs that outweigh intended benefits?

- 5.1.3 **Trust model for super:** Superannuation funds operate under a trustee⁴ model derived from the general law of equity. Given the nature of today's public offer, and other large, super funds, is this model still appropriate? Does it still deliver the best outcomes for members?
- 5.1.4 **UN Principles for Responsible Investment (UNPRI):**⁵ How should APRA-regulated super funds approach the question of becoming a signatory to the UNPRI or a similar set of principles? Should adopting such principles be mandatory? If this is not the right approach, then what would be preferable?
- 5.1.5 **Public sector:** Are there governance issues specific to public sector funds? If so, what are they?
- 5.1.6 **Best practice:** What is the best way to drive best practice governance across the industry, for example, in the areas of transparency, disclosure, conflicts management, environmental, social and corporate governance and shareholder participation?

5.2 Trustees

- 5.2.1 **Trustee duties:** Would the full or partial codification of duties to act in good faith, avoid and/or disclose real or apparent conflict of interest and not seek personal profit have a significant impact on trustee governance and the priorities given to various aspects of their operations? Would explicit provisions setting the priority of shareholder and member interests and enabling trustees to override deeds that require the trustee to invest or outsource within the corporate group help reduce trustee conflicts of interest? Should any additional duties apply to superannuation fund trustees?
- 5.2.2 **Trustee knowledge, skills and training:** Are trustees adequately equipped to do their jobs? Is too much expected of trustees?
- 5.2.3 **Trustee performance:** How is trustee performance measured? How should it be measured? Can and do trustees adequately measure their own performance? Are there adequate benchmarks? What are, or should be, the consequences for under-performance?
- 5.2.4 **Apprehension of personal liability:** Is trustee behaviour adversely affected by their apprehension of personal liability, thereby making fund governance more problematic, or is there an adequate balance between the duties of trustees and their potential liability in the case of a contravention?
- 5.2.5 **Trustee independence:** Should trustees be members of a fund of which they are a trustee so their interests are more fully aligned, or should they not have a personal interest in the fund?

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

5 See <http://www.unpri.org/>

- 5.2.6 **Reliance on outsourcing:** In many cases, trustees engage third party experts to perform a large number of the functions of the fund. Have funds struck the right balance between internal and external expertise?
- 5.2.7 **Conflicts in outsourcing:** In outsourcing so many functions, how do trustees who are associated with a service provider manage the conflict that arises between the interests of members and their own or associated interests? What should the rules be where a trustee has a relationship (by way of employment, directorship or ownership) with a fund service provider?
- 5.2.8 **Composition of the boards and succession planning:** Around three-quarters of all trustees are male and over 50 years old.⁶ Some trustee directors stay in office a long time and others are trustees of more than one fund. What rules should there be around qualifications, length of time in office, multiple trusteeships and selection processes for trustees?
- 5.2.9 **Stock lending:** Should it be left to trustees to decide if it is in the interests of super fund members to have equity investments owned by the fund made available for the purposes of short-selling or hedging by third parties, or should this practice be regulated in some way?
- 5.2.10 **Consolidation:** Should trustees of small funds be obliged to take steps to merge the fund in the pursuit of economies of scale in the long-term interests of members?

5.3 Government and regulatory

- 5.3.1 **Government policies:** Because super is concessionally taxed, compulsory and otherwise facilitated by Government, should Government:
- 5.3.1.1 use the system to advance other policy objectives such as sustainability, corporate social responsibility and managing climate change;
 - 5.3.1.2 be able to influence whether super funds make particular investments (eg infrastructure) either by directly mandating some level of participation (eg like a '20/30 rule') or providing strong incentives to do so; and
 - 5.3.1.3 remove barriers (if any) preventing trustees investing in long-term investments, such as infrastructure? To what extent do these barriers exist? Are portability and the ability of members to switch between investment options inhibiting the ability of funds to make long-term investments? Should the Government have a role in reducing these barriers and, if so, how?

6 APRA INSIGHT ISSUE ONE 2008, Superannuation fund governance: Trustee policies and practices. <http://www.apra.gov.au/Insight/APRA-Insight-Issue-1-2008.cfm>

5.3.2 **APRA regulation:** Should:

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

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

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

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

5.3.5 **2007 PJC Inquiry:** In August 2007, the Parliamentary Joint Committee on Corporations and Financial Services issued a report into the structure and operation of the Australian superannuation industry.⁷ The committee made 31 recommendations. The Review proposes to examine the recommendations of the committee that fall within its terms of reference and seeks feedback on the following recommendations relating to Governance issues:

Recommendation 4

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

Recommendation 6

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

5.4 **Accountability to members**

5.4.1 **Accountability to members:** Are super funds, individually or as a class, sufficiently accountable to members? How successful has the policy committee structure (Part 9 of the SIS Act) been? Do super fund members need a body or association that just represents them and advocates their issues? Also, members lack an annual general meeting equivalent. Should larger funds host, for example, online AGMs?

⁷ Parliamentary Joint Committee on Corporations and Financial Services *The structure and operation of the superannuation industry* August 2007 <http://www.aph.gov.au/senate/committee/corporations_ctte/completed_inquiries/2004-07/superannuation/report/index.htm>

- 5.4.2 **Corporate governance of underlying investments:** There is currently no formal connection between the views of super fund members and the exercise of votes on equity investments held by the fund. As members of superannuation funds are collectively substantial owners of capital, should they have a say on who represents their interests in corporate board rooms? How could this be achieved?
- 5.4.3 **Responsibility for investments:** How do superannuation trustees decide what choices to offer members? How much responsibility should be placed on trustees for individual investment strategies when members make investment choices either with or without separate advice? Is it appropriate to allow fund members to direct a trustee to follow any investment strategy a member chooses from the trustee's available investment options?

5.5 Operational

- 5.5.1 **Investment Time Horizon:** It is often said that superannuation funds and investment managers are too focused on short-term performance. Is this criticism valid and, if so, what are the factors driving short-termism and what, if anything, could be done to encourage a longer-term horizon?
- 5.5.2 **Tilt towards equities:** Australian super funds seem to have had a bias towards equities in their portfolios (around 57 per cent before the global financial crisis, compared with an average of 36 per cent in 20 OECD countries⁸ where data are available). This meant that Australians' superannuation savings were more vulnerable to the global market turmoil, but equally are likely to benefit from a market recovery. Is this tilt towards equities justified? Should the Government impose restrictions to enforce more diversification to other asset classes or allow trustees to decide?
- 5.5.3 **Portfolio rebalancing:** How rigorously do super funds adhere to their portfolio rebalancing policies? What are members told about this? Should there be clearer rules about how far out of balance familiar types of portfolios (eg balanced, growth) can go before some action has to be taken; for example, some prescribed ranges?
- 5.5.4 **Leverage:** Are the current exceptions to the borrowing prohibition suitable? Should superannuation funds be permitted to make investments that can result in investment losses beyond the initial capital outlay (such as instalment receipts or contracts for difference) even if they do not involve borrowing?
- 5.5.5 **Tax governance:** To what extent do trustees take an interest in the taxation of the underlying portfolio and, for example, the amount of capital gains tax being incurred? Crystallising capital gains in the accumulation phase can be adverse to members' interests, but will be unavoidable in certain circumstances and for certain types of funds. What are members (or their professional advisers) told about the tax governance policies of the fund? Is mandating an across the board obligation to have regard only to after-tax returns (eg in rewarding managers) a solution?

⁸

OECD, Australia – Highlights from *OECD Pensions at a Glance: Retirement-Income Systems in OECD Countries 2009*.

6 SELF-MANAGED SUPER FUNDS

There are some important governance issues specific to the SMSF sector. We propose dealing with those issues, and other issues relating to SMSFs, in the Structure phase. However, stakeholders wishing to make submissions about SMSF governance in this phase are welcome to do so. We expect to devote a substantial part of the resources of the Review to SMSFs and would not want any contrary inference drawn merely because we are proposing to do so in phase three, rather than phase one.

7 MAKING A SUBMISSION

There is no set structure for submissions and participants may comment on any matter they consider relevant to the topic. This could range from a short letter outlining your views on the topic to a more substantial document covering a range of issues. Where possible, you should provide data and/or documentation to support your views.

We ask that submissions follow these guidelines:

- Each submission should be accompanied by a cover sheet as set out in the appendix to this paper (also available on the Review website www.supersystemreview.gov.au). This is so we have your contact details. You do not need to repeat your contact details in the actual submission.
- While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.
- If making a paper submission, please send it printed in black ink on A4 paper.
- If your submission is more than five pages, please include a summary upfront.
- Make sure you read the information about public posting and privacy below.

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All submissions will be treated as public documents. They will be published on the Review website, including any personal information of the authors, unless you tell us that you want the submission to be treated as wholly or partly confidential or the Review thinks that the submission should be kept confidential.

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APPENDIX

SUPER SYSTEM REVIEW SUBMISSION COVER SHEET (This form will not be published with your submission)		
Please complete and attach this form to your submission:		
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