AIST Submission

Review into the governance, efficiency, structure and operation of Australia's Superannuation System

Phase One: Governance

16 October 2009

Background

The 'Super System Review', announced by the Government on 29 May 2009, is a review into the governance, efficiency, structure and operation of the current superannuation system in Australia. The review is split into three segments, with the first being 'Phase One: Governance'.

The Australian Institute of Superannuation Trustees (AIST) welcomes the opportunity to provide a submission in relation to this first phase of the review, specifically, our submission addresses questions posed in section five of the 'Governance – Issues Paper' released on 25 August 2009.

We look forward to being involved in the remaining phases of the review program.

AIST

AIST is a national not-for-profit organisation whose mission is to promote and protect the interests of Australia's $450 billion not-for-profit superannuation sector. AIST's membership includes the trustee directors and staff of industry, corporate and public-sector funds, who manage the superannuation accounts of nearly two-thirds of the Australian workforce.

As the principal advocate and peak representative body for the not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

About this submission

This submission is dealt with in two parts. The 1st part of the submission deals with the summary recommendations made by AIST in answer to the specific questions asked by the review panels' documents.

The 2nd part of this submission deals with the key themes raised in the submission and focuses heavily on the benefits of the representative trustee system.

Executive Summary

This Superannuation System Review is occurring at a time of unprecedented stress within the global financial system and during a period of considerable self-examination in the nation's superannuation system itself.

This submission argues that Australia's unique representative trustee system for superannuation funds, developed since the mid 1980s, has delivered superior results for Australian workers over a number of decades. This model of representation stands in stark contrast with other parts of the finance sector where conflicts of interest and unethical conduct have been widely criticised.

In the two decades during which the not-for-profit superannuation sector has grown into a system managing $450 billion in retirement benefits for two thirds of the workforce, the representative trustee system has delivered such good governance in a tightly regulated environment that there have been few, if any, losses to members through defaults, malfeasance or other dubious practices.

AIST recognises that superannuation is of central economic importance to the nation and is increasingly complex to administer. Consequently, we advocate best practice standards for the ongoing training and continued professional development of trustees. We also advocate for the recognition of superannuation trusteeship as a separate and unique skill set, requiring professional accreditation.

The current representative trustee population, overwhelmingly drawn from employer and employee ranks, provides a wealth of experience. In this submission we deal with certain aspects which we believe will strengthen the trustee system in the next decade to encourage greater heterogeneity, including succession planning and the encouragement of talented younger people to become an integral part of superannuation trustee boards. The focus is on ensuring the recruitment of trustees who are motivated by a "member first" philosophy and who share the independence of judgement which has been a notable facet of not-for-profit boards over previous decades.

This submission argues that the success of the equal representative trustee system, in delivering sound governance and superior results for members at low cost, indicates it is the most appropriate model for dealing with mandated superannuation contributions.

The Issues Paper produced by the Review asks submissions to deal with the structure of default options and the role of choice. In this submission, we support formal legislative recognition of a default fund model, including a default option and member choice options, but only insofar as such legislative change can lead to better member outcomes across the whole system.

Despite the shock to the entire global financial system in the past two years, we assert that a prudent and calm approach to managing the nation's superannuation assets is the only appropriate response to such dislocation. In that sense, we believe the freedom to invest has been an important facet of the long-term out-performance of Australia's

superannuation model and argue that government mandating of investment policy would be a backward step.

Representative trustees have, by their nature, a strong member focus. This is most commonly expressed in their approach to communications. This submission argues that one of the major impediments to effective communication with members is the complexity of the regulatory regime.

We are a strong supporter of a tough regulatory regime, which has stood Australia in good stead not only during the past tumultuous two years but since the present superannuation system was first established more than 20 years ago. However we support better, rather than more, regulation in the disclosure and communication area.

We believe that trustees need to be open and accountable - individually to their memberships, and collectively to the community at large. We do not suggest that no change to current governance arrangements be countenanced, but we believe the evidence is clear that the representative trustee system has performed well in managing member interests and ensuring that Australia's superannuation system has contributed significantly to dealing with the nation's many challenges, from managing longevity issues to the establishment of nation-building enterprises.

Recommendations and Key Points

5.1 General

5.1.1 Global financial crisis (GFC)

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?

The global financial crisis highlighted the risks inherent in investment options with insufficient diversification. Those funds that were appropriately diversified and had effective liquidity management processes in place were well-equipped to deal with the challenge.

The impact of cash flow and membership demographics on liquidity needs to be recognised. Funds with large positive net cash flows and stable membership bases were in a far better position to manage and reduce liquidity risk than those funds with a low or negative cash flow and an active membership – such as a fund with a high proportion of members closer to retirement or in retirement products.

We believe funds should place more emphasis on stress-testing and understanding their membership from an investment perspective. For example, better membership knowledge and stress-testing would have provided funds with insight into scenarios that, prior to the GFC, may not have received due consideration. For example, stress-testing would have indicated that rapid devaluation of the Australian share market would place significant liquidity strain on funds where they were engaged in foreign exchange hedging via forward contracts.

In addition, the GFC identified that, at fund level, risk management plans and strategies were not always sufficient in terms of the risks they identified and the corresponding controls. More emphasis should be placed on the scope of risk management plans and strategies to ensure they capture all risks relevant to investment markets.

Whilst some criticism has been directed to trustees in relation to asset allocation during the crisis, we believe the issue lies in the legislative requirements on trustees in relation to benchmark and asset allocations. It could be argued that it is not in the best long-term interests of members for funds to be forced to trade assets based on the requirement to remain within their asset allocation ranges.

The GFC has also highlighted the importance of the structure of the default settings in superannuation, given that it is now even more clear that no matter what seems to be happening in investment markets globally, most super fund members remain in their fund's default option and do not switch investment options. Research undertaken for AIST by Paul Gerrans, Associate Professor of Finance, and Edith Cowan University (ECU) of 3.4 million fund members showed that less than 6.5% of pre-retirement savings were switched during the GFC[1].

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[1] Gerrans, Paul, *Member Investment Choice Response to the Global Financial Crisis* (2009), Centre for Retirement Incomes and Financial Education Research, Edith Cowan University (for the Australian Institute of Superannuation Trustees).

This situation also poses the question of whether it is necessary to have so much investor choice in superannuation, and who is paying for that choice. Further, our research shows that members who do make a choice often miss-time the market. This highlights the need and importance of sound and appropriate financial advice and/or education being provided to members at key life-stages.

In addition to advice, the GFC highlighted the need for better products that provide more security in retirement as retirees and those close to retirement were the worst hit by the downturn.

The GFC identified the need to focus on long-term returns, rather than short term gains. Despite the global down turn, the 10 year returns for balanced options within not-for-profit funds was 5.41% on average and 3.96% for retail master trusts.[2] What is important is the net benefit to members over the long term.

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?

We believe complexity does cause governance problems in the following key areas:

- Funds are required to operate under dual license requirements and regimes, subject to different regulators, which results in confusion and duplication of workload.
- While broadly supporting the dual regulator approach (APRA and ASIC), AIST members report a high level of frustration and duplication of workload in reporting to two regulators. Aspects of the dual regulator approach increases costs ultimately eroding member benefits.
- In addition to APRA and ASIC requirements, funds must comply with a myriad of additional laws and frameworks including the SIS Act, the Corporations Act, Privacy Laws, Anti-Money Laundering frameworks, Accounting Standards and Tax Laws. In a system where we are looking to drive costs down, this duplication is both costly and time consuming.
- Current disclosure requirements create a significant barrier to effective member communications leading to market inefficiencies, high costs and ultimately, sub-optimal policy outcomes, not to mention confused members. We consider the most cumbersome area of law in relation to disclosure requirements is under Chapter 7 of the *Corporations Act 2001.*
- We believe the many and varied legislative requirements that govern superannuation add to the complexity of the system. Simplification is required and best achieved by amalgamating the legislation that governs super funds into the one Act, which logically would be the SIS Act.

[2] *Fund Crediting Rate Survey*, SuperRatings, June 2009.

RECOMMENDATIONS:

- Simplification of superannuation legislation is required and in our view this would be best achieved by bringing together and amalgamating all of the legislation that governs the operations of a superannuation fund under one Act, which logically would be the SIS Act.
- Should the current legislative structure be maintained, then Chapter 7 of the *Corporations Act 2001* be reviewed and re-oriented to a specific superannuation perspective. This would not only reduce complexity and costs for funds, but would permit a more communication and educative approach to funds' disclosure materials and activities.
- Implementation of a front-office reporting and statistics collection, jointly sponsored by APRA and ASIC to reduce costs and offer some scope to transfer SMSF regulation to APRA.

5.1.3 Trust model for super

Superannuation funds operate under a trustee 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?

The trust model is not only still appropriate, it is fundamental to the success of the system and provides a sound and efficient framework for generating retirement benefits of members.

Of the two key trustee models within the superannuation industry, it is our view the representative trustee model best represents member interests for the following reasons:

- Minimising and managing conflicts of interest: The representative model fosters strong competition within the superannuation system. Representative trustees are not bound by parent companies and are free to act in the best interest of members, rather than shareholders. The retail model involves complex, built-in conflicts of interest. Free from the shackles of parent company ownership and built-in conflicts of interest, not-for-profit trustees (and their fund's executive) are able to select the best fund managers, custodians, asset consultants and other service providers, whilst also driving a hard bargain on fees – all to the obvious benefit of members. (this issue of conflict of interest is addressed further at 5.2.5)
- Reducing administration and agency costs to a minimum; the model has provided the opportunity to maximise economies of scale benefits through the formation of collective vehicles which have been able to deliver superior returns with lower fees to members.

- Ensuring that members' interests are represented and single-mindedly pursued by trustees; Only the representative model allows trustees to solely focus on member' interests. John Bogle, the founder of the Vanguard Group – the world's second largest mutual fund has been examining governance models for many years – believes: *"the driving force of any profession includes not only the special knowledge, skills and standards it demands, but the duty to serve responsibly, selflessly and wisely".* AIST believes that the representative superannuation system combines skill with the duty of care that Bogle refers to.

- Ensuring that trustees remain independent of vested interests in the financial sector, and capture the decision making benefits of diversity and representation. A key competitive advantage of the representative model is, as the name suggests - representative. The inherent nature of this model – whereby there are an equal number of employer and employee representatives - strongly aligns board and member interests. This ensures a mission-driven culture that focuses solely on delivering net benefits to members.

- Ensuring the best possible application of innovation in investment management, and recruitment of the best possible investment managers. The representative model has been innovative in its approach to long term investments. For example, the not-for-profit sector was an early adopter of alternative investments which have delivered results to members and provided much-needed investment diversification options.

- Meeting the emerging need for national savings to address problems such as climate change and the post- GFC economy: The not-for-profit sector has a 25 year track record of out-performance: Research indicates funds with representative trustee boards out-perform those operating under different trustee models of up to 2.4 per cent per annum. This is evident in both positive and negative investment markets.[3] Evidently, governance plays a role in performance.

RECOMMENDATIONS:

- AIST strongly supports the continued application of the trust structure for superannuation.

- Given the strong performance of the equal representative trust model, we recommend that this be the mandatory model for default superannuation.

[3] Bryan, Dick, Gillian Considine, Roger Ham & Mike Rafferty, *Agents with Too Many Principles? An Analysis of Occupational Superannuation Fund Governance in Australia* (2009), Workplace Research Centre, University of Sydney (for the Australian Institute of Superannuation Trustees).

5.1.4 United Nations Principles for Responsible Investing (UNPRI)

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?

We strongly support the UNPRI and encourage our members to become signatories, as we have done. However, we note the UN principles are aspirational and non-binding. Therefore it is unlikely mandating adoption of these principles will ensure better practice in relation to Environmental, Social and Governance (ESG) matters.

Whilst many superannuation funds have taken leadership positions when it comes to incorporating ESG considerations into their investment decision making, some funds are still concerned that the sole purpose test prohibits them from incorporating ESG considerations.

AIST does not believe this to be the case; we believe trustees have an obligation to address ESG as part of their existing fiduciary duties and as such, we believe APRA should encourage trustees to incorporate ESG principles into risk management planning for their investments. This being said, we believe ESG issues are one of many investment risks which should be considered and these issues should not be elevated in importance over other risks.

We note that Senator Sherry when he was the Minister responsible for Superannuation, wrote to APRA asking for guidance for trustees around risk management and ESG considerations, and note that to date, APRA has not yet responded with a guidance paper on this issue.

AIST believes that by identifying EGS risks as a mainstream investment risks, this guidance will clarify that these issues may affect investment performance and therefore should be fully understood and incorporated into investment decisions.

We also support trustees pursuing active shareholding initiatives.

RECOMMENDATIONS:

- The UNPRI should not be mandated.
- ESG issues should be considered as part of a funds' overall risk management framework and not elevated in importance over other investment risks.

5.1.5 Public Sector

Are there governance issues specific to public sector funds? If so, what are they?

We support reforms to bring all funds within the ambit of SIS, on an equal footing with other not-for-profit funds.

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?

We believe that best practice should be driven by a variety of mechanisms that include government, regulators, professional associations, and competitive forces.

We note that provision of guidance through regulators via RSE licensing and the prudential framework has assisted in promoting best practice across the industry.

RECOMMENDATION:

- We support the continual development and promotion of the current prudential framework.

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?

We believe the present Section 52 covenants and the application of common law provide an appropriate framework for prudential behaviour by trustees.

We do not believe it is constructive to impose a duty to avoid conflicts and prefer that conflicts of interest are managed by strict operational procedures at board level. For example, when directors are discussing a matter which may result in a conflicted response, the director concerned should remove themselves from the discussion.

We do not believe that codification of the prohibition against personal profit would reduce the conflicts arising from corporate structures, and in any event, the prohibition already exists in trust law.

RECOMMENDATIONS:

- We support the prioritisation of trustee shareholder and member interests.
- We support stronger action on conflicts of interest, including mandating that all trustees must develop, implement and disclose a conflicts of interest policy, which must cover certain areas.
- We support the outlawing of "structural conflicts" where service providers are stipulated in governing documents.

5.2.2 Trustee knowledge, skills and training

Are trustees adequately equipped to do their jobs? Is too much expected of trustees?

From our experience as a registered training organisation, trustees are generally well-equipped to do their job. Currently 92% of trustee boards require their directors to undertake a minimum of 20 hours of continual professional development per annum, which generally involves structured training, attendance at conferences and professional development courses. This is particularly evident in the not-for-profit sector where research indicates:

- 83.6% of trustees have tertiary, graduate or post graduate qualifications,
- 11% have a Diploma or Advanced Diploma in financial services and;
- 48% have other relevant qualifications
- The qualifications attained by trustees are varied. [4]

However, there is no standard qualification for a trustee director and as such we believe a mandatory, uniform qualification should be introduced for all new trustees, as part of their induction process.

We believe this should be standardised through the introduction of a mandatory level of training required for all **new** trustee directors as part of their induction process.

Whilst comparison is often made between company directors and trustee directors, the two roles are different in nature, trustee directors are responsible for mandated superannuation guarantee contributions they operate in a highly regulated area, with legislative requirements that are far more onerous than those of company directors.

Trustee boards are collective by nature and board decisions require a 2/3 majority. In addition, fit and proper guidelines requires assessment of not only directors as individuals, but as a board group as a whole.

[4] Newitt, Shey, *Trustee board governance in the not-for-profit superannuation sector* (2009), Australian Institute of Superannuation Trustees.

With 58 per cent of trustees already meeting RG146 requirements, we believe this 'standard training' requirement would be best served if codified within an RG146-type framework, specifically designed for trustees and incorporated within RSE licensing law.

We believe that at this point a minimum of 30 hours of continued professional development, incorporating both internal fund training with external training from relevant providers, is best practice. As the superannuation sector grows and increases in fund and industry complexity, we believe the need for professional standards, mandated training requirements, and more formal trustee training requirements will follow.

As well as having training and experience in superannuation, trustees come from a diverse range of backgrounds. To illustrate the depth of both experience and diversity within trustee ranks, we note the following high-profile individuals are not-for-profit superannuation trustees: Steve Bracks, former Premier of Victoria; Bernie Fraser, former Governor of the Reserve Bank of Australia; Susan Ryan, Former Federal Government Minister; Sue Dahn, Director, Pitcher Partners Investment Services; and Peter Collins, Former Leader of the NSW Opposition. A further small sample from our 1,300 members is provided in *Appendix A*.

Across AIST's membership base there is a wealth of qualifications which includes qualifications in law and accounting, MBA's, PHD's, Engineering and Science degrees, Economists and Masters of Education to name just a few.

RECOMMENDATIONS:

- As part of their induction process, all new directors must undertake mandatory training, which should include an introduction to trustee legal duties and responsibilities, investments, and risk management. This should be codified within an RG146-type framework, and incorporated within RSE licensing law.
- We believe a minimum of 30 hours continuing professional development, consisting of both internal fund training and external activities, is best practice.

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?

AIST strongly believes that trustee assessment should occur regularly to ensure trustees are meeting the overriding objectives of their fund. A review of the board's effectiveness in its oversight of the fund is as critical as any review of executives, staff, advisers and investment managers.

We believe that board assessments should be carried out by an external and independent body or organisation, and such an assessment should be completed against a fund's board charter.

From a governance perspective, boards need to consider the extent to which the fund has the appropriate and effective decision-making structures in place to effectively run the fund.

Introducing a board performance review processes improves accountability for directors who are primarily accountable to members and in a broader sense, to a much wider group of stakeholders.

Another key benefit is that where the board oversees and is responsible for good governance, and engages in a review, it makes it easier for the practice to flow through to the rest of the organisation. An effective process also invites constructive feedback and encourages greater attention to how the board actually operates, thereby promoting greater efficiency and effectiveness.

We believe the following areas should be considered for performance and evaluation purposes:

- Strategy and planning;
- Board and committee structure and role;
- Board director responsibility;
- Governance;
- Meeting process;
- Risk management and performance monitoring;
- Education and training;
- Investment oversight;
- Insurance oversight.

In addition to assessing their performance, it is important that trustees are able to benchmark their fund against others based on net benefit to members. We believe there is a shortage of reliable industry statistics. The development of relevant metrics for funds to assess performance and to benchmark themselves against others would facilitate this process and be beneficial to funds in understanding the competitiveness of cost structures across their key areas. AIST is currently investigating the possibility of developing such a benchmark.

An effective board performance process should include measures for dealing with the consequences of non-performance. We believe underperformance should be addressed and if not then overcome, the board should discuss it with the sponsoring organisation and consider replacement of the director.

RECOMMENDATIONS:

- We do not believe that short-term financial performance of the fund can be used as a proxy for board performance.
- We do not support maximum periods for which trustee directors may serve on a board, but we do support amendment to law to provide for terms of appointment, provided that trustees may seek reappointment at the expiry of their term.
- We support the use of external organisations for the completion of board performance reviews.
- A metrics system and benchmark framework is developed to measure fund-level 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?

We believe that the balance between personal liability and trustee directorial duties is broadly appropriate. AIST has not seen any evidence of an apprehension of personal liability leading to a lack of willingness of individuals to become trustee directors.

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?

AIST supports changes to law to permit independent trustees to be members of the fund for which they serve as trustee. The SIS Act currently requires that independent directors are not members of the fund in which they are a trustee and we believe this should be repealed.

We strongly support all trustees being able to be members of their fund if they choose and we believe this assists with aligning their interests to those of members.

We note however, that there may be some practical issues to consider, particularly where trustees are a member of more than one board.

RECOMMENDATION:

- That the SIS Act be amended to remove the requirement that independent directors are not members of the fund of which they are a trustee.

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?

One of the key skills trustees have is the ability to make decisions about the capacities of other organisations to deliver adequate services on a cost-effective basis.

There are varying levels of outsourcing evident in the superannuation sector, from funds operating with a small secretariat and virtually all services outsourced, to funds who operate with little outsourcing including self administration, self insurance and in-house investment teams. This illustrates the fact that trustees actively consider and assess which services should be delivered and in what manner, which we believe is a positive outcome for members.

In our view, the predominance of outsourcing in the superannuation industry should be seen as a strength and not a weakness. Utilising a specialised service provider means, in theory, funds have access to the following benefits:

- Specialist expertise: management and boards have access to industry and technical specialists covering a variety of areas including law, administration, custody, and asset consultancy. This sharing of expertise results in better practice and superior outcomes for members.
- Cost reductions: through access to economies of scale, process improvements and new technologies.
- Focus on core business: management and trustee boards are able to focus on key business activities and can devote less time to day-to-day back office operations, which instead, are left to a specialist service provider.
- Service standards: improvements in service quality may arise as providers are focussed on meeting contractually agreed service level standards.

RECOMMENDATION:

- We believe the current system provides trustee boards with the freedom to make appropriate decisions about outsourcing and in-sourcing.

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?

We believe that conflicts of interest between service providers and trustees must be managed in accordance with a robust conflicts of interest policy that must be transparent and actively managed. Where service providers are related parties, that relationship must be disclosed to members. Of particular concern, are the in-built conflicts of interest when a fund uses a service provider who shares the same parent company as themselves.

RECOMMENDATIONS:

- AIST supports amendments to regulations to mandate that trustees must formulate and publish a Conflicts of Interest Policy that includes specified basic requirements. Such a requirement should be broadly consistent with the requirements under Sections 191-194 of the *Corporations Act*.
- We believe trust deeds should not be able to specifically dictate the name of a service provider, for example, 'the administrator for XYZ fund is ABC'.
- We support stronger disclosure requirements in annual reports and product disclosure stations in relation to outsourced service providers and related-party transactions.

5.2.8 Composition of boards and succession planning

Around three-quarters of all trustees are male and over 50 years old. 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?

It is important to note that when compared to company boards, the not-for-profit superannuation industry has a strong track record of promoting diversity on trustee boards. For example, women comprise only 1 in 12 positions on company boards, whilst women make up nearly 25% of boards in the not-for-profit sector.

We recognise that there will continue to be a bias towards older directors, given the need to accumulate industry experience, however, we believe more can be done to ensure that further age and gender diversity is present on boards of the future.

The demographics of trustee boards also mean that funds must ensure that they have appropriate mechanisms in place to deal with succession planning. As current directors retire, funds need to ensure that they are bringing not only diversity, but appropriately skilled individuals to trustee roles.

This is an important issue for sponsoring organisations such as unions and employer associations who are responsible for appointing most trustee directors to superannuation funds.

Where appropriate, sponsoring organisations should identify future trustees and begin a process of training and development for them. Where appropriate they should provide them with access to boards as either alternate directors or as participants on board committees.

Sponsoring organisations also need to recognise that those who take on trustee roles need to have the time to give the role the commitment it deserves.

We believe that super funds should have the right, in regulation, to request a review of a sponsoring organisation's nomination, if the nomination does not meet with the fund's fit and proper policy, skills or other requirements.

With respect to sitting on multiple boards, we believe it should be appropriately left to the trustee board to determine whether there is an indirect or direct conflict of interest that would inhibit the effective participation of a director on that board. Allowing funds to request a review of a sponsoring organisation's nomination would assist in managing the issue of multiple directorships.

RECOMMENDATIONS:

- As previously noted, we recommend mandatory minimum training requirements for new trustee directors.
- Trustees must seek renomination after a three-year term.
- It should be appropriately left to each trustee board to determine whether there is an indirect or direct conflict of interest that would inhibit the effective participation of a director on a board.
- AIST recommends that the equal representative provisions be amended to explicitly permit boards to reject a nomination where they resolve that the nominee does not meet the requirements of the fund's Fit and Proper Person Policy and skill requirements.
- If a fund does not wish to accept a nomination for a director who may sit on multiple boards, this can be managed by the nomination rejection process.

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?

Superannuation Funds, and ultimately superannuation fund members, benefit from covered short selling and from stock lending. As such, it should be left to trustees to make

decisions in relation to this. In this submission, reference to short selling means covered short selling unless otherwise indicated.

As major participants in investment markets, it is appropriate for trustees to have access to the full range of investment tools and strategies, and emphasis should be placed on ensuring trustees fully understand what they invest in rather than on restricting their options.

We support transparency with respect to both stock lending and short selling.

We support all reasonable measures to eliminate market manipulation, but believe that the process by which manipulators achieve illicit profits should be distinguished from the activity which has itself been manipulated.

Just as in the case of insider trading, it is not share trading which is the problem but the abuse of fiduciary duty. Accordingly we believe market manipulation is the problem, not stock lending or short selling.

RECOMMENDATION:

- We believe covered short selling is a legitimate investment strategy and should be available for trustees to use at their discretion.

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?

AIST believes that the trend towards industry consolidation will continue over the next decade as a natural progression within the superannuation industry. We do not however, support mandated consolidation and believe it is neither feasible nor constructive.

AIST believes that there is room for small, medium and large funds within the industry, and that the existence of these funds creates competition which is good for members. Small to medium size funds are able to access economies of scale through service providers, particularly in the investments and administration areas.

In addition many smaller funds have specific membership groups with special needs, legacy benefit designs and other factors which mean consolidation is not as straightforward or desirable as simplistic scale-based arguments might suggest. For all but the very smallest funds, trustee costs are not a significant proportion of overall costs and hence, do not represent sizeable cost savings on consolidation.

We believe the argument 'smaller funds may be a greater governance risk' is best addressed through trustee director training and competencies.

Many small to medium size funds in the range of $1-5 billion dollars regularly feature in the top 10 performance figures of superannuation funds. It is important the focus stays on net returns and benefits to members as opposed to the size of the fund.

We do however believe that where funds are not able to deliver service to members in a cost effective way, then it is incumbent on the trustee to act in the members best interest,

which may well be to merge with another fund, to find scalability. In our view, government should facilitate this outcome via incentives and pathways which encourage, and simplify, consolidation.

RECOMMENDATIONS:

- AIST believes that smaller funds need access to information to assist them to analyse the efficiency of their funds and make decisions about whether or not a merger is in the best interest of members. Improved industry benchmarking information would assist with this process.
- We do not support mandated consolidation.
- We call for permanent exemption for CGT in respect of successor fund transfers.

5.3 Government and regulatory

5.3.1 Government policies:

Because super is concessionally taxed, compulsory and otherwise facilitated by Government:

5.3.1.1 Should Government use the system to advance other policy objectives such as sustainability, corporate social responsibility and managing climate change??

We strongly support the role of superannuation funds in advancing social aims surrounding sustainability, corporate social responsibility and climate change where it is pursued in line with the sole purpose test. We believe incorporating these factors improves risk management and the long term performance of member investments.

We see an obligation for trustees to address ESG issues as part of their existing duties and believe greater transparency on these issues will enhance investor understanding of underlying investments, allowing investors to address risk more systematically.

RECOMMENDATION:

- Trustee boards should be encouraged to consider ESG issues as a means to foster an investment culture which is focussed on sustainable practices.

5.3.1.2 Should Government be able to influence whether funds make particular investments (e.g. infrastructure) either by directly mandating some level of participation (e.g. like a '20/30 rule') or providing strong incentives to do so?

Market demand and supply should not be distorted by government policy. Therefore, we do not support the mandating of investments by government. Typically, mandated investment policy inflates asset values negating the aims of the policy initiative.

Decisions on how a fund is invested, including the structure of default options, is best left with funds themselves. Each fund has different demographics and the fund is therefore best placed to make the decisions about what is best for its particular membership.

RECOMMENDATION:

- We support the provision of incentives for investments in areas the Government wishes to be pursued.

5.3.1.3 Should Government 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?

We believe the government should act to remove barriers to infrastructure investing, however we also believe that under no circumstance should the government mandate an investment level or approach.

A key issue with regards to infrastructure is that it is still considered by some as an alternative investment. Other barriers to infrastructure investment are concentrated around the bureaucracy involved with planning and local and state government regulations, which absorb a disproportionate share of the projects' costs, and increase the at-risk bid costs.

In relation to switching and its impact on long-term investing, our research shows that switching was relatively low throughout the crisis especially within funds with a relatively young membership. It follows that such funds should take advantage of their relatively young membership and invest in longer-term infrastructure assets.

For some funds, liquidity may be a barrier to long-term investments, particularly where the fund operates within a highly competitive market. The competitive environment is a direct consequence of the choice and portability requirements and reflective of the short-term nature that is being promoted by ratings agencies.

Another barrier to long-term investing, is the promotion of short-term returns by the media and superannuation rating agencies. We question the relevance of monthly performance figures for products established with an investment time-frame which can easily exceed 30 years.

Member investment choice also provides barriers in that super funds are investing with a focus on long-term while there members are able to switch in the short-term.

RECOMMENDATIONS:

- Government should act to remove barriers to infrastructure investing.
- The Government has begun a dialogue with the industry in relation to refining the processes of infrastructure investing, and we recommend that this continues.

5.3.2 APRA regulation

5.3.2.1 Should 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?

We believe APRA's current powers are appropriate for prudential regulation of the industry as APRA has the ultimate power of being able to remove a fund's licence to operate or to disqualify individuals.

Australia has coped with the Global Financial Crisis better than most countries because our robust regulatory systems.

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

In general, we do not support any further extension of APRA's policy making powers. However, we do believe that APRA should have appropriate mechanisms in place to identify and remove under-performing funds.

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?

We believe the existing enforcement framework and sanctions are appropriate.

We do not support the application of further penalties to breaches of the SIS 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?

Whilst we support the spirit of the legislation, we believe that pursuing a regime where superannuation funds are subject to related party transaction requirements, as per the *Corporations Act*, will lead to expensive and cumbersome processes. This is particularly evident in the case of funds with large membership bases.

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 of PJC Review

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.

We support formation of compulsory accounting and disclosure requirements in relation to trustee and executive remuneration.

RECOMMENDATIONS:

- With regard to trustee remuneration, we recommend that these amounts are disclosed within designated bands, including reference to any additional remuneration for participation by each director on related boards and committees of the board.
- In relation to executive remuneration, we believe that funds should disclose the remuneration of the five highest paid employees as a total amount.
- In relation to disclosure of advertising and sponsorship expenses, we believe that Choice of Fund legislation has created the need for funds to be able to advertise in a variety of forms. As such, advertising and sponsorship cost should not be required to be dealt with or disclosed in a different manner than other items of fund expenditure as they are a normal operating expense of running any business.

Recommendation 6 of PJC Review

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

We believe the current requirements for outsourcing under the SIS Act and APRA outsourcing guidance is appropriate. The market for key service providers is dominated by a few major players, with the specialist skills required. It is unlikely that public tendering alone would lead to a significant broadening of the available providers and we feel it would only result in an additional layer of cost to members.

RECOMMENDATION:

- We do not support government mandating of public tendering of 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?

Based on our experience of our membership, we believe trustees are sufficiently accountable to their members. We note that trustees take very active approaches to member education and communication and are keenly aware that many of their members are neither engaged nor voluntary participants in the superannuation system. The vast majority of members in the superannuation system now have access to choice of fund, and this again enhances trustee accountability because if members are disgruntled there are no barriers to switching to another fund.

In relation to the policy committee structure, we support the representative trustee model we do not believe the policy committee structure adds value as ultimately, the decision still rests with the trustee board.

We do not support the establishment of a member association, nor do we support the mandatory extension of the AGM concept into the superannuation arena. A major purpose of AGMs is to enable shareholders to move resolutions and vote on them. This is not practicable in the superannuation sphere, given that SIS prohibits trustees accepting direction from members.

In addition, the sheer logistics of the number of members of funds would render AGMs impractical and/or very costly due to fund size and member geographical diversity.

To actively promote member engagement, we encourage funds to consider the use of technology to provide members with the information generally covered in an AGM, without the confines of this structure. Many funds already provide 'Member Annual Briefing' sessions to give members the opportunity to listen to directors and senior management and have their questions answered.

RECOMMENDATION:

- We support the use of technology – rather than AGMs or member associations - to provide members with a voice.

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?

Superannuation funds invest in a vast number of public-listed companies, both in Australia and overseas. As long term investors with stringent fiduciary duties, it is critical that trustees are aware of how these companies are managed in respect to corporate governance frameworks.

We therefore support engagement by superannuation funds with the companies, in which they invest, including by voting their shares.

We believe voting of shares is best performed by trustees acting on the advice of investment consultants, fund managers and other specialists. There are a number of limiting factors in extending this entitlement to members, including disengagement, costs and the logistics. In addition, it would be impossible to reflect of the diversity among a large membership.

As legal responsibility, including sole purpose test, lies with trustee directors it is therefore appropriate that all decision-making in relation to investments rest with them.

RECOMMENDATION:

- Voting of shares should be completed by trustees.

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?

We believe that quantifiable investment objectives are the best benchmarks for consumers, and are the key representations made by trustees on which choice decisions may be based. They also are likely to yield better decisions than choices made on the basis of historical returns.

Given that more than 80 percent of superannuation fund members are in default funds, we believe that the structure and design of default funds and default options is paramount.

As many members in defaults funds appear not to have made an active choice, it is inappropriate that these members be exposed to high-cost and commissioned-based default products.

As such, we believe low-cost not-for-profit funds are the most appropriate vehicle for accepting default contributions.

AIST believes there is significant ambiguity and tension between the covenants expressed in section 52(f) of SIS, and the widespread use of investment choice within the industry.

We recommend that SIS be amended to introduce the concept of "default option", as distinct from "choice options", and that the covenants be amended to reflect the existing, traditional interpretation in the case of default options, and the involvement of member decision-making in the case of choice options.

Further, we believe that some elements of the traditional fiduciary duty cannot be abrogated, and that trustees are required in all cases to have due regard to diversification, liquidity and risk, notwithstanding that the relevant member may have made a decision in relation to broad asset allocation.

We also recognise the increasing interest within the trustee community for target-date investing and age-based defaults. We will be making further submissions in respect of the default option structures as part of our response to Phase Two of the Review.

Under the Choice of Fund legislation and investment choice, members have the right to direct how their balance is invested. Trustees have no choice but to act on this direction, regardless of what the potential impact on their retirement savings could be. Whilst we believe it is appropriate for the member to have this right, we believe the limited advice model will assist trustees and fund staff to help members make more informed choices. We recognise the need for members to have access to financial advice at different life stages and we believe more should be done to facilitate this.

RECOMMENDATIONS:

- That all funds be required to formulate and publish quantifiable investment objectives with risk and return indicators. Quantifiable investment objective should form the key benchmark used in APRA fund disclosure (once statistics on investment options are available to APR), and that they form the return projection assumption for the proposed superannuation forecasts.
- The law be amended to ensure that all default funds and options are based on a not-for-profit model.
- No commissions default funds and options.
- That the SIS Act is amended to introduce the concept of "default option", as distinct from "choice 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?

As previously noted, the implementation of the Choice of Funds legislation has driven inter-fund competition and short-termism within some sections of the industry.

Media coverage of short-term rating agency performance date has the potential to prompt members to use this measure as a fund comparison. These figures are a good indicator of long-term performance and we question the relevance of monthly returns on a product that can have a 30 year life.

Whilst we support members having access via their fund to all performance data, we are concerned that the emphasis on short-term performance is of dubious benefit to members.

RECOMMENDATION:

- We recommend the Review investigate options for the regulation of ratings agencies and how performance figures are published.

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 countries 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?

The asset allocations of Australian funds are designed to provide long-term returns using various asset classes in a variety of market conditions. Whether those asset allocations remain appropriate in light of the global financial crisis is a matter for trustees to consider in the context of advice from their experts. Moreover, evidence suggests that equities outperform other asset classes over the long term.

International comparisons are rarely useful when comparing the Australian compulsory system with other pension systems. One contributing factor to the difference noted in the Issues Paper is the tendency for default funds in the US to have very conservative asset allocations, due to the perceived risk of litigation for loss of capital.

The ability to access franking credits has been beneficial in reducing funds' effective tax rates to an average of approximately 8 per cent. The higher tilt towards equities reflects this tax effectiveness.

RECOMMENDATION:

- As previously noted, we do not support Government restrictions and directions as to asset allocation and we believe this is a decision for trustees to make.

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 (e.g. balanced, growth) can go before some action has to be taken; for example, some prescribed ranges?

We support the use by funds of portfolio rebalancing policies and disclosure of asset allocation ranges to members. Rebalancing is closely related to funds' investment strategies and the operational demands of liquidity, as well as their capacity to access a variety of assets.

We believe that funds should not be forced to rebalance; however, they should act true to label in accordance with their rebalancing policy.

As previously discussed, it could be argued that it is not in the best long-term interests of members for funds to be forced to trade assets based on the requirement to remain within their asset allocation ranges.

RECOMMENDATIONS:

- We do not support Government prescription of asset allocation ranges.
- That additional disclosure (within a funds PDS) be provided to members in relation to the fund's underlying assets of each investment and the frequency of portfolio re-balancing.

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?

We believe the conceptual aim of the prohibition remains valid. We note that trustees typically invest in companies which themselves have levels of debt, so it is not practically possible to exclude all leverage risk from a portfolio.

However we have concerns with the risk in the ability of Self Managed Superannuation Funds to use instalment warrants. The lower standards of prudential supervision to which SMSFs are subjected, as well as lower standards of trustee training and competency indicate that controls of leverage are most required in this sector.

RECOMMENDATION:

- Tighter prudential regulation of SMSFs.

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 (e.g. in rewarding managers) a solution?

We believe trustees appropriately balance tax and investment aspects in their overall investment strategy and operations. Arguably the broad fiduciary duties currently applying to trustees are relevant to after-tax returns as much as pre-tax returns. Whilst we support the reporting of after-tax returns, we don't believe any mandating of after-tax returns is necessary.

We believe trustees appropriately balance tax and investment aspects in their overall investment strategy and operations. As such we do not believe there should be any major reforms in this area.

The nature of superannuation investing, as the name suggests, is about investing and naturally will involve the occurrence and crystallization of capital gains. The utilization of current tax polices allows funds to best manage these issues.

SMSF's

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.

Whilst some might argue SMSFs represent the ultimate alignment of member and trustee interest, we believe that this might be overshadowed by governance short-comings in the SMSF sector.

Our main areas of concern are:

- Risk taking: trustees are likely to take a very different approach to risk-taking on behalf of thousands of members than they are prepared to undertake in respect of their own fund. For example, some SMSF investors may not take on enough risk due to a lack of understanding of investments or due to time commitments, which results in a reduced balance upon retirement. Contrary to this, some SMSF investors may take on excessive levels of risk which results in losses and therefore, a reduced balance at retirement.

- Trustee diversity: we believe the diversity of trustees and their experiences, along with the greater number of APRA regulated boards, will lead to better governance practices occurring outside of the SMSF sector.
- Training: greater standards of training and competency for trustees should be introduced and it is unlikely SMSF trustees would be able to achieve these standards.
- Consistency: the current approach results in one side of the compulsory superannuation system being highly regulated, whilst the other has minimal requirements.

For the reasons listed above, we believe APRA should be responsible for the regulation of SMSFs and not only would this minimise or eliminate these issues, it would ensure we have regulatory consistency across the compulsory superannuation sector.

Discussion of Key Themes

Lessons from the global financial crisis

In the aftermath of the global financial crisis deep wounds are starting to heal and many valuable lessons have been learnt. The volatility that was experienced at the peak of the crisis was described by many commentators as a one in a hundred year event. The crisis was an extreme event, which tested the financial system globally and delivered the modern world's first rapid, globally co-ordinated policy response.

While individuals' superannuation savings bore the brunt of the crisis, the national savings pool represented by superannuation served to soften the impact on the Australian economy. As Dr Ken Henry stated in his recent address to the Australian Conference of Economists Business Symposium, "Australian superannuation funds were instrumental in financing the large structural change that took place as companies de-leveraged, and this large scale corporate de-leveraging could not have been achieved without the substantial pool of savings that the superannuation sector provides to our capital markets"[5]. In effect the presence of large and sophisticated funds has been an important economic anchor in this financial crisis, ensuring that Australian capital markets are sufficiently large and deep to absorb the recapitalisation of our companies.

Trust model for superannuation

A theme to which we will often return in this submission is that the art of decision-making, diversity of opinion and breadth of experience are among the greatest virtues. This is so in times of prosperity and predictability, but doubly so in times of change and uncertainty. These attributes point to the quality of wisdom, as distinct from mere cleverness. To be worthy of trust requires elements of wisdom, and is at the centre of the classic formulation of trusteeship.

The *Managed Investment Act 1998* (MIA) resulted in the replacement of the separate roles of trustee and manager with the single role of Responsible Entity. Comparing this structure to the representative trustee system reveals a number of prudential shortcomings, and some of the recent collapses are evidence of how ineffective prudential supervision can result in a loss of investor confidence and monies. Investors have recently experienced substantial loss through maladministration, negligence and fraud on the part of managed fund operators licensed by the Australian Securities and Investments Commission (ASIC) as responsible entities (REs).

The trustee system, through its governance structure and codified duties via the *Superannuation Industry (Supervision) Act* 1993 (SIS) has performed exceptionally over time to protect members' interests, putting them first above all else. The MIA fails to put member's interest first, amongst many other critical shortcomings. The Responsible entity of a managed investment scheme is not subject to prudential supervision by APRA thereby increasing the risk of the schemes collapse.

[5] Dr Ken Henry - Address to the Australian Conference of Economists Business Symposium

Performance and Governance

While the trust model provides protection for superannuation members, the chief function of the system, to generate investment returns, is also affected by governance structures. AIST has commissioned an extensive research project into fund governance by Dr Mike Rafferty of the University of Sydney and his colleagues. As Dr Rafferty points out[6], there are two quite distinct governance models in the Australian superannuation industry, with one sector comprised of not-for-profit funds, and the other by retail funds. SMSFs constitute a third sector, but are outside the scope of this Phase of the Review. Dr Rafferty's work is part of a growing body of evidence confirming the benefits of the representative governance model over the retail model.

The study finds that, over the period March 2004 to December 2008, not-for-profit funds outperformed for-profit, or retail funds by 2.4% per annum, and points out that this is consistent with similar studies conducted overseas. A performance shortfall of 2% per annum, if sustained over 40 years, would produce a 35% shortfall in final benefit at retirement[7]. This outperformance is now acknowledged fact in the industry, and attention has turned to the key explanatory reasons for it.

Clearly, fees and costs are a major driver of outperformance, and this is associated with the commission based distribution model used in the retail sector, as well as the conflicts of interest discussed at length in this submission. However, we see a number of other factors playing a role. Not-for-profit funds have steadily established collective vehicles for a wide range of fund functions, including administration, funds management, and insurance broking. This has enabled economies of scale and has cut costs for funds. There is also evidence that more active asset allocation by not-for-profit funds, and their greater use of unlisted investment vehicles, has enhanced risk-adjusted returns.

Governance models in superannuation

In analysing the cost and performance differences between the two sectors, it is important to realise there is a great deal of commonality in the underlying business processes. Administration and reporting processes are similar, regardless of the governance model, and the investment management processes are also similar. Perhaps the greatest irony of the dispute is that the most important function of a superannuation fund, investment management, is often carried out by the same firms and even the same individuals, in both sectors.

This irony demonstrates that governance is at the core of the differences between the sectors, and raises the question of what are the interests standing in the way of progress toward a unified governance model which best meets the policy objectives of the system. AIST believes that the key issues are:

[6] Rafferty, Mike, Roger Ham & Dick Bryan, *Governance and Performance in Superannuation Fund Management – An Issues and Research Design Paper* (2008), Workplace Research Centre, The University of Sydney (for the Australian Institute of Superannuation Trustees).
[7] Assumes wage growth of 4%pa, Super Guarantee contributions only, real returns of 3% versus real returns of 1%

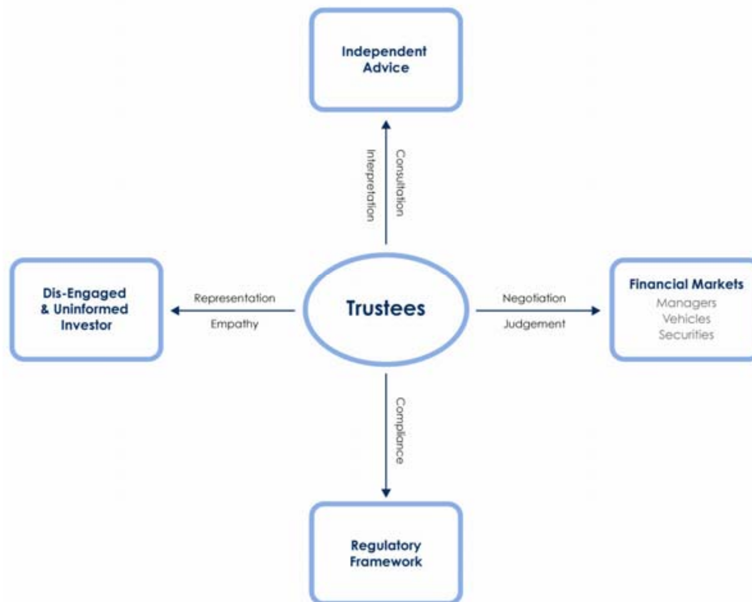
- The conflicts of interest inherent in corporate trustees of retail superannuation funds which are owned, controlled, and directed by banks and other profit-making financial conglomerates. The directors of such conglomerates are typically middle- to senior-ranking executives of the parent group, who will see their jobs and career prospects inextricably linked to the financial returns the trustee delivers to the parent, not the returns the fund delivers to its members.

- The fees extracted from retail products to service the commissions supporting the institution's distribution channels. While we welcome recent moves toward fee-for-service models, we believe more needs to be done. However, this is a matter of fees and efficiency, and hence we will be taking this point up further in Phase 2 of the review.

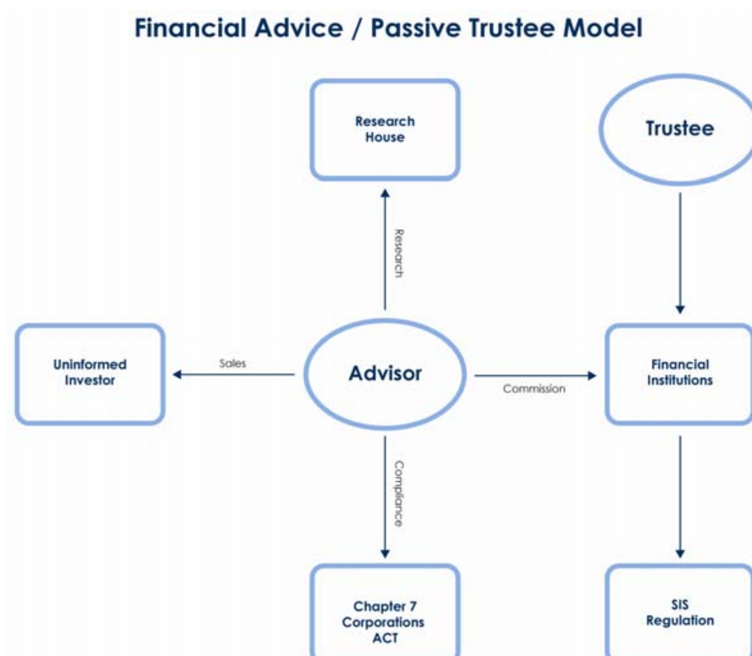
- The ambiguity in responsibility for investment strategy and planning in the retail sector. Because trustees are either in-house to the product promoter, or are contracted to provide trustee services on terms dictated by the promoter, the promoter, through the trustee constructs superannuation products for distribution by its advisers and agents, rather than for consumers. The advisers on the other hand, purport to provide asset allocation and manager selection services to the client, when in fact the asset allocation role is massively under-resourced compared to what a not-for-profit trustee can achieve, and the manager selection has been more a process of commission-selection for the adviser. This structure dislocates the critical investment management functions, and interposes a commercial relationship fraught with conflicts between the promoter and the adviser, effectively emasculating the one party (the trustee) with the statutory responsibility to work in the member's best interests.

We believe addressing these structural conflicts of interest is the most important task of the Review. However, we believe the equally insidious "passive trustee" model is itself a significant drag on overall system performance. It should be noted, again in the context of the irony noted above, that to remove the conflicts of interest, or to address passive trusteeship would not diminish in any way the access of funds to professional investment management and other services, because financial institutions with deep resources and professional staff would remain active in the wholesale market for these services.

Not-for-profit funds utilise what might be called an "active trustee model", where not only are the legal protections of the trust model in place, but the trustee is the key decision maker, controlling a process whereby the interests of ordinary investors are mediated to the financial markets. This process occurs with the assistance of independent investment advice, and within the context of regulation.



The structural deficiencies of the passive trustee model are illustrated in the following diagram. Not only is the application of trust protection diluted through the conflicted position of the trustee, but the investment strategy decision making process is dislocated.



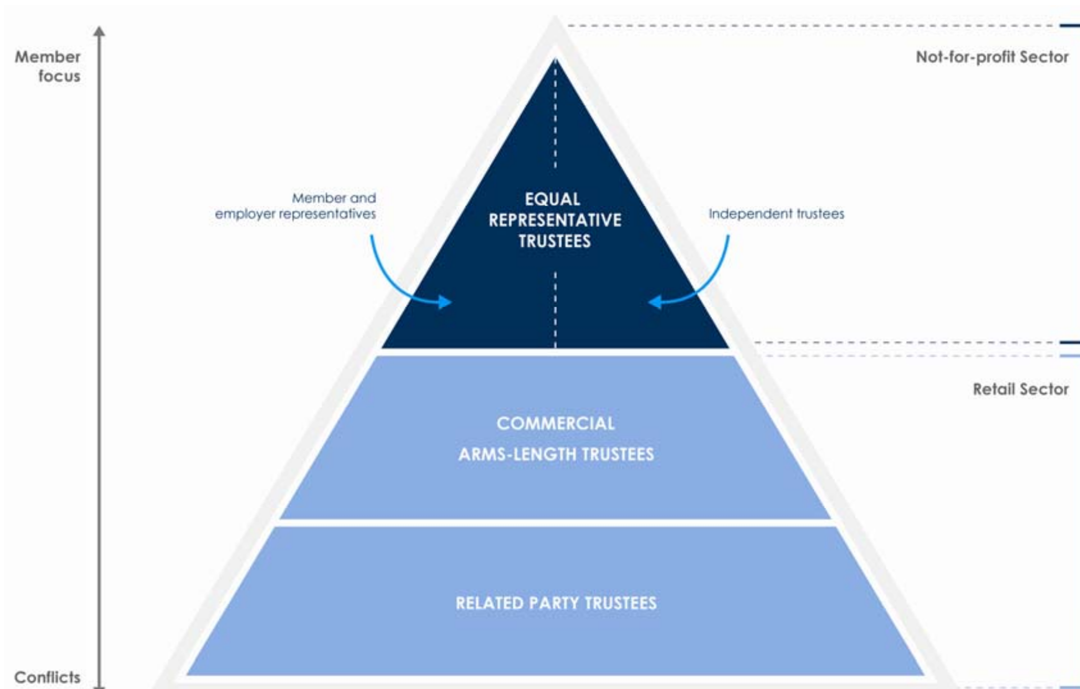
There is another very important dimension to the representative trustee system. As the member's representatives, who do not, and cannot under trust law, profit from the trust, representative trustees need not be motivated to recruit new members, and grow their funds under management. While growing funds under management to achieve economies of scale and hence reduce fees and costs is a common and desirable approach to improving net returns, the arguments about scale are more complex, and frequently less compelling than is often represented, as we point out elsewhere in this submission.

If trustees really are the representatives and servants of their memberships, then they can be freed from many of the competitive pressures and promotional urges which drive the focus on short-term returns. They can adopt long-term, innovative, and potentially illiquid investment strategies, secure in the knowledge that their informed members understand and implicitly endorse their strategy, and their disengaged members will not move in significant enough numbers to either raise liquidity problems, or erode the fund's fee revenue base.

A hierarchy of trustees

Some retail funds use arms length commercial trustees. While these trustees are not representative of the memberships, and are conflicted to the extent that they rely on continued appointment by the fund manager or promoter, there is an additional level of independence from the promoter.

Therefore, we can conceive a hierarchy of trustees, ranging from in house or related party trustees with the greatest conflict and the least capacity to single-mindedly pursue members' interests, to commercial arms length trustees, with a slightly better level of independence, to equal representative trustees, who are truly independent of external, profit-making financial institutions.



Another point we will make throughout this submission is that the notion of independence as defined in SIS is outdated, and while it may historically have had value in promoting the skills on boards, it does not promote the independence that really matters, that is independence from financial institutions and their distribution channels.

While we support the ability of representative trustee boards to appoint independent directors, as provided for currently under the SIS Act, we believe the concept of independence is more useful within the policy framework, when applied to the relationship of a trustee to a financial institution.

Trustees

Why Trustees are different

Governance is an issue relevant to all corporate bodies in modern society, ranging from kindergarten committees of management to boards of listed companies. The skills, experiences, education and qualifications relevant to directors or members serving on each governing body will vary widely, depending on the roles and activities of the organisation in question, arguably to a much greater degree than the legal basis of incorporation or regulation.

While most superannuation trustees are incorporated as companies under the Corporations Act 2001, and are nominally regulated under the same corpus of law as major listed companies, the roles, responsibilities and activities of the trustee boards and listed company boards have similarities, but also stark differences. Indeed, it should be remembered that a key reason for incorporating superannuation trustees as companies is to bring them within the legislative scope of the Constitutional powers of the Federal Government.

We believe therefore that governance structures which have proven useful in the corporate sphere, potentially over many decades, cannot be presumed to be applicable to superannuation funds, but need to be assessed in the context of the unique structure and public policy role of superannuation in Australia. The key difference between superannuation funds and listed companies is of course that superannuation funds, as distinct from their trustees, are trusts not companies.

While there has been significant debate about whether the trust model remains appropriate, and that is a key question raised in the review, the nature of the underlying investors in both superannuation funds, and listed companies supports the continued use of trusts in the superannuation sphere.

Shareholders of listed companies invest voluntarily, and are often professional or institutional investors, while members of superannuation funds are individuals who have often not chosen to invest, and may even resent the fact that their participation is required under law. Clearly, there are information and decision-making asymmetries in the two cases, and the presumably poorer decision-making position of the superannuation fund member suggests a more paternalistic approach from the superannuation fund trustee is more appropriate.

Company directors and superannuation trustees are both intermediaries standing between the ordinary citizen as investor, and a profit making venture, but each looks from the intermediating position in the opposite direction. Importantly, the two roles are distinct, but complementary. Company directors are running a business, in which their shareholders seek to derive a return. However, unlike a superannuation fund, a company does not and should not seek to deliver an integrated, diversified investment vehicle suitable for the retail investor market.

While "investor relations" departments have become more common in companies over recent years, in the main company directors are, unsurprisingly, focused on running their business, and their responsibilities to deliver a dividend and share price to investors is very much seen as a corollary of their prime responsibility of running the business.

Trustees on the other hand are single-mindedly focused on their members. They are not charged with running a business, but in investing in businesses run by others. This responsibility entails that they engage with company boards on strategic issues, and are acquainted with the challenges and opportunities faced by their investee companies, but their focus remains directed to their members. Many of those members are unsophisticated investors, or even "financial conscripts"[8], and trustees react to that fact in part with a paternalistic approach. That paternalistic approach is consistent with the historical concept of trust, and underscores both the empirical and normative differences between trustee and company directors.

Effective governing bodies

Having individuals with the right motivation, and the right skills is only part of building an effective governing body. Those individuals bring their experiences and commitments as well as their skills into the forum, and the group must make a practical and sometimes prosaic decision from diverse and firmly held views, and passionate and potentially conflicting commitments.

Diversity among board members is essential in order to increase discussion, exchange of ideas and overall performance.[9] Greater diversity undoubtedly improves organisational performance by pulling together different opinions and perspectives.[10] It is unrealistic to expect a trustee to know everything about all issues, and therefore, diversity assists boards in covering all their technical bases.

Superannuation boards demonstrate more gender diversity than their corporate counterparts, particularly in the not-for-profit sector. More than 20 per cent of trustees in this sector are female, compared to only 10 per cent on corporate boards, although the majority are males approaching retirement age, which is not ideal.[11] AIST strongly believes

[8] Bryan, Dick, Gillian Considine, Roger Ham & Mike Rafferty, (2009) *Agents with Too Many Principals? An Analysis of Occupational Superannuation Fund Governance in Australia*, Workplace Research Centre, University of Sydney (for the Australian Institute of Superannuation Trustees).

[9] Kang, Helen, Mandy Cheng & Sindney J. Gray, "Corporate Governance and Board Composition: diversity and independence of Australian boards", *Corporate Governance*, Vol. 15 (2), 2007.

[10] Rafferty, Mike, Roger Ham & Dick Bryan, (2008) *Governance and Performance In Superannuation Fund Management – An Issues and Research Design Paper*, Workplace Research Centre, University of Sydney (for the Australian Institute of Superannuation Trustees).

[11] Newitt, Shey, (2009) *Trustee board governance in the not-for-profit superannuation sector*, Australian Institute of Superannuation Trustees.

that sponsoring organisations' must continue to be made aware of underrepresentation issues regarding gender and age, so that such problems can be addressed. We believe that sponsoring organisations should consider skills and abilities in line with a fund's skills matrix when making nominations, but gender should also be considered during this process. Research shows that board diversity in the corporate sector improves effectiveness and can lead to superior performance.

Diversity

The representative trustee model is more conducive to board diversity than the model used in the retail sector. Superannuation trustees are selected from a wide range of backgrounds, bringing diversity in education and life experience to the decision-making process.

The representative trustee model also allows for better (but not optimal) gender and age diversity, whereas the retail model generally draws directors from a small pool of professionals who have reached a particular level in their career or within an organisation (generally achieved with age).

AIST believes age diversity is important, as different age groups have different focuses and therefore bring different perspectives to the board. For example, younger people are generally more family-focused while older people are more retirement-focused. However, we also recognise the value of experience, and note that greater age diversity needs to be accomplished while maintaining a focus on experience as a beneficial factor for governance.

Occupational and educational diversity, in terms of discipline rather than the level of qualification, is also important. As with gender and age diversity, occupational and educational diversity further enhance board effectiveness by incorporating a greater range of experiences and perspectives. The trustee representative model allows for a much more diverse range of educational and occupational experience than the retail model. Directors of ASX-listed and corporate companies, for example, are often sought for their legal and finance expertise and from a small pool of professionals, which does not allow for diversity of occupation. The representative model requires trustee directors to be nominated by a sponsoring organisation, which allows for a greater range of occupations to be represented on trustee boards.

Diversity of personality types is also an important consideration. Interaction between different personality types, and between people with different backgrounds, results in a more diverse range of views, more informed decisions, and different decision-making processes. Such interaction also encourages people to behave differently to how they might behave in say, a group of like-minded people, or a group of people with the same occupation.

An effective governing body makes decisions as a group, and this imposes particular basic requirements of behaviour on the individuals in the group. Clearly, individuals need to feel free to express their view frankly, even in circumstances where it is clear their colleagues may not agree with them. This right to express opinions needs to be respected by all members of the group.

The importance of representation

Above we make the point that governing bodies exist for a wide range of institutions across our society, and that the people who serve on them often come from the industry in which the institution is engaged, or from within the community or interest group the institution serves. We are fortunate to live in a society where such representation flourishes, and we often overlook the fact that representation is integral not only to our democratic system of government, but to the liberal, pluralistic philosophy which underpins our culture and way of life.

In his 1995 book "Trust: the Social Virtues and the Creation of Prosperity"[12] Francis Fukuyama identifies a number of factors leading to dynamic and economically successful societies. One key factor is the depth and diversity of co-operative groups or institutions on a scale larger than the family, but smaller than, and independent of the state. Representative organisations project the interests of their constituents onto a wider social stage, but also imbibe, digest, and represent the ideas and experiences of ordinary folk into the forums of national decision-making. In doing so, they disperse power throughout society. If Fukuyama's analysis is correct, Australia is well-endowed with these "mezzanine" level institutions and organisations, and they are powerful contributors to our economic prosperity.

Throughout this submission, we make the point that superannuation is a mandatory investment for most Australians, and that this imposes unique community expectations and challenges in respect of governance. As we have seen above, an important feature of superannuation fund governance, and one that is in marked distinction to company boards, is that trustees' focus can, and should be, wholly and single-mindedly on their members, and their members' retirement savings.

We see the equal representation rules for trustees in the SIS legislation as both reflecting and strengthening that member-first philosophy. Indeed, we believe representation is a crucial factor in the not-for-profit sector's outperformance relative to for-profit funds. Clearly, under a representative system, trustees are appointed by stakeholders, and this creates an alignment of interests between the trustee and the fund member. However, the strength of the representative system goes well beyond a simple alignment of interests. A number of additional factors create a complex and subtle culture of trusteeship which fosters independent thinking and robust debate, leading to consensus decision making, guided by a unanimous focus on members' interests.

These additional factors include:

- Many trustees have backgrounds in the industrial relations sphere, reflecting superannuation's long connection with employment and industrial relations. This background has provided many of these trustees with skills which are very valuable when assessing the capabilities of investment managers and negotiating the terms of contracts.

[12] Fukuyama, Francis, *Trust: The social Virtues and the Creation of Prosperity*, Free Press 1995

- Employer representative trustees also bring a wide range of business skills from their own professions which add to the diversity of experience on the board.
- The empathy that representative trustees share with their members provides a unique insight into the most appropriate and effective methods and channels for communication. As detailed elsewhere in this submission, effective communication, rather than passive disclosure is crucial if the system is to achieve optimal policy outcomes.
- Many funds still have complex, older defined benefit products, in which the implied employer support is much more generous than the superannuation guarantee. In these funds, members view their representatives as guardians of these entitlements, with an understanding of their historical development and the complex interaction of the fund design with the industrial relations background.
- Many not-for-profit funds have quite specific occupational coverage, and their members tend to spend their entire working life in that occupation. This occupational specificity gives an additional edge to the importance of representation, since members view their fellow professionals as "one of us" and uniquely positioned to advance their interests.

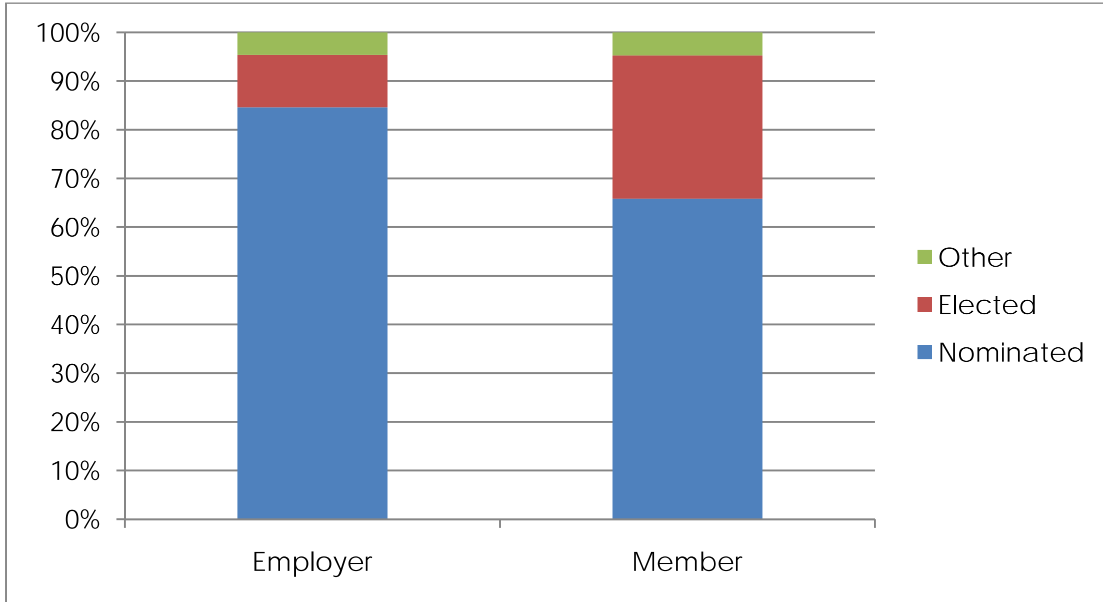
Equal representation brings together the key protagonists within the industrial relations arena, and the view is often advanced that equal representation leads to a situation where boards are necessarily adversarial in nature, and conflict between member and employer representatives undermines decision making. We do not believe such views are reflective of the reality within equal representation boards. The reality is that trustees are very conscious of their responsibilities, and act in the members' best interests, regardless of whether they are member representatives, employer representatives, or independents.

The appointment process

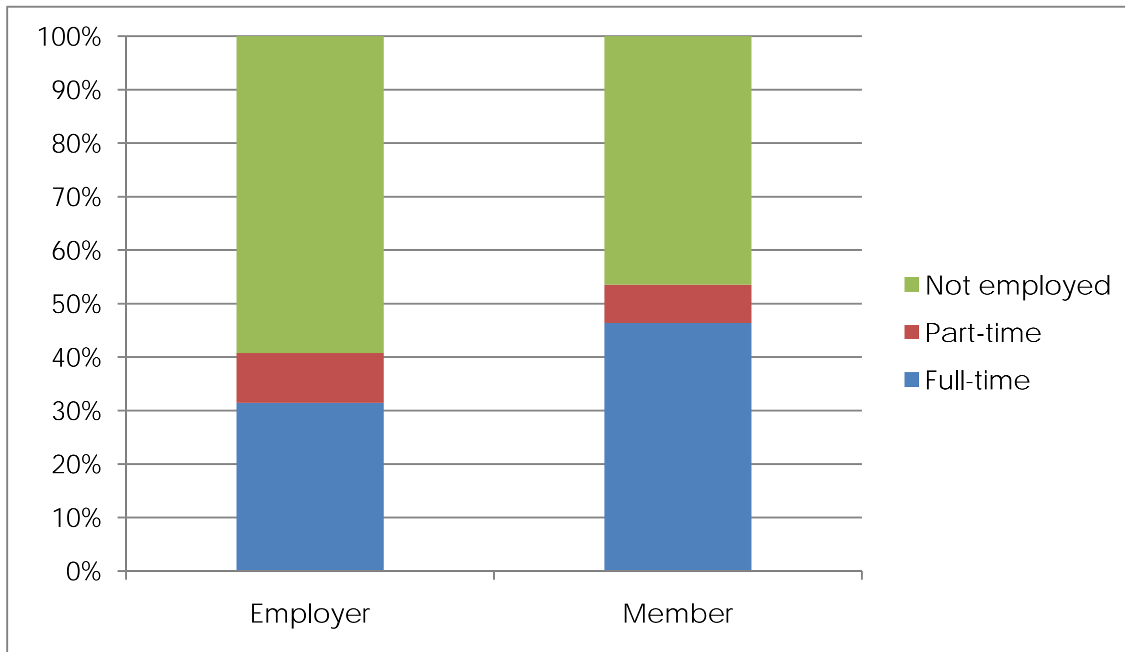
There are a number of methods employed by funds to meet the equal representation rules, both on the employer representative and member representative side. Member representatives are often nominated directly by trade unions or other representative bodies, and in other circumstances are elected directly by members. Where member representatives are nominated by a union however, they may have already been elected by the union membership as an office bearer of the union, making them in effect, elected representatives.

Employer representatives are sometimes nominated by a single sponsoring employer (including by a government or government agency), nominated by the executive body of an employer group, elected by the members of an employer group, or elected by the sponsors of the fund.

In 2008, AIST undertook an extensive survey of our equal representative trustee directors. The results of that survey indicate the following breakup for methods of appointment for employer and member representatives:

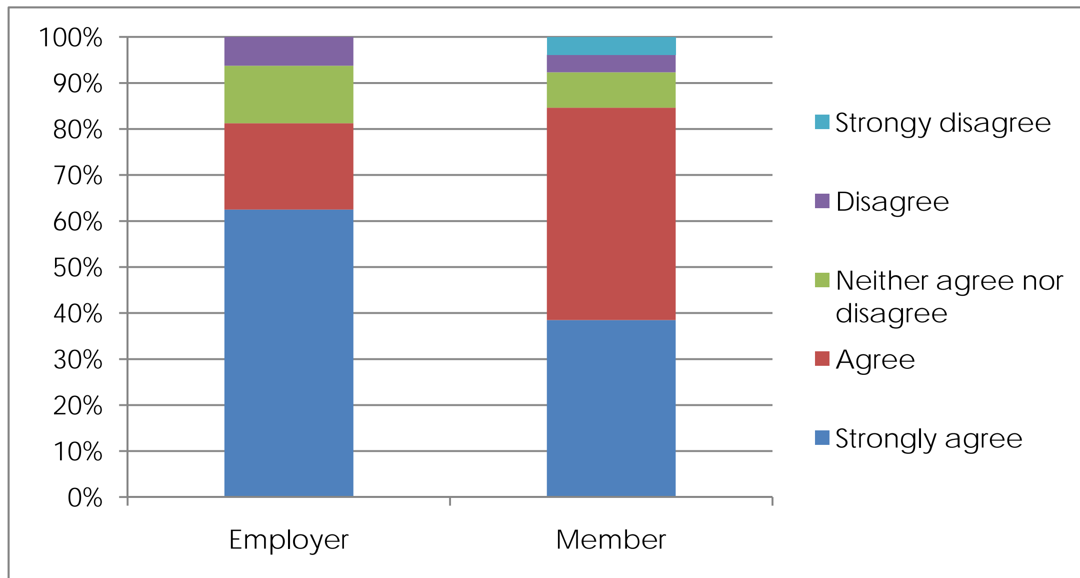


A clear majority of both employer and member representative trustees are nominated by representative organisations. However, among those nominated by representative organisations, fewer than half are full-time employees of the nominating organisation:



Clearly, these results refute the contention that the representative trustee system is compromised because nominated directors are conflicted through their employment by their nominating organisation. In fact one of the key strengths that the sponsoring organisations bring to their funds is the support they provide in terms of assisting funds to reach employers, members and provide low cost distribution channels.

Another common criticism is that nominated trustees are not allowed sufficient time and resources by their nominating body to undertake their role. Where they are not employees it is clearly their own responsibility to ensure they have sufficient time and resources, but among those nominated and employed full-time, most strongly agree or agree with the statement "My nominating body provides adequate time and resources to enable me to properly discharge my obligations as a trustee."



AIST believes it is the responsibility of nominating bodies to properly support their nominees where they are also employees. While we are satisfied that the vast majority of our nominated members feel they are well supported, we will continue our engagement with nominating bodies to continue improving that level of support. We also encourage boards to engage with nominating bodies to ensure their directors are adequately supported.

As the requirement for training and skills for trustees becomes more onerous, nominating bodies will need to ensure their nominees meet those requirements. In fact nominating bodies are already required to ensure their nominees meet the requirements of the Fit & Proper standard under the RSE licensing law.

AIST is committed to working with nominating bodies to ensure they can continue to meet these challenges. AIST's conferences and trustee training activities are already supported by both unions and employer groups, and we are developing trustee accreditation programs through which nominating bodies will be able to develop internal talent for nomination onto boards.

What is independence and why is it important?

The notion of an independent director has originated from the corporate sphere. As a managerial class emerged in corporate America during the 1960s and 1970s, shareholders became increasingly concerned that their interests as owners of, and investors in, the company were being subordinated to the interests of the managers of the corporation.

Investors identified executive directors on the board as a key impediment to the pursuit of shareholder interests at the board level. Independent directors, i.e. directors' independent of managers, were seen as an important part of the solution to the problem.

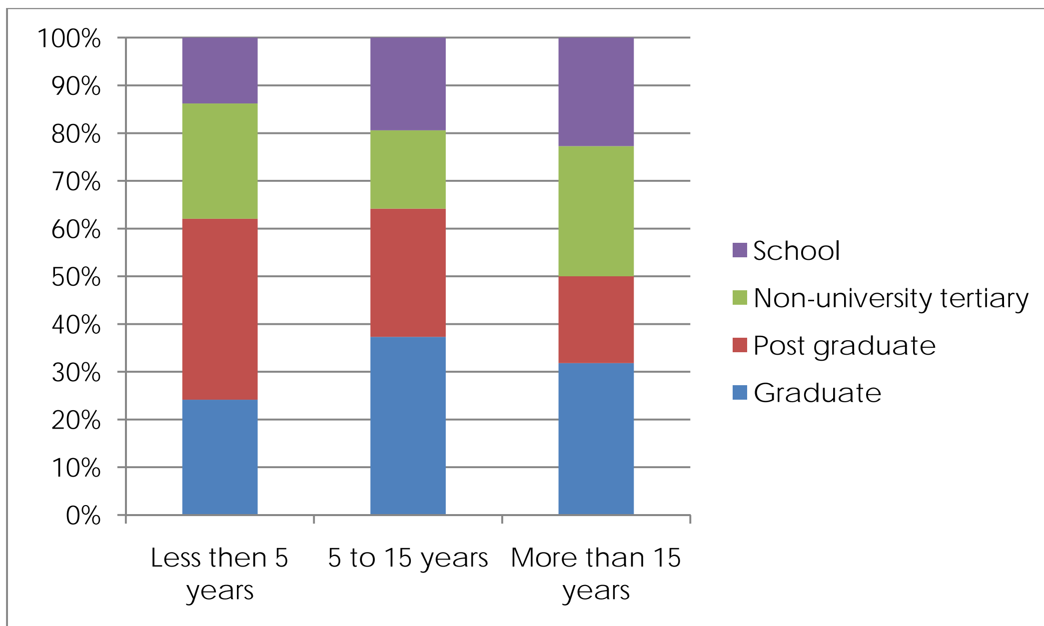
There is widespread debate within the corporate governance arena as to whether the focus on independent directors has really contributed significantly to improved governance. However, it is clear that whatever other benefits they may or may not bring to the board, the push for independent directors in the corporate sphere is not intended as a means of improving the technical competency of boards.

While the governance challenges within the superannuation industry can be seen as an instance of the agency problem, the different structure of superannuation, and the historical development of two distinct sectors in the industry in Australia suggests the emphasis on independence, while important, is fundamentally misplaced.

While funds were small and largely confined to a single employer, the trustees were typically drawn from the staff of that company sponsor. Bringing in an independent director was seen as a way of bringing additional skills and experience onto the board. The SIS definition of "independent trustee" reflects this historical context. As the industry has matured, funds have become larger, trustees have become more experienced and have been more widely trained, and nominating bodies representing employers and employees on a whole of industry basis have been able to draw on a wider population of potential nominees.

These factors have increased the skills and experience among the representative trustee population, so that the need for boards to appoint independents specifically to fill skills gaps has diminished. Of course, the current independent director population includes highly skilled individuals who fill important roles on their boards, however, more and more skilled individuals who do not have a connection to the nominating body are being nominated directly on the basis of the skills and experience they can bring.

The following chart shows the educational attainment levels for both employer and nominated trustees, by period of participation in the industry.



The chart clearly demonstrates a reduction in the proportion of nominees who have achieved school only education, and an increase in the proportion of nominees who have achieved post-graduate level qualifications.

In the retail fund sector, many trustee companies are subsidiaries of the institution promoting the fund's products. The directors of these "related party" trustees are typically senior executives of the promoting financial institution, in which case technical skills and formal qualifications are unlikely to be problems which need to be addressed by bringing in outside or "independent" trustees. For other retail funds an arms length commercial trustee is used, typically also operated by a legal or financial institution. In this case also, trustees can be assumed to have access to formal technical skills on the board.

This evident availability of technical expertise raises the question of why the retail sector has persistently underperformed against the not-for-profit sector, and the evidence is now clear that conflicts of interest, related party transactions, and the use of commissions, combined with the passive trustee model is to blame. We believe independence needs to be seen less as an avenue to recruit particular skills onto not-for-profit boards, and more as a means of ensuring better resolution of conflicts of interest within retail funds – by providing independence from the promoting financial institution.

However independence is defined, whether independent of an employer sponsor, union, or financial institution, it is of little use unless exercised in conjunction with the "ordinary virtues" of integrity and prudence within an active trustee model. The overriding fund governance obligations of a trustee, irrespective of their method of appointment, or which industry sector they work in, are that they apply an "independence of mind" in the discharge of their responsibilities.

In our opinion, independence of judgement is often determined by the strength of an individual's character and integrity. These cannot be objectively assessed by stakeholders on a consistent basis and therefore, technical requirements for imposing greater 'independence' may not have the desired effect of increasing the prevalence of these personal qualities.

The existing approach on representation provides a proven and effective alignment of interest without compromising the application of this "independence of mind".

Our experience of the commitment of member and employer nominated directors is such that it exemplifies a high level of commitment and empathy by these trustees to members of the fund as a whole. In fact, a wider application of independence of mind and judgement would necessitate far-reaching action on conflicts, as these are major barriers to trustees achieving true independence.

Experts and generalists – striking the balance

The personal values that contribute to independent judgement, the empathy and understanding that are central to representation, and the diversity of experience that drives effective governing bodies can be enhanced and developed through generalist education and training. Indeed, we see the interaction of the ordinary virtues, acquired through a generalist education, industry experience, or civic engagement, and a specific and targeted level of technical expertise as the key to effective superannuation trusteeship.

Superannuation is a complex field, which requires expert knowledge. Traditionally, trustees have sought expert advice on many issues, and we believe expert advice will continue to be central to good governance. AIST believes there is now a need for all trustees to have basic technical competencies.

Trustee directors, much like company directors, do not run the day-to-day operations of superannuation funds; they oversee the strategy, direction and operation of both senior management and the chief executive officer. As such, it is important to remember that trustees are not required to be experts in all areas. Trustee training should be aimed at assisting each director to develop the necessary skills required to form their own opinions, and question their technical experts, allowing informed and member centric decision making.

To achieve this, it is our view that fitness requirements for trustee directors should be linked to current fit and proper standards and mandated on both an individual and collective basis. A basic and mandatory qualification should be introduced for new trustee directors, covering what we see as "core competencies" for trustees. These core competencies include:

- *Superannuation Law* – understanding of legislation relating to the governance of superannuation funds, including (but not limited to) the Superannuation Industry (Supervision) Act and Regulations ("SIS") and licensing requirements under that Act, the *Corporations Act* and Regulations, the *Superannuation Guarantee Act*, the *Family Law Act*, Taxation legislation, Trust law and Privacy provisions.

- *Governance & Trusteeship* – understanding the role of the Trustee as outlined in the Scheme's Constitution and Trust Deed; understanding the respective roles of the Board and management; being able to understand and interpret technical advice on a range of subjects; being able to make decisions in a group setting on the basis of expert advice; being able to work effectively and co-operatively with others, while maintaining independence of judgement.

These core competencies need to be applied on an individual basis, so that each director meets this basic standard.

A higher level of expertise would be required under the "collective competencies" which would ultimately be defined by each trustee as part of its Fit & Proper policy, but which we would expect at a minimum to include investment, accounting, law, risk management, marketing and communications, and member advocacy. The training and experience relevant to meeting the collective competencies would be more diverse, incorporating previous employment experience, university qualifications, and professional memberships. While the level of expertise required under the collective competencies is higher than that required of each individual under the core competencies, we do not see it as a replacement for the skills and experience drawn from external advisers. We still see external advisers as a key source of information and expertise for trustees to utilise in the decision-making process.

We believe this three tiered system, comprising core and collective competencies, as well as external advice, would provide the industry with a framework in which the public and regulators can have confidence in respect of technical expertise, while the unique contribution of representative trustees is enhanced and empowered. It would also ensure that a standard, minimum level of fitness exists across the industry.

An appropriate method for achieving the core competencies could be based on the 'Certificate in Foundations of Trustee Governance'[13] program currently offered by AIST. This course, along with the RG 146 workshop and Trustee Induction Training are the most common courses completed by directors through AIST. Effective training should be aimed at assisting each trustee director to develop the skills and abilities to ask the requisite questions of their technical experts and therefore make informed decisions in the best interests of all members.

Whilst collective competencies are typically more onerous for each individual than core competencies, we note from the educational attainment and backgrounds reported in our membership survey, there is currently a wide range of skills which are meeting the collective competency criteria. This is supported by APRA's research, which found trustee directors of large funds were, generally, well qualified, appropriately experienced and reasonably trained in their trustee duties.[14] In addition, the research found 65 per cent, or 859, directors surveyed held university degrees, whilst only 11 per cent, or 146, had no tertiary qualifications.

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[13] AIST, *Foundations in Trustee Governance – Course Overview*, www.aist.asn.au
[14] Australian Prudential Regulation Authority (APRA): *Superannuation Fund Governance: Trustee Policies and Practice*, 2008

This is further exemplified upon comparison of the Australian system to other international retirement systems, such as the United Kingdom Pension sector. A study[15] of this system indicated many trustee directors were not especially expert in investments and 62 per cent of those surveyed held no professional qualifications in finance or investment. Ongoing training and development was low with 44 per cent of trustee directors having not attended any courses since their initial 12 months of trusteeship. This experience is markedly different from the results of our and other surveys of the Australian trustee population.

It is important to ensure the right combinations of 'experts and generalists' exist within a board, as a variety of disciplines, skills and experiences are required to adequately manage a superannuation entity[16]. For this reason, we would not support any requirement that does not provide sufficient latitude to recognise a director's professional and personal experiences outside of the superannuation industry. This diversity is crucial to the success of the trustee structure and removes the risk of narrow minded and counterproductive 'group-think' decision making.

Board renewal

Succession planning and the long-term continuation of fund performance are key issues for trustee boards, as the superannuation sector will be facing the retirement of a substantial number of directors over the coming years[17]. Whilst this change is inevitable, we feel it is important that a representative model continues to evolve and that the industry avoids a sudden shift to boards composed of a homogenous group of similarly qualified financial experts. With a greater emphasis on basic skills, an orderly succession process will relatively quickly build a much broader skills base.

AIST is aware that many of its members in conjunction with their sponsoring organisations have processes in place to deal with succession planning, and that whilst we need to continue to monitor developments in this area, planning for board renewal is occurring.

An emerging imperative for funds has therefore been for trustee boards to develop a best practice approach on these issues.

1. Regulatory and Community Expectations

There are various documents and instruments issued by regulators which are relevant to the issues of board succession and tenure. These are summarised below.

(i) APRA Circulars

APRA Superannuation Circular No. III A.3 regarding "Trustee Arrangement- Public Offer Superannuation Funds" September 2000 contains broad guidance on these issues.

In paragraphs 49 to 62 with respect to the Appointment of Representative, we specifically refer to paragraph 51 that states the following:

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[15] Myners, P, *Institutional Investment in the United Kingdom: A Review*, 2001

[16] Kang, H Cheng, M and Gray S, *Corporate Governance and Board Composition: Diversity and Independence of Australian Boards, Corporate Governance: An International Review*, Volume 15, 2007

[17] Newitt, S, *Trustee Board Governance in the not-for-profit superannuation sector*, 2009

"It is desirable that each director/representative be appointed for a fixed term to encourage new representation and new ideas to the trustee body or policy committee. This may involve a staggered nomination process to ensure continuity and an appropriate transfer of knowledge and skills to new directors/representatives. Of course, representatives may stand for re-election if permitted under the rules."

We also refer to the Prudential Standard APS 510 Governance that states at Paragraph 57:

"The Board of a regulated institution must have in place a formal policy on Board renewal. This policy must provide details of how the Board intends to renew itself in order to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise. The policy must give consideration to whether directors have served on the Board for periods which could, or could reasonably be perceived to, materially interfere with their ability to act in the best interests of the regulated institution."

The key point of these standards is that APRA is encouraging continuity on the board whilst at the same time promoting and renewal of board membership.

(ii) ASX Listing Rules

The ASX Corporate Governance Council was formed in August 2002 and is chaired by the Australian Securities Exchange (ASX). The Council comprises of various business, investment and shareholder groups.

The Council has developed a set of comprehensive guidelines that provide a flexible framework for corporate governance that apply to listed Australian companies. It states in the relevant section on board succession and renewal:

"Board renewal is critical to performance and directors should be conscious of the duration of each director's tenure in succession planning."

"The nomination committee should consider whether succession plans are in place to maintain an appropriate balance of skills, experience and expertise on the board."

The ASX Corporate Governance Council has therefore sought to take a practical way forward on these issues, effectively leaving it to listed corporations to determine their approach on these issues.

2. AIST Engagement

There should be an emphasis on ensuring that there is sufficient renewal of directors who have either the existing skills or the capacity to build their skills in the area relevant to superannuation fund trustee director duties.

With respect to sitting on multiple boards, we believe it should be appropriately left to each individual trustee board to determine whether there is an indirect or direct conflict of interest that would inhibit the effective participation of a trustee on a board. By allowing

funds to reject a sponsoring organisations nomination if the individual does meet the funds requirements, we believe that this further allows funds to deal with the issue of multiple directors. We note however, that the majority of directors who sit on multiple boards are women. Directorships particularly suit women as they balance both family and careers. Sitting on multiple boards enables individuals to develop expertise in superannuation.

Importance must be placed on fostering active succession planning models and a gradual replacement cycle of directors to ensure adequate levels of collective and individual skills are maintained. Furthermore, gradual replacement and changeover of directors will help preserve the ethos of member service and nation building now prevalent within the not-for-profit trustee community[18].

As the majority of trustee directors are appointed via nomination from a member or employer organisation and often, are not directly elected by individual fund members[19], it is important that sponsoring organisations are encouraged to develop the 'talent pool'. Nominations should be made with a view to preserving and enhancing the diversity of experience on the board, and have the necessary skills, or capacity to attain these skills, in order to ensure the succession planning process is effective. Once nominated into a trustee role, it is crucial sponsoring organisations continue to provide support and ongoing development opportunities to the individual.

For these reasons, we believe there should be no specific limitations on periods in office, but rather that individual directors should be required to be nominated or elected at least once every three years. We believe periodic re-nomination or re-election is consistent with the philosophy of representation, and is common in governance structures elsewhere in our society.

In addition, boards should be encouraged to consider their approach to succession planning through the implementation of staggered terms of office. Women and younger members are currently under-represented in trustee roles[20] and we advocate for nominating organisations to consider this under-representation in their nomination process. We are aware of many examples where boards are effectively dealing with this issue.

It is our belief that this advocacy will produce increased levels of diversity in the board room, whilst ensuring gradual replacement occurs and that rapid-changeover does not lead to skill losses. This being said, it is important to note that trustee directors have access to committee structures and are able to introduce various additional skills through the committee system.

The agency problem in superannuation *governance*

The agency problem has been at the heart of the corporate governance debate since at least the 1930s[21]. As ownership of corporations has become more widespread, so owners have effectively delegated decision making to a class of professional managers. This shift in control of the corporation has opened the possibility of conflicts of interest, and requires

[18] Newitt, S, 2009, p14
[19] Newitt, S, 2009, p18
[20] Newitt, S, 2009, p22
[21] Berle and Means, The Modern Corporation and Private Property 352-357 (1932) "The New Concept of the Corporation"

mechanisms and incentives to ensure that managers act in the interests of the beneficial owners of an entity.

To date the governance literature has mainly concerned itself with company boards, and the need to maintain independence from managers, so that owners of the business are effectively represented.

While there has not been widespread research into the application of the agency problem and corporate governance to the realm of pension or superannuation funds, that research is beginning to emerge. In late 2007 AIST commissioned Dr Mike Rafferty and his colleagues at the University of Sydney to undertake an extensive research project into superannuation fund governance in Australia.

The authors link the governance differences between not-for-profit funds on one hand and retail funds on the other with the agency problem, as traditionally formulated within the corporate governance literature.

> The potential conflicts between fund members and fund boards can the thought of as an agency problem. Fund members (principals) employ fund managers (as agents) with the task of managing their funds. However, fund managers may have different objectives and incentives than fund members.[22]

Finance theory suggests that where an efficient market exists, rational behaviour by participants (in the case of superannuation funds, fund members) will lead to fund flows away from underperforming funds, and toward better performing funds. As the authors of the AIST study point out:

> For a fund market to work as competitively as the ideal model is very demanding. Empirical evidence has been mounting that the market does not always equalise performance. If market processes (or market governance) permits some funds to consistently outperform, the way funds are organised and governed can clearly be an important factor in creating and sustaining differential performance.[23]

Current approaches to Conflicts of Interest

Given the importance of the agency problem in superannuation governance, effective management of conflicts of interest is crucial. Most superannuation trustees are constituted as companies, and while the Corporations Act provides a framework for disclosure of interests, it has limited application to proprietary companies, and is structured more for the corporate sphere than for superannuation funds. There is currently no separate requirement for trustees to formulate a conflict of interest policy.

An APRA survey of superannuation trustees reports that 90 per cent of funds have formal policies to manage potential conflicts of interest.[24] However, the report also notes that more than half of retail fund directors are employed by related parties or by the fund itself.

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[22] Bryan, Ham, Rafferty & Yoon: *Governance and Performance in the Australian Occupational Superannuation Industry*, p.13; www.aist.asn.au

[23] Bryan, Ham, Rafferty & Yoon: *Governance and performance in the Australian Occupational Superannuation Industry*, p.7; www.aist.asn.au

[24] Australian Prudential Regulation Authority (APRA): *Superannuation Fund Governance: Trustee Policies and Practices*, March 2008

Clearly, while policies for management of potential conflicts are widespread, there is ample scope for potential conflicts to arise, and where a large number of directors on a board are similarly conflicted, application of the policy may reduce the number of participating directors, restricting the decision making capacity of the board, or rendering the meeting inquorate.

In addition to the APRA research, Rafferty also concludes that the conflict of interest issue in the boardroom of retail funds could be a factor in their underperformance, when compared to the not-for-profit sector. As John Bogle so aptly states 'no one person can serve two masters'.

AIST approach to Conflicts of Interest

AIST believes all funds must formulate a Conflicts of Interest policy, and make copies available to their members and employers. We believe the policy must require as a minimum:

- A commitment to disclose conflicts in accordance with Section 191 of the Corporations Act, even where a trustee may not presently fall within the scope of that section, including that the exemption for proprietary companies under 191(2)(b) is of no effect.
- That where trustee directors are members of the fund, that it is appropriate for them to disclose the investment options in which their superannuation monies reside.
- Standing notice of potential conflicts must be disclosed on joining the board, or on acquisition of the interest. Standing notices must be entered in a register of interests, but standing notices should not relieve the director of the obligation to bring a standing declaration to the attention of the board when a potential conflict arises.
- Declarations should be sufficiently detailed to enable the Board to make a proper decision about how to handle the conflict. Boards should make their own evaluation of what information is required, and make sure their policy reflects that evaluation.
- That where the Board is aware of a potential conflict, it must resolve to take action or not to take action, and that decision must be reflected in the minutes.

Government and regulatory

Government

One of the main areas of complaint about superannuation from members is the constant changes being made to the system. Whilst the Government has an obligation to ensure that the superannuation system, is both effective and safe, it also needs to understand that constant changes and added complexity leads to a lack of certainty and engagement by members with their superannuation. AIST hopes that this review, coupled with the Henry Review will steer the course of the superannuation system for the next 20 years and put an end to constant change. This would in turn provide greater security for members to plan with certainty for their retirements.

Regulatory

AIST agrees that the superannuation industry needs strong regulatory oversight. However, complexity and regulation together take up considerable levels of trustee resources and as a result, simplification in this area is required, particularly in relation to serving multiple masters, investment barriers and related party transactions.

Section 8 of the *Australian Prudential Regulation Authority Act 1998*(APRA Act)states that APRA is established "…for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing policy to be applied in performing that regulatory role."

The APRA Act, in conjunction with the SIS Act, provides APRA with the power to cancel an RSE license, or disqualify an individual, if required. Given the purpose of APRA, along with current levels of regulatory authority, we don't support any further extension of APRA's prudential powers and we believe, given the importance of superannuation and national savings, responsibility for formulation of law in this area should rest with Parliament. As APRA is ultimately able to shut down the operation of a fund, the regulator already holds sufficient power to properly discharge its functions.

Whilst APRA is able to disqualify an individual, if required, we believe the balance between personal liability and the rewards from being a trustee are broadly appropriate. Upsetting this balance, for example, making it more complicated to be a trustee via introduction of tighter sanctions will upset the balance between personal liability and personal compensation. Therefore, increased levels of remuneration would be needed to justify the levels of personal risk involved with the position; this is an unnecessary direct cost and produces additional indirect cost burdens for funds, such as raising indemnity insurance premiums.

In our view, the industry, in terms of regulators, could be better streamlined to minimise the burden of administration on funds. Whilst we support the segregation of duties between APRA and ASIC, there should be greater cooperation between the two regulators and a combined 'front office' should be introduced to simplify reporting requirements.

Currently, a combined approach, via a specific website, is used by the two regulators for breach reporting and this has simplified administration for funds and enabled a more streamlined process. Implementation of a joint "front of shop" for data collection would provide a central point for the superannuation industry in terms of collecting statistics and 'bundling' them together for use by the industry and other regulatory bodies. Phase 2 will investigate efficiency in more detail and we will elaborate further at this point.

Related party transactions

We note, from the APRA report, that there are widespread related party transactions within the superannuation industry:

> Retail funds are much more likely to use service providers that are related parties, because they often operate within broader financial conglomerate structures. Typically, the provider is the parent company of the trustee, or the provider and trustee have a common parent company.[25]

Chapter 2E of the *Corporations Act* details related party requirements in respect of protecting the interests of a public company's members. Specifically, the legislation requires member approval to be given for transactions involving financial benefits being provided to related parties that could endanger member interests.

For this reason, we support the intention of the *Corporations Act* in relation to related party transaction disclosure requirements; however, given the size and nature of the superannuation industry, we believe implementing these requirements in this arena will lead to expensive and cumbersome processes. For example, consider the costs involved for funds with 500,000 members, whom are required to seek endorsement for a related party transaction. This regime would add expense and complexity to fund operations.

While we do not support a requirement for funds to seek member approval for related party transactions, we do support full disclosure of them. In this context, we note that related party transactions reported in funds' financial statements under the accounting standards are not seen by the vast majority of members who do not request a full copy of the financial statements of their fund. We intend to cover this issue more fully in our submission to Phase 2 of the Review.

We strongly support the amendment of legislation to specifically prohibit funds naming specific service providers in their trust deed. Selection of service providers should be completed via assessment of a pool of providers, with the organisation selected being chosen based on merit, cost, services available and other differential parameters, not simply chosen due to a direction incorporated in the trust deed. We believe such arrangements encumber trustees' discretion and are against the spirit and intention of Section 58 of the SIS Act.

[25] Australian Prudential Regulation Authority (APRA): *Superannuation Fund Governance: Trustee Policies and Practices*, March 2008

Mandated Investments

Should a government seek to mandate a level of investment in a particular asset class or asset this would have the affect of distorting the market dynamics for that asset class or asset. The distortion that is likely to evolve is that the mandated requirement will create a level of excess demand, which typically leads to higher prices. This effect becomes more pronounced if the supply of the assets in question is fixed due to physical constraints or due to regulatory restrictions, a characteristic of the infrastructure asset class. Infrastructure is normally associated with barriers to entry, be they physical or regulatory.

Given the above discussion, we do not support the government mandating of any investment level within any asset class. The effect of such a policy is highly likely to result in an across the board price increase in the value of assets with the mandated asset class. Market efficiency dictates that such an increase is likely to occur very quickly following the announcement of a government mandated policy.

Funds' portfolios are constructed to achieve a nominated risk return characteristic. If the government elects to mandate an investment into an asset class or particular asset there is a high probability that the inclusion of the mandated investment is likely to upset the risk return balance of the existing portfolio. Accordingly, if a fund's portfolio requires rebalancing to incorporate the mandated investment the fund will be compelled to trade incurring additional costs. In an extreme example, if the mandated requirement results in an industry wide need to sell a particular asset or asset class this is likely to lead to higher losses, as the requirement will be priced into the market almost immediately.

Regulation of SMSFs

Self managed superannuation funds are a sizeable piece of the superannuation puzzle, accounting for approximately $332.3 billion, held on behalf of over 410,000 funds.

Whilst some might argue SMSFs represent the ultimate alignment of member and trustee interest, we believe that this might be overshadowed by governance short-comings in the SMSF sector.

We note that Phase 3 of the review will investigate SMSFs further and we will elaborate at this point.

Accountability to members

The role of choice in Australia's superannuation system

Choice comes in two varieties: investment choice within funds, and choice to choose between funds. In some instances, this distinction becomes blurred, for instance when a retail fund offers many other managed funds as distinct investment options.

Investment choice originated in Australia in the mid 1990's, as compulsory super took off, and more funds moved from a defined benefit to an accumulation basis. Importantly, investment choice can be linked to the gradual change from a system typified by patchy coverage, where most people who were in funds saw them as a privilege, to a mandatory system where superannuation was seen as a right.

Choice of fund was first pursued by the Howard Government on election in 1996, but did not eventuate until 2005. Again, choice of fund can be seen as a policy response to the development of superannuation into a mandatory universal national system.

It was anticipated that the introduction of choice of fund legislation would result in significant member movement within the superannuation sector[26]. To date, outside of the substantial growth in uptake rates of SMSF products, this wave of member movement has not eventuated.

We believe there are three distinct motivating factors behind policy-makers' evident commitment to the choice concept:

1. Choice is an expression of individual freedom, and is consistent with the principles of a liberal society;
2. Choice is a political legitimating strategy in a mandatory system, and;
3. Choice is a crucial element in the economic theory that rational consumer behaviour will drive down costs, and lead to better returns.

Research commissioned by AIST demonstrates that the choice and competition has failed to deliver the improvements in fund performance envisaged. Dr Mike Rafferty states that:

> A basic assumption that informed much fund governance research from the outset was that in efficient (i.e. well functioning and competitive) fund management markets, conflicts of interest between fund members and funds would be low, and it should be extremely difficult for funds to consistently earn higher risk adjusted returns than the rest of the market. The logic for such an expectation is simple - out performers will receive more funds and underperformers see fund withdrawals. This process of fund flow (and the competitive pressures that follow), if strong enough, should equalise fund returns.

[26] Clare, Ross: *The Introduction of Choice of Superannuation Fund: Results to Date*, Australian Accounting Review, VL: 16, NO: 40

While the intuition that market discipline on funds would be more direct than on corporations is simple and appealing, for this to work requires a range of demanding assumptions, including that:

- accurate information about risk adjusted performance is widely and freely available, and readily understood,
- it is relatively easy to switch funds,
- fund members act as motivated and informed investors and shift funds to higher expected performers,
- the fund industry is efficient and competitive, and
- competitive pressures on funds ensure that non-market governance arrangements will be optimal in minimising agency costs.

These are very demanding conditions for any fund management market to meet. Yet if any (or some combination) of these conditions are not met, i.e. if there are market failures in the fund industry, the expectation that fund performance will equalise may be unrealistic. The financial services industry in Australia is, in general, a long way from meeting these conditions.[27]

Perhaps partly in response to the fact that these conditions are not met, members have shown remarkable reluctance as a group to switch investments within their fund[28], even during the dramatic falls on financial markets from October 2008 to March 2009. Professor Paul Gerrans states:

> In describing the response of superannuation fund members to the GFC two distinct stories emerge. The first is of the overwhelming majority of members who did not change their superannuation investment strategy in response to the GFC. Despite having the opportunity to change to lower risk options, and in the face of unprecedented impacts on their savings, more than 90 percent of members chose not to make an investment change.[29]

However, Gerrans' Research also shows that although very few members elected to switch investments, many who did, did so with poor timing, and arguably in a less than well-reasoned manner.

This and other research now indicates that choice has failed to deliver the consumer market efficiencies the theory outlined in point three above suggests it should. However, the other points remain valid, that choice is seen as an expression of individual freedom,

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[27] Bryan, Ham, Rafferty & Yoon: *Governance and performance in the Australian Occupational Superannuation Industry*, p.7; www.aist.asn.au pp10-11

[28] Professor Gerrans' research indicates switching rates or around 5-7% of members. We are aware of not-for-profit funds which have experienced switching rates over 20%, but these are clearly outliers.

[29] Gerrans, Paul: *Member Investment Choice Response to the Global Financial Crisis,* For Australian Institute of Superannuation Trustees, 2009, p 3

and does moderate public opposition to mandatory savings. It is important to realise that these benefits of choice apply, whether choice is exercised by individuals or not.

It is our view that, choice of fund is an important factor in the superannuation sector. Whilst its role in driving effective competition may be questioned, it provides an important relief valve for those who find themselves in clearly substandard funds, and is a legitimating strategy for a compulsory system.

With respect to the role of choice in driving better competition among funds, the question then turns to whether it is possible to improve the performance of the consumer market, to realise Rafferty's "demanding assumptions", or to seek alternative governance models to drive best practice outcomes.

Is universal, informed, rational choice achievable?

Given the generally low levels of switching evidenced since the introduction of choice, it is conceivable that a 20 year old starting their first job today might join their employer's default fund, and retire in 45 years time, without ever having actively chosen their fund. Moreover, if such an individual is so fundamentally passive, and uninterested in their financial affairs, it may be counter-productive to encourage them to make decisions they may not be prepared to properly research and consider.

It is often assumed in some quarters in the superannuation industry that individuals who do not engage with their superannuation provider are apathetic, ignorant, or somehow neglecting an important civic duty to learn, make decisions, and drive market efficiency. We believe this is an unrealistic view, given that the system is mandatory, and many in our community are simply uninterested in financial matters, and exercise their freedom of choice to choose not to use their valuable time to learn about superannuation and investments. Such people probably quite reasonably presume that the superannuation industry employs many well-equipped professionals to make decisions on their behalf.

Given the levels of member disengagement with superannuation, the default investment option is critically important and occupies a special place among a suite of options. We believe a significant level of member disengagement is an unavoidable and permanent feature of the system, and demands an appropriate policy response.

While a significant level of disengagement may be unavoidable, there are many others who can and will meaningfully engage with their superannuation provider, and exercise choice in an informed, rational manner. While this is clearly a function of age and greater account balances, pejorative labelling of non-engaged members does not reflect the reality of the situation, and many older members who steadfastly refuse to exercise choice or otherwise engage are in fact highly qualified professionals. We believe members' comfort level in leaving their superannuation on "auto-pilot" is probably driven by two factors:

- Personal preference and levels of interest in financial affairs; and
- Sense that the governance of one's fund is in trustworthy hands.

Trustees' duties and investment choice

AIST believes there is significant ambiguity and tension between the covenants expressed in section 52(f) of the SIS Act, and the widespread use of investment choice within the industry. We recommend that SIS be amended to introduce the concept of "default option", as distinct from "choice options", and that the covenants be amended to reflect the existing, traditional interpretation in the case of default options, and the involvement of member decision-making in the case of choice options.

Further, we believe that some element of the traditional fiduciary duty cannot be abrogated, and that trustee boards are required in all cases to have due regard to diversification, liquidity and risk, notwithstanding that the relevant member may have made a decision in relation to broad asset allocation.

We also recognise the increasing interest within the trustee community for target-date investing and age-based defaults. There is an emerging debate in the industry regarding the viability of a static default investment option. We welcome that debate and will make a more detailed submission on the future structure of default options in Phase 2 of the review.

While we believe a level of member disengagement is probably a permanent feature of the system which needs to be accommodated, we do not see that fact as exempting trustees from a duty to communicate, engage, and facilitate active decision-making when that is a member's preference. Rather, we see it as an indicator that trustees need to carefully direct their resources to those most likely to respond, and to those most in need.

Fund governance for those who choose

As we have made clear throughout this submission, the role of the trustee is protecting the member, and managing risk, is central to the superannuation system, and should be not only maintained, but fostered and extended. For those who do not exercise choice, trustee responsibilities accurately reflect those in the SIS covenants. In respect of members who choose, the responsibility is modified, and perhaps moderated, but we argue, is still there.

We have seen that the many barriers to effective informed rational choice (Rafferty's "demanding assumptions") call into question the role of competition in realising policy outcomes such as system efficiency. However, choice serves other important functions, and it is not feasible to withdraw choice, were it even desirable.

We have also seen that "passive trusteeship" as used widely in the retail sector, leads to a separation of the critical investment strategy functions of asset allocation and manager selection, between financial advisers and trustees.

What then is the appropriate governance model where individuals choose, but where active trustees work within a legal framework more consistent with the traditional understanding of the fiduciary duty?

We have already demonstrated the benefits of representation for trustees. We believe the member focus of representative trustees will enhance the ethos of member communications and education throughout the industry. But that greater focus on effective communication will not make the crucial difference itself.

A discussion of the choice model cannot be separated from the disclosure regime introduced as part of the Financial Services Reform Act 2003 (FSRA). The FSRA was structured as a complement to a more deregulated, and more choice-oriented financial system.

An important aspect of the rational choice and competition philosophy is that market participants will naturally seek out and analyse information. Hence "disclosure" is the paradigm – consumers actively seek out and interpret complex information, and the only regulatory intervention required is to force otherwise reluctant trustees to disclose the information.

The reality in the not-for-profit sector is almost the precise opposite of this unrealistic world view. Trustees recognise their duties not only to disclose, but to communicate and promote understanding. Consequently, they devote resources to achieve these outcomes, usually significantly in excess of what would be required to meet mere disclosure compliance. Far from being active information seekers, their members are more likely to be passive, and none-too-reliable receivers of those communications efforts.

Active, member oriented, and representative trustees are the people with the right motivation, the right alignment of interests, and the central position in the investment strategy formation process, to drive effective decision making on the part of members, but cannot do so from within the barren context of disclosure. While disclosure is the "skeleton" of effective communication, we need to move to a system where communication is recognised and rewarded at a regulatory level.

Advice, education, AGMs

Whilst we support, in spirit, the intention of the Corporations Act in relation to AGMs, we do not support the mandatory extension of the AGM model, as it stands, into the superannuation industry. A major purpose of AGMs is to enable shareholders to move resolutions and vote on them. This is not practicable in the superannuation sphere, given the prohibition on trustees accepting direction from members.

In addition, the sheer logistics of the number of members of funds would render AGMs impractical and/or very costly, and would mean that most participants are only those with the time to attend, or the geographical proximity to the meeting location.

We believe superannuation fund trustees are aware of their trust responsibilities, and that many of their members are neither informed nor voluntary participants in the superannuation system. These factors encourage trustees to take very active approaches to member education and communication, including accountability. Currently, many funds already reach their members face-to-face via the use of member education officers and worksite visits, which are held more frequently than yearly.

To actively promote member engagement, we encourage funds to consider the use of technology to provide members with the information generally covered in an AGM, without the confines of this structure. Many funds provide 'Member Annual Briefing' sessions to give members the opportunity to listen to directors and senior management and have their questions answered. We support the use of technology to provide members with a voice whilst ensuring the impractical and costly logistics of AGMs are avoided.

Active trusteeship in corporate governance

We have argued that active trusteeship has an important role to play in investment management. We have also seen how the limitations of the choice philosophy have been exposed, and how a more targeted, activist communications approach to those who do not choose can build better overall governance.

It is now widely accepted that funds have a role to play in engaging with the boards of companies in which they invest, and that role should be exercised exclusively in pursuit of long-term performance for the fund and its members.

Clearly members will have strongly held opinions regarding the activities of companies in which their funds invest, and these opinions will in many cases run counter to what the fund trustee believes is the correct course of action to maximise long-term value. To permit an arrangement where members can "vote" their shares in a company held by the fund would potentially compromise the trustee's fiduciary duty and would represent a breach of section 58 of the SIS Act.

However, the fact that members might have an expectation that as their representatives, trustees would take their opinions into consideration, illustrates another dimension to the representative system, and the promotion of ESG risks to the same level of importance as other risks faced by trustees. Within an ESG investing framework, trustees can demonstrate that many of those opinions are actually consistent with long-term financial outcomes, and members can have confidence that their trustees' ESG framework aligns the pursuit of members' financial interests with widely held community values.

More importantly, while not being able to actually direct their trustee's voting behaviour, members can encourage their trustees to take positions on ESG issues, a position we would support.

Default funds are crucial

If widespread member disengagement continues, we can expect a heavy proportion of savings to remain in default options. This means that a large proportion of the national savings pool remains in defaults, and most people are still relying on defaults for most of their retirement income.

In relation to default funds under the Choice of Fund legislation, AIST recommends that:

- Trustee boards of all default funds are required to meet the equal representation rules;
- The law be amended to ensure that workers' and employers' representatives are ultimately charged with determining default funds, whether through awards or otherwise;
- No commissions are permitted on default funds.

These are the governance imperatives for default funds, but clearly there is much discussion presently about the optimal structure for defaults. While we will take this issue up in Phase 2 of the Review, we believe that it is only trustees conforming with the representative structure which can design default options for default funds which reflect default members' needs at the lowest possible cost.

Appendix A
Who are trustees in the not-for-profit sector? A small selection:

Name	Position
Bernie Fraser	Former Governor of the Reserve Bank of Australia
Heather Ridout	CEO, Australian Industry Group
Paul Howes	Secretary, Australian Workers Union
Elana Rubin	Chair, Victorian Workcover Authority, Non Executive Director, Transport Accident Commission
Grahame Willis	Director of Finance, Australian Industry Group
Steve Bracks	Former Premier of Victoria
Michael O'Sullivan	Chair, Australian Council of Super Investors
Gabriel Szondy	Former Partner, PriceWaterhouse Coopers
Wilhem Harnisch	CEO, Master Builders Association
Phillipa Smith	Former CEO, Association of Superannuation Funds of Australia
Andrew Fairley	Lawyer
Thomas Parry	Chair, Sydney Water, Director, ASX
Susan Ryan	Former Federal Government Minister
Peter Collins	Former Leader of the NSW Opposition
Denis Hogg	Former CEO, Epworth Healthcare, Past President, Australian Private Hospitals Association
David Emslie	Chief Operating Officer, International Business, Crown Limited
David Galbally	QC
Chris Cuffe	Funds Manager
Sue Dahn	Director, Pitcher Partners Investment Services
Michael Skully	Professor of Accounting
Barry Watchorn	Former Director, Australian Chamber of Manufacturers and Ai Group, Former Trustee of the Year
Pam Mitchell	Director and Company Secretary for Australian Farms Fund Management Pty Ltd.
Jeff Lawrence	Secretary, ACTU
Robert Hinkley	Barrister and Lawyer
Donald Good	Chair of Trustees, St John of God Hospital
Claire Filson	Company Secretary and Head of Governance & Risk, Hastings Fund Management Limited
Gerard Noonan	Former Editor, Australian Financial Review
Virginia Deegan	Director Infrastructure, Property & Technology at The University of Adelaide
Jan McMahon	General Secretary of the Public Service Association
Associate Professor Bill Griggs	Director, Trauma Services - Royal Adelaide Hospital,
Grant Belchamber	Economist, ACTU
Ged Kearney	Federal Secretary, Australian Nurses Federation
Dick Gross	Former three time Mayor of the City of Port Philip
Michael Tilley	Chair of the Lower Murray Region Water Authority.
Belinda Morieson	Registered Nurse
Angela Emslie	Professional Trustee and Consultant, LIME Management