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Governance requirements for RSE licensees: proposed amendments

Our feedback in relation to aspects of the proposed changes to superannuation governance is attached. Any questions in relation to this submission can be directed to Mr Rod Masson, General Manager, Corporate Affairs - rmasson@cbusmail.com.au (03) 8648 6954).

David Atkin
CEO
3 August 2015

Introduction

Cbus (United Super Pty Ltd) provides superannuation services to construction, building and allied industry workers and retirees, their families and their employers. Cbus was established in 1984 and is one of Australia's oldest industry superannuation funds.

The fund has more than 715,000 members and 94,000 employers and has funds under management valued above $31 billion. Cbus operates on a profit-for-members basis. All returns are used for the advantage of fund members and there are no dividends paid to stakeholders.

Cbus also invests back into the construction and building industry, which not only provides strong long-term investment returns, but helps boost our economy and create jobs within the industry.

Issues

Cbus welcomes the opportunity to comment on the proposed approach to implementing the proposed governance changes to RSE licensees.

We note that this process is being undertaken when there is still considerable uncertainty regarding the final version of the primary legislation. A bill to implement the changes has not been introduced into Parliament and will probably be the subject of inquiry by relevant committees and could be amended during negotiation with various stakeholders. Consequently our submission is simply a response to APRA's letter and the current wording of the various proposals which may change.

We should also be clear that we support the wider policy position regarding the proposed legislation by Industry Super Australia in their submission to Treasury which is critical of both the rationale and detail contained in the legislation and the powers the legislation proposes to bestow upon APRA.

APRA states that "Later in 2015, APRA will release drafts of amended SPS 510 and new SPS 512 for consultation, with a view to releasing the final prudential standards before the end of 2015." We suggest that this timeline may be optimistic given the uncertainties of Parliamentary processes.

As a general comment we believe that (wherever possible) APRA should adopt a principles based approach and allow individual funds to make decisions in the best interests of their members regarding the appointment of directors, and the optimum composition of boards and committees. This would recognise the distinct variations between funds who return all profits to members and the for-profit retail sectors; and the diversity of structures that exist across industry funds. Individual funds can, and should, be empowered to make decisions and design processes that are appropriate for their circumstances.

- ***Issues and practicalities regarding the definition of independence and material relationship***

The draft legislation states:

> *"A person is **independent** from an RSE licensee if the person:*
>
> *(a) does not have, and is not directly associated with a person who has, a substantial holding (within the meaning of the Corporations Act 2001) in the RSE licensee, or in another entity that is a member of the same group as the RSE licensee; and*
>
> *(b) does not have a material relationship with, and is not employed by an entity that has a material relationship with:*
>
> *(i) if the RSE licensee is a body corporate – the RSE licensee; or*
>
> *(ii) if the RSE licensee is a group of individual trustees – any of the trustees; and*
>
> *(c) 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:*
>
> *(i) if the RSE licensee is a body corporate – the RSE licensee; or*
>
> *(ii) if the RSE licensee is a group of individual trustees – any of the trustees.*

APRA states that it "intends to amend SPS 510 to supplement the proposed definition of independence in the SIS Act by substantially aligning SPS 510 with the requirements applying to the banking and insurance industries in *Prudential Standard CPS 510 Governance* (CPS 510)."

Attachment A of CPS 510 specifies that:

> *"A director is <u>not</u> independent if the director:*
>
> *1. is a substantial shareholder of the APRA-regulated institution or an officer of, or otherwise associated directly with, a substantial shareholder of the institution;*
>
> *2. is employed, or has previously been employed in an executive capacity by the institution or another member of the group, and there has not been a period of at least three years between ceasing such employment and serving on the Board;*
>
> *3. has within the last three years been a principal of a material professional adviser or a material consultant to the institution or another member of the group, or an employee materially associated with the service provided;*
>
> *4. is a material supplier or customer of the institution or another member of the group, or an officer of or otherwise associated directly or indirectly with a material supplier or customer; or*
>
> *5. has a material contractual relationship with the institution or another member of the group other than as a director.*

The definition in the draft legislation purports to be appropriate for industry superannuation and retail funds, despite having different ownership structures and stakeholders. Unfortunately there is the possibility of inadvertent outcomes given the range of ownership structures and director backgrounds that exist in the industry superannuation landscape.

We note that the definition of 'directly associated' is not apparent from the draft legislation.

'Material relationship' is also not defined in the exposure draft legislation but will be clarified by APRA when it updates SPS 510. Nevertheless, APRA states that it proposes to include "material professional advisors, consultants or suppliers as examples of material relationships. Further, as outlined in the explanatory guide to the draft legislation, material relationships are likely to include relationships between the RSE licensee and standard employer sponsors, parent companies and bodies with the right to nominate potential directors."

It appears that the existence of a relationship will be enough to disqualify a person from acting as a director, regardless of whether that relationship has any impact on the person's ability to act in the best interest of members.

We submit that the 'material relationship' should relate to the nature of the relationship, not the simple existence of a relationship that may not be material.

If a strict limitation on material relationships (particularly including employees of employer sponsors) is implemented then it would dramatically limit the number of potential independent directors that might be available.

It would appear likely that any employee of any standard employer-sponsor of a fund would be considered non-independent, regardless of their role or the materiality of the relationship. As a matter of principle, the mere fact that a person is an employee of a standard employer-sponsor does not undermine his or her ability to act in members' best interests.

A number of practical problems may also arise. For example, Cbus has over 90,000 contributing employers; however this does not automatically mean the relationship is material. Excluding anyone that has worked for one of these employers, regardless of their individual connection to the RSE licensee, potentially excludes a significant number of people from the pool. Material relationships should be associated with potential material interference with the exercise of independent judgement, as per CPS 510.

Where the law allows, APRA should adopt a principles approach so that funds can make their own judgements regarding the suitability and possible conflicts of any potential director.

(b) Independence in conglomerate groups

APRA has indicated that "the proposed definition will result in some independent directors on entities within a conglomerate group being prevented from also serving as an independent director on the RSE licensee board. This will particularly be the case where a group independent director is director of an entity that has a material relationship with the RSE licensee; in that situation, that director could not be considered independent for the purposes of the RSE licensee board."

Cbus would have significant concerns with how this might inadvertently impact on its operations. By way of illustration Cbus Property is a wholly owned subsidiary of United Super (Cbus Trustee).

Cbus Property is required by its constitution to act in accordance with the same fundamental principles as United Super – ie act in the best interests of Cbus members. Cbus Property is also bound by a formal investment management agreement to act in accordance with an agreed set of principles. All the assets and earnings of Cbus Property flow to members of Cbus which assures

alignment of the interests between the fund beneficiaries and the wholly owned subsidiary. A director's duties and obligations on one board cannot conflict with their duties on the other.

The Cbus Property constitution mandates that 4 members of its board must come from the Cbus Board. The proposed restriction would not reduce any risk of conflict and its application would simply restrict the ability of Cbus to appoint the best candidates to the Cbus Property Board.

We would be disturbed if APRA rendered a director no longer independent by virtue of simply being appointed to the board of a wholly owned subsidiary. Funds should be able to appoint the best directors to these boards based on skills and experience.

We submit that there is no logic to this potential prohibition which is overly prescriptive and would simply restrict the ability of funds to appoint the best people to the respective boards.

- ***Issues and practicalities regarding the requirement for a majority of independent directors on the Audit & Remuneration committees***

APRA proposes to amend SPS 510 to:

- require that a majority of both the Board Audit Committee and Board Remuneration Committee be independent directors;

As a matter of principle we believe that boards should be able to define the composition of their committees. A requirement for the board to have one third independent directors, but a majority of independents on board committees, will most likely have negative consequences and may in fact weaken rather than strengthen the prudent management of a fund.

Firstly, the proposed definition of independent in the proposed legislation will narrow the pool of potential board candidates.

Secondly, the proposed requirement to have a third independent directors on the board will increase the demand on this smaller pool of independent directors.

Thirdly, the proposed requirement for the Board Audit Committee and Board Remuneration Committee to have a majority of independent directors could result in a shortage of independent directors with those specific skills. This may also create a scenario where independent directors with expertise in other important areas such as investments or digital technologies are not appointed because of the need to satisfy the requirements for the Audit and Remuneration committees.

Consequently, the specific requirement for the Board Audit Committee and Board Remuneration Committee to have a majority of independent directors is likely to be difficult to implement in the first instance but may also have negative implications on the overall governance capabilities of the fund.

It potentially prevents directors with valuable expertise serving on certain committees by virtue of their non-independent status and the numerical restrictions. It also potentially reduces the opportunities for non-independent directors to gain valuable experience and skills that would benefit the fund.

Again we submit that individual funds should be allowed to make decisions and appointments that are best suited for their circumstances and needs.

(d) Director appointment and removal processes

The current version of SPS 510 includes a requirement to have a policy on board renewal, including a process for appointing and removing all directors.

We note that:

> "APRA intends to **expand these requirements** to set out other aspects to be addressed as part of the RSE licensee's appointment and removal processes. ***This is expected to include provisions relating to the process by which candidate directors are nominated for board positions and the framework used to assess the suitability of those candidates for appointment. APRA also expects to support these provisions with guidance."*** *(emphasis added)*

It is unclear what this means and we would seek clarity given the potential importance of such requirements. We note that it does potentially suggest that APRA will prescribe requirements regarding the composition and processes of the nominations committee. We do not believe it is necessary for APRA to mandate any further requirements beyond what is already contained in SPS 510, namely to have a Board renewal policy. We also note that CPS 510 does not make any prescription in this area beyond an identical requirement to have a Board renewal policy.

(f) Capacity for APRA to determine a director independent or not independent

The draft Bill would give APRA powers to decide whether a director is independent or not.

We appreciate that APRA only intends to use this power rarely; however we believe it would be a substantial level of control for a regulator to have over internal matters and does not appear to apply in other sectors such as banking or insurance, where boards self-assess whether directors meet the test of independence.

Even if the power is never exercised its existence means trustees will have less certainty regarding their compliance given that the power could be applied at any time. We also note that there seems to be no obligations for procedural fairness when APRA is making a determination. In particular it appears that APRA may determine that a person is not independent without giving them the right to respond.

We would harbour genuine concerns for APRA's serious and successful commitment to building and maintaining a collaborative relationship with the Funds it regulates if this extraordinary power were granted and inevitably exercised.