Independence and the Governance of Superannuation Funds

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Abstract

The failure of the Federal government's *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* to pass through the Senate in November 2015 means that the political spotlight has for the time being shifted away from the issue of independence on superannuation fund boards. This creates a valuable opportunity for further reflection on precisely what board member independence might offer the superannuation system.

This paper aims to contribute to that deliberation. It introduces a variety of seminal concepts drawn from independence theory, reviews the growing literature on pension fund governance and maps the ways in which the regulatory regime currently aims to promote cognitive independence on the part of superannuation fund board members. It uses that as a foundation for deriving a more sophisticated, nuanced and ultimately more compelling rationale for the imposition of structural independence on superannuation fund boards. That rationale encompasses both a desire for improved decision-making by superannuation fund boards and a recognition of the valuable role that structural independence can play in inspiring confidence in the system. This confidence, in turn, can contribute to the legitimacy of a system in which participation, as a result of the Superannuation Guarantee, is almost compulsory. A second, complementary paper will evaluate the practical issues associated with using structural regulation specifically to achieve cognitive independence on superannuation fund boards.

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Introduction

Board independence has become the proposed solution to a range of governance problems in recent decades. In the listed company sector the adoption of independence requirements has become standard across a number of jurisdictions. In Australia, for example, changes to the ASX Listing Rules in 2003 required listed companies to comply or explain their non-compliance with stipulations about independence contained in the ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations*, ASX (2003) (*'ASX Principles').* The independent director reforms have provided exacting definitions of independence;[1] increased the number of independent directors;[2] and, increased the power and responsibilities of these directors to change corporate governance outcomes. [3]

While this approach is now embedded and well-accepted in the listed company sector, attention has now turned to the position of Australia's superannuation funds. The application of independence to the governance of entities in the superannuation system has been constrained by the 'equal representation' rules found in Part 9 of the *Superannuation Industry (Supervision) Act 1993* (Cth). These rules require that the individual trustees, or the board of a corporate trustee, of a public offer superannuation fund must consist of equal numbers of member representatives and employer representatives.[4] The Government has expressed a commitment to reform this. In early 2015 it expressed an intention to abolish the equal representation rules and to introduce a requirement that a minimum of one third of the board of publicly-offered, APRA-regulated superannuation funds satisfy a tailored definition of 'independence'.[5] The failure of the government's *Superannuation Legislation Amendment (Trustee Governance) Bill 2015*, which was intended to achieve these

1 In Australia the current definitions of independence are contained in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (3rd ed, 2014) *('ASX Principles').* There are also a plethora of international instruments that seek to define independence: see, for example, Financial Reporting Council, *UK Corporate Governance Code* (2014); *NYSE Listed Company Manual* § 303A.

2 In Australia the report of the Working Group on Corporate Practices and Conduct (chaired by Henry Bosch), *Corporate Practices and Conduct* (1991)(known as the *Bosch Report*) included an early statement of guidelines for directors and a recommendation that a board contain a majority of non-executive directors with a third being independent. First issued in 2003, the *ASX Principles* increased the recommendation to state that a majority of the board should be independent.

3 In part this has involved giving additional responsibilities, and access to information, to independent directors through their placement on committees controlling the audit, compensation and nomination functions once exercised by management. See, for example, the *ASX Principles*, Recommendation 2.1; Sir David Higgs (Chair) *Review of the Role and Effectiveness of Non-Executive Directors*, Department of Trade and Industry (2003) (hereafter known as the '*Higgs Report*'); *NYSE Listed Company Manual* § 303A.

4 *Superannuation Industry (Supervision) Act 1993* (Cth) ('*SIS Act*'), s 89. As of 30 June 2015 there were just 2 large scale superannuation funds administered by individual trustees, so the discussion below is expressed wholly in terms of an incorporated trustee; APRA, *Annual Superannuation Bulletin 2015*. Accessed at http://www.apra.gov.au/Super/Documents/2016ASBPDF201506.pdf on 15 February 2016.

5 *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* (Cth).

reforms, to pass through the Senate in November 2015 does not appear to have changed this objective.[6]

In some ways the failure of the Bill to pass the Senate was a blessing in disguise. It was poorly drafted, containing a number of unintended loopholes and areas of imprecision, as a result of which it was highly unlikely to achieve the objectives advanced for it by the government. The genie is however out of the bottle. The idea that existing regulatory measures designed to ensure that trustees place member needs first are inadequate, and that structural reforms are therefore required to buttress them, is unlikely to go away. Moreover, the case for scrutinising the governance of superannuation funds holding $2 trillion[7] of the retirement savings of Australians is a compelling one, irrespective of one's political inclinations. The hiatus in the legislative process provides an opportunity for revisiting, in a less pressured and politicised environment, what independence reforms of superannuation governance might achieve, and what might be required to get there.

One of the challenges in achieving this is that although independence is often seen as a panacea for a wide range of ills, it is under-theorised and often poorly understood. Independence is commonly thought to have great advantages for corporate and other boards as a means of addressing conflicts of interests, enhancing the monitoring of management, providing alternative perspectives on decision-making, and demonstrating a commitment to good governance. In other contexts, such as the judiciary, it is seen as a way of immunising decisions from inappropriate distractions and influences. There are, however, also significant complexities associated with creating an environment in which independence can make the contribution expected of it in the different circumstances. This will be no different in the superannuation context.

There are obvious questions around what independence means in the superannuation context. Is it independence from management (as in the usual corporate context)? Independence from service providers (which would reinforce the de-entrenching provisions introduced under Stronger Super)? Independence from members? There are also different reasons for seeking independence, including a desire to ensure decision-making autonomy and loyalty to the interests of members, or perhaps the expectation that loosening the equal representation rules might permit consideration of a wide range of possible candidates, some of whom may have new and valuable skills and experiences to bring to the board table. Even amongst advocates for independence there is evidence of different express and implicit objectives and differently weighted priorities. This variegation can also be seen in the differing definitions present in the *SIS Act*, the Financial Services Council ('FSC') membership rules and Australian Institute of Superannuation Trustees ('AIST') governance guidelines. These are discussed in more detail in Parts 4 and 5 below. Beyond that there are many practical issues, including those arising from the unique appointment processes surrounding the boards of many not-for-profit funds, the heightened requirement for transparency and democratic legitimacy in a quasi-public activity such as compulsory superannuation, the remuneration of independent and other directors, the role of board committees in light of APRA's regulatory oversight, as well as the role played by the different layers of regulatory and self-regulatory rules. It is important that the design and implementation of the government's policy have close regard for these constraints and

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6 http://kmo.ministers.treasury.gov.au/transcript/075-2015/. Also David Crowe, 'Choice of super back on agenda as Coalition targets union deals' *The Australian,* 10 January 2016.

7 APRA, *Quarterly Superannuation Performance*, September 2015 (issued 19 November 2015), 6.

competing considerations because independence is unlikely to deliver the desired benefits unless it is implemented with care and supported by appropriate structures, processes and expertise.

This paper draws on a theory of independence developed in the corporate governance literature in Australia and overseas that considers the opportunities and challenges of implementing the Government's policy in relation to independence on superannuation fund boards. Part 1 reviews the growing literature on superannuation (and pension fund) governance globally. It finds that much of that literature is normative at best, with at this stage little reliable empirical analysis to guide the normative prescriptions being advanced in many of the papers. A small number of studies address the notion of structural independence.[8] However with few exceptions they involve contexts in which the structural conflicts of interest and duty are much starker than those typically present in Australian superannuation funds. The conclusion of this review is that there is little evidence in the empirical literature to support an assertion that independence on superannuation fund boards will deliver enhanced investment performance. Part 2 then explores the existing theory of independence in other domains, what it is intended to achieve and how it should be conceptualised. It highlights that an inability to discover compelling empirical evidence of enhanced investment performance as a result of good governance, and independence specifically, ought not to be regarded as fatal and that there are important benefits on other dimensions that independence can bring. It then identifies that there are four key approaches that should be considered when regulating for independence: capacity, power, status and structural barriers. Part 2 argues that careful consideration of the goals of independence will assist in identifying and implementing the appropriate regulatory pathway. Part 3 then maps the patchwork regulatory regime that is designed to promote cognitive independence amongst those to whom decision-making has been delegated in the superannuation system; the trustees and their directors. Finally, Part 4 assesses the measures designed to impose structural independence of the type apparently envisaged by the government in the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* in light of the analyses in Parts 2 and 3.

[8] 'Structural' independence is used here to describe measures designed to recognise and proscribe directors having certain types of formal and informal relationships with third parties. Exactly which types of relationships are prescribed will depend on the definition of independence. The term is contrasted with 'cognitive' independence, which pertains to the state of mind of the director (an in particular its freedom from distraction or constraint). For a discussion that suggests this distinction, see Sally Wheeler, 'Independent directors and corporate governance' (2012) 27 *Australian Journal of Corporate Law* 168.

1 Review of the literature examining superannuation fund governance

Superannuation and pension funds are increasingly influential actors in the financial markets of most OECD countries and of global markets generally. Altogether they comprise over US$25 trillion.[9] It is widely believed that the governance of financial institutions contributes materially to their financial performance[10] and to the risks of negative externalities that they pose to society at large.[11] It may come as a surprise therefore that research into the impact of governance structures and attributes on the investment performance of superannuation and pension funds around the world is comparatively underdeveloped. Research across the economics, governance and legal domains identified 65 articles and other scholarly publications on superannuation and pension fund governance over the past twenty or so years.[12] The majority (almost 60%) of these are purely qualitative in method with normative prescriptions derived from the authors' experience, ideological bent or some other (usually undisclosed) source. Of the remainder, 12 are based on survey data,[13] leaving just 17 based on empirical analysis of the type most commonly employed in applied finance and economics scholarship. Moreover, less than a third of all studies (20) refer to director/trustee independence in their assessment of the impact of governance, and of these only eight are empirical.

This is not to suggest that good governance is not a desirable outcome. It is rather to puncture gently the inflated expectations that exist in some quarters that 'good' governance, and structural independence in particular, has been shown unequivocally to generate to superior investment performance in the superannuation (pension) fund context. There simply is not evidence in the literature relating to the superannuation and pension context to support (or indeed contradict) that claim with any confidence. Although there are a handful of studies that find a positive relationship

9 OECD, *Pension Markets in Focus 2015*. Accessed at http://www.oecd.org/finance/private-pensions/globalpensionstatistics.htm on 8 January 2016.

10 See for instance the Cooper Review: Super System Review, Review into the Governance, Efficiency, Operation and Structure of the Superannuation System, *Final Report - Part One: Overview and Recommendations* (July 2010), 2.

11 See for instance the Walker Review in the UK; HM Treasury, 'A review of corporate governance in UK banks and other financial industry entities' (2010), accessed at http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/walker_review_information.htm on18 January 2016.

12 A listing of the studies identified in this research can be found in the Appendix.

13 Amongst these is a set of very influential papers associated with industry doyen, Keith Ambachtscheer. These papers purport to establish the existence of a 'governance' deficit but on closer examination prove to be based on an estimate, by management of each pension plan, of the extent to which their Board contributed to (ie detracted from) financial performance. The estimates of the deficit are thus neither objective (given the inherent bias in having fund CEOs explain the contributions to their funds' performance) nor reliable (given the absence of any actual measurement). The weight of reliance placed on this body of research is therefore quite unfortunate. The study was initially reported in Keith Ambachtsheer, Craig Boice, Don Ezra, and John McLaughlin. (1995) 'Excellence Shortfall in Pension Fund Management: Anatomy of a Problem', and cited in Keith Ambachtsheer and Don Ezra, *Pension Fund Excellence* (Wiley, 1998), 18. The study was conducted a second time and reprised in Keith Ambachtscheer, Ronald Capelle, and Hubert Lum 'The Pension Governance Deficit: Still with Us' (2008) *Rotman International Journal of Pension Management*, Fall, 14.

between 'good' governance and actual investment performance,[14] none identify that structural independence specifically is associated with superior investment performance.

Unpicking the question a little further, the impact of good governance might be detected directly (for instance in the absence of conflicted investment structures, which might be expected to lower costs) or indirectly (for instance in the application of greater skill to investment decisions, which might be expected over time to enhance risk-adjusted performance).

Turning first to the potential for a direct impact, research by Coleman *et al*,[15] Liu and Arnold[16] and Nguyen *et al*[17] in Australia and by Albrecht and Hingorani[18] in the US, supports the hypothesis that poor governance practices and structures are correlated with higher costs.[19] This cost hypothesis is intuitively plausible and extends a richer research literature investigating the cost structure of mutual funds in the US.[20] It is also directly relevant to the issue of independent directors, since oversight of contractual negotiations with key service providers is certainly one function that independent directors could potentially play. Notably however the Australian studies pre-date the imposition of the Financial Services Council's independence requirements (see below), so the comparison being made is an obsolete one between the representative model (with little or no structural independence) and the executive director model (since reformed to include independent directors). The representative model was found to outperform, in large part because those directors were able to contain costs better. It remains to be seen whether the introduction of independent directors into the executive director model will affect this finding.

The research concerning the indirect impact of good governance on financial performance is even more equivocal. This is not surprising as the reward for the application of skill in investment markets

14 These include Manuel Ammann and Andreas Zigg, 'Performance and governance of Swiss pension funds' (2008) 9(1) *Journal of Pension Economics and Finance* 95; Oskar Kowalewski, 'Corporate Governance and Pension Fund Performance' (2011) 6(1) *Contemporary Economics* 14; Karen Benson, Marion Hutchinson and Aswin Sriram, 'Governance in the Australian Superannuation Industry' (2011) 99(2) *Journal of Business Ethics* 183.

15 Anthony Coleman, Neil Esho and Michelle Wong, 'The impact of agency costs on the investment performance of Australian pension funds' (2006) 5(3) *Journal of Pension Economics and Finance* 299.

16 Kevin Liu and Bruce Arnold, 'Superannuation and the Cost of Insurance' (2013) *JASSA*, iss. 1, 56; Kevin Liu and Bruce Arnold, 'Australian Superannuation Outsourcing' (2010) *JASSA*, iss. 4, 6.

17 Thi Thuy Chi Nguyen, Monica Tan and Marie-Anne Cam, 'Fund Governance, Fees and Performance in Australian Corporate Superannuation Funds. A Non-parametric analysis' (2012) 11(2) *Journal of Law and Financial Management* 2.

18 William Albrecht and Vineeta Hingorani, 'Effects of Governance Practices and Investment Strategies on State and Local Government Pension Fund Financial Performance' (2004) 27(8-9) *International Journal of Public Administration* 673.

19 See also Raymond Markey, Michael Rafferty, Louise Thornthwaite, Sue Wright and Christopher Angus, *The Success of Representative Governance on Superannuation Boards* (The McKell Institute, June 2014). Accessed at http://mckellinstitute.org.au/wp-content/uploads/2014/08/McKell_Super_A4_WEB.pdf on 25 January 2016. Unpublished research suggests that this result appears to be robust even when conditioned on other possible explanations; Kevin Liu, *Governance and Performance of Private Pension Funds: Australian evidence*, (2014) School of Risk and Actuarial Studies, University of New South Wales, Australia.

20 See for instance John P Freeman and Stewart L Brown and Steve Pomeranz, 'Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test' (2008) 61 *Oklahoma Law Review* 83; Peter Tufano and Matthew Sevick, 'Board Structure and Fee Setting in the US Mutual Fund Industry' (1997) *Journal of Financial Economics* 46.

is exceptionally noisy, and any statistical signal is therefore liable to be swamped by other random or other influences.[21] There is also the problem that the *ex ante* optimal portfolio for a defined benefit fund in surplus will almost certainly differ from that of a defined contribution fund whose members are predominantly young; regard must be had for the objectives of the fund as this will powerfully influence the *ex ante* risk associated with any given investment strategy. It is also possible that different governance attributes (such as independence and expertise) are salient in different circumstances.[22] Finally there is the problem that data integrity and availability has been poor in almost all markets until comparatively recently, and remains poor in almost all markets relative to the listed corporate sector and other private non-retirement savings markets, such as mutual funds.

Notwithstanding these technical concerns, there are a number of studies which detect a difference between the investment strategies (and hence *a priori* the investment performance) of funds employing 'good' internal governance structures and practices and those which do not. These include Coronado *et al*,[23] Useem and Mitchell,[24] and Cocco and Volpin.[25] There are sound reasons for not seeing these as directly relevant to the Australian situation, however.

It is always tempting to look for empirical evidence from other comparable jurisdictions to test the validity of a proposition, but we should be careful about applying studies from other countries to the Australian superannuation fund context. There are a number of reasons for this. The Australian superannuation system is one of the most advanced and regulated in the world. Many of the governance issues identified in other countries' systems either do not apply or have already been specifically addressed in Australia. For example Romano,[26] Useem and Mitchell,[27] Iglesias and Palacios,[28] Albrecht *et al*,[29] Yang and Mitchell,[30] Impavido,[31] and Kruijf and De Vries[32] examine the

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21 Robert Ferguson, 'The trouble with performance measurement' (1986) 12(3) *Journal of Portfolio Management* 4.

22 See for instance Jackowicz and Kowalewski who found that expertise was specifically and especially required during the financial crisis of 2008; Krzyszt Jackowicz and Oskar Kowalewski, 'Crisis, internal governance mechanisms and pension fund performance: Evidence from Poland' (2012) 13(4) *Emerging Markets Review* 493.

23 Julia L. Coronado, Eric M. Engen and Brian Knight, 'Public Funds and Private Capital Markets: The Investment Practices and Performance of State and Local Pension Funds' (2003) 56(3) *National Tax Journal*, 579.

24 Michael Useem & Olivia S. Mitchell, 'Holders of the Purse Strings: Governance and Performance of Public Retirement Systems' (2000) 81(2) *Social Science Quarterly* 489.

25 Joao F. Cocco and Paolo F. Volpin 'Corporate Governance of Pension Plans: The UK Evidence' (2007) 63(1) *Financial Analysts Journal* 70.

26 Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93(4) *Columbia Law Review* 795.

27 Useem and Mitchell, above n 24.

28 Augusto Iglesias and Robert J Palacios, *Managing Public Pension Reserves: Evidence from the International Experience*. (2000, World Bank Social Protection Discussion Paper, No. 0003).

29 William Albrecht, Hannarong Shamsub & Nicholas Giannatasio, 'Public Pension Fund Governance Practices and Financial Performance' (2007) 19(2) *Journal of Public Budgeting, Accounting & Financial Management* 246. Also Albrecht and Hingorani, above n 18.

30 Tongxuan Yang and Olivia Mitchell, 'Public pension governance, funding and performance, a longitudinal appraisal' (2005) Pension Research Council Working Paper 2005-2, University of Pennsylvania – Insurance and Risk Management Department.

31 Gregorio Impavido, *On the Governance of Public Pension Fund Management* (2002, Working Paper No. 2878 World Bank Policy Research).

impact of different governance attributes of public sector pension plans, noting the diversity of the arrangements and the peculiarities introduced by virtue of their public nature. There are, of course, superannuation funds in Australia dedicated specifically to public sector employees. However their governance arrangements are typically similar to those found in the private not-for-profit sector either because they have formally submitted to regulation by the Commonwealth and the Australian Prudential Regulation Agency ('APRA'), or because they have undertaken to maintain governance and administrative arrangements functionally equivalent to those required under the Commonwealth regulatory regime.[33] So Australian public sector schemes simply do not demonstrate the same diversity of governance structures as appear in other countries, nor are Australian public sector schemes as distinctive from a governance perspective from their defined contribution counterparts as are public sector schemes in other countries. Similarly, most of the overseas studies focus on the structural governance issues associated with defined benefit plans, and particularly the issues associated with the role of employer sponsors in the governance of the plans. There are large defined benefit plans in Australia, but their number and relative quantum have declined steadily in the decades since the introduction of the superannuation guarantee in 1993. Today defined benefit schemes account for just over 10.5% of total system assets in Australia,[34] and a sizeable portion of these are administered within third party 'hybrid' funds which contain both defined benefit and defined contribution divisions but are administered by entities not associated with the employer. There have been issues related to employer influence on funds' governance in Australia,[35] but the situations in which they can arise are becoming increasingly rare. As a final example, Ammann and Zingg[36] found that governance practices such as objective setting and the derivation of formal statements of investment strategy were correlated with superior investment performance in Swiss pension plans. Both of those practices are already formally required of Australian superannuation trustees under the *SIS Act*[37] so the study does little more than support the relevance and importance of regulatory measures already in place in Australia.

The absence of compelling evidence that good governance contributes to superior investment performance should come as little surprise. It seems reasonable to expect that once major structural issues, such as the presence of interests or duties that compete with the trustee's duty to members,[38] are eliminated, the marginal impact of individual 'softer' governance measures on investment performance might reasonably be expected to be quite small. In addition, many of the more behavioural aspects of good governance are likely to be difficult to observe. (Clark *et al*'s

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32 Johan Kruijf and Michael De Vries, 'Governance and stakeholder involvement in the Dutch pension industry, lessons for developing countries' (2014) 34 *Public Administration and Development* 332.

33 There are 19 individually public sector funds excluded from Commonwealth jurisdiction by Heads of Agreements between the Commonwealth, State and Territory governments. See http://www.apra.gov.au/super/publications/pages/annual-superannuation-publication.aspx.

34 APRA, above n 7, 11.

35 See for instance the fact situation behind the litigation in *Re VBN* [2006] AATA 710.

36 Above n 14.

37 Section 52(6), *SIS Act*.

38 See for instance Kevin Liu & Bruce Arnold, 'Superannuation and Insurance: Related Parties and Member Cost' (2013) 5(1) *The Journal of Superannuation Management* 44; Coleman, Esho and Wong, above n 15.

study[39] into the cognitive capabilities of the trustees of a sample of UK pension plans is a striking and important exception to this).

That said, the difficulty associated with correlating governance arrangements with financial performance is not unique to the superannuation sector. The listed company sector has adopted the independent director reforms without compelling empirical evidence that they will change governance outcomes. There are two main reasons for this. First, a change to the composition of the board affects only one element of the governance process. As the *OECD Principles of Corporate Governance* indicate, the governance of corporations:

> involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. [40]

Governance outcomes, then, are a product of a variety of inputs (such as people), regulation and processes and practices. In view of the complexity of any organisation's governance regime it would be surprising if changing one aspect of the demography of the board would lead to a clear and marked effect on performance. Second, studies that measure the effect of governance arrangements are notoriously difficult. Scholars have long attempted to measure the effect of various governance changes on financial performance in the corporate sector. However the difficulty such studies pose is significant. The contributors to financial performance are many and varied—arising endogenously and exogenously through market forces-- and studies that attempt to isolate and measure the contribution of a single factor are open to challenge. This may well explain the fact that these studies do not achieve any consensus about the value of independence.[41] In an alternative approach, some studies rely on a proxy for good governance such as increased audit costs[42], or removal of the CEO,[43] as a way of measuring the effect of independence. Again while this literature may contribute to better understanding it provides no definitive answer and should be

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39 Gordon Clark, Emiko Caerlewy-Smith and John Marshall, 'The consistency of UK pension fund trustee decision-making' (2007) 6(1) *Journal of Pension Economics and Finance* 91. Notably this research assessed the decision-making capacity of board members rather than the decisions actually taken by the boards in administering the plans.

40 OECD, *Principles of Corporate Governance* (2004) 11.

41 So, for example, Sanjai Bhagat and Bernard S Black, 'The Uncertain Relationship Between Board Composition and Firm Performance' (1999) 54(3) *Business Lawyer* 921 find that there is no conclusive evidence to show that increasing independence improves performance but Ira M Millstein and Paul W MacAvoy, 'The Active Board of Directors and Performance of the Large Publicly Traded Corporation.' (1998) 98 *Columbia Law Review* 1239 conclude that independent boards perform significnatly better. See also Rafel Crespí-Cladera and Bartolomé Pascual-Fuster 'Does the Independence of Independent Directors Matter?' (2014) 28 *Journal of Corporate Finance* 116.; Peter Swan and David Fosberg, 'Does Board "Independence" Destroy Corporate Value?: Outcome of a Quasi-Natural Experiment' UNSW Working Paper (2014).

42 Steven Young, 'The Increasing Use of Non-Executive Directors: Its Impact on UK Board Structure and Governance Arrangements' (2000) 27(9) *Journal of Business Finance & Accounting* 1311.

43 Benjamin E Hermalin and Michael S Weisbach, 'Endogenously Chosen Boards of Directors and Their Monitoring of the CEO' (1998) 88 *American Economic Review* 96.

approached with some caution. A further problem arises due to the varied definitions of independence that are employed in these studies.[44]

In conclusion, then, the research literature offers precious little empirical support for imposing structural independence on superannuation fund boards. The 'evidence' of superior investment performance from good governance in the superannuation and pension sector rests primarily on the higher cost structures sometimes observed where trustees employ related parties to assist in the administration of the fund. Beyond this, it is hard to find empirical support for imposing structural independence on boards, especially given there have now been a number of legislative initiatives in Australia expressly designed to address this issue.[45] The effect of these have not yet been measured. That said, there are other rewards that good governance, and especially perceptions of good governance, can earn. The value of these should not be underestimated, even if they are difficult to measure. We explore this in Part 3.

2 Theorising Independence

In order to understand independence better it is useful to begin by considering the purpose for which independence might be sought. This powerfully influences which means of promoting or securing independence is likely to be optimal in any given situation.

2.1 Why impose 'independence'

Independence is not an end in itself. It is a pathway by which some more fundamental objective is sought. Broadly, these objectives to fall into two categories. First, there is a desire to improve the quality of decision-making. Second, there is a focus on demonstrating the legitimacy of the decision-making process to stakeholders, which in the case of the superannuation sector encompasses both members and policy-makers. Both of these objectives are laudable, but the relative importance of each will depend on the circumstances. Corporate governance in large public companies is an example of an area where the desire to improve the quality of decision-making, and the desire to provide public reassurance exist together.[46] This can be contrasted with the position of the closely held private company where public legitimacy is unlikely to be a strong priority and personal relationships of trust are critical for effective governance. As we shall see, both objectives are crucial for the success of the Australian superannuation system.

Concern about the quality of decision-making means that decision processes are designed to incorporate independence where there is a need to ensure a 'correct' decision. An example of this is judicial office, where it is critical that judges be free to make their decisions without fear that their

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44 Laura Lin, 'The Effectiveness of Outside Directors as a Corporate Governance Mechanism' (1996) 90 *Northwestern University Law Review* 898.

45 Key amongst these is the introduction of sections 58A and 58B into the *SIS Act*. These provisions void the 'entrenchment' of service providers in the trust's governing rules, a commonly practiced way of sidestepping the traditional conflicts rules.

46 It is, however, possible to think of situations where there is no public interest but simply a desire to improve the decision-making quality. Private companies, for example, might appoint an independent director because they have an interest in promoting the interests of their shareholders, but no wider public interest. Alternatively an independent person might be valued because there is a public interest in doing so, even where there is no decision being made.

tenure could be curtailed or some other negative personal consequence might eventuate.[47] There, independence is seen as a pillar for effective judicial decision-making.[48] The auditing of corporate accounts by an independent, external auditor is another role where there is a risk that the reliability of the decision-making process could be undermined.[49] In the absence of independence, an auditor might be swayed by a financial interest in a continuing flow of work from the audited body to overlook concerns about the corporate accounts.[50] This sensibility has adherents in the superannuation context also. For instance, a recent report on the governance of superannuation funds stated that 'independence is often equated with good decision-making, because it connotes objectivity and impartiality'.[51]

The aim of improving the quality of decision-making also bears some scrutiny. From a procedural perspective, the decision-maker might be expected to take account of appropriate information and disregard irrelevant or unreliable information, and also exercise the power exclusively for the purpose for which it was granted.[52] Independence standards could assist on each of these fronts. It is possible that drawing on independent persons could enhance the quality of decision-making by ensuring the person has appropriate distance from the matters being decided and thus takes a detached perspective. The process by which decisions are made may also be enhanced by the need to ensure a diverse decision-making body is in possession of appropriate information and has an opportunity to consider carefully the decision. Finally, independence may promote the probity of decision-making by removing distractions and conflicts of interest that might otherwise be present. The mandating of independence is an attempt to carve out space for decision-makers to exercise their judgment in an unconstrained and undistracted manner. Of course independence has its limits as well. A person who is perfectly independent but has no expertise is unlikely to arrive reliably at 'good' decisions. This suggests that features in addition to independence should be considered in the context of improving the standards of governance, a point we will return to in Part 5.

The objective of improving the quality of decision-making has an additional significance in the superannuation context. The success of the Australian superannuation system to achieve its social and economic goals relies heavily on 'distributed' decision-making.[53] This is not articulated

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47 See Richard Larkins, 'Judicial Independence and Democratization: A Theoretical and Conceptual Analysis' (1996) 44 *American Journal of Comparative Law* 605, 606 (arguing that judicial independence allows the courts to be 'more forceful mechanisms for the defense of constitutionalism and justice').

48 Gabrielle Appleby and Suzanne Le Mire, 'Judicial Conduct: Crafting a System That Enhances Institutional Integrity' (2014) 38(1) *Melbourne University Law Review* 1, 37-8.

49 See Emma Ladakis, 'The Auditor as Gatekeeper: Auditor Independence and the CLERP Reforms--A Comparative Analysis' (2005) 23 *Company and Securities Law Journal* 416, 417; R P Austin, 'What is Corporate Governance? Precepts and Legal Principles' (2005) 3 *New Zealand Law Review* 335, 356.

50 See for instance Curtis E Clements, John D Neill, O Scott Stovall, 'Inherent Conflicts Of Interest In The Accounting Profession' (2012) 28(2) *Journal of Applied Business Research* 269; Austin Emmanuel and Herath Kanthi Siriyama, 'Auditor Independence: A Review of Literature' (2014) 5(1) *International Journal of Economics and Accounting* 62.

51 Mercer, 'Governance of Superannuation Funds: A Report on Independence Requirements for Trustee Boards' (2015) 4.

52 For a rigorous doctrinal examination of these requirements in a variety of legal contexts, see Geraint Thomas, *Thomas on Powers* (OUP, 2nd edition, 2012).

53 M Scott Donald, Hazel Bateman, Ross Buckley, Kevin Liu and Rob Nicholls 'Too connected to fail: the regulation of systemic risk within Australia's superannuation system' 2015 *Journal of Financial Regulation* Online.

definitively in any particular official pronouncement, but one common explanation for this crucial aspect of system design is an implicit belief in the superior ability of markets to promote systemic efficiency and local inefficiency.[54] Stated more precisely, the placement of decision-making authority in the hands of trustees, and increasingly members,[55] permits the discovery and pursuit of local, fund-by-fund optima within the system. An alternative system design would be to centralise all decision-making in a single place, such as a national provident fund, or in a small number of funds. A centralised system design such as that would facilitate the exploitation of economies of scale and allow scarce expert resources to be more centralised. That is not the way the Australian system has developed. Indeed there is an assumption implicit in the design of Australia's superannuation system that is relevant here: if the opportunity set and local objectives are sufficiently heterogeneous, a system built around distributed decision-making in which local decision makers identify local optima may deliver a superior outcome for the system as a whole than if decision-making was centralised. That is to say, the benefits of having the boards of superannuation funds maximising utility at a local, and hence highly granular, level would offset the efficiencies and concentration of expertise that centralising decision-making (say in a national provident fund) would bring.[56] The efficacy of this 'distributed' system design depends on the diversity of the members of each fund but also, to a material extent, on the ability of the boards of superannuation funds to identify accurately and pursue in an undistracted manner their local objectives and opportunity set. They must, to use the terms employed in the *SIS Act*, act in the best interests of their members.[57] Good governance is at least in part directed towards creating decision environments at a local, fund-by-fund level where that can happen.

The second motivation for seeking independence is that it signals the legitimacy of the decision-making person or body to external stakeholders. There may be a need to establish the impartiality of a person or body in order to justify the grant of responsibility to that person. This motivation lies behind the appointment of independent persons to head government inquiries. Independence is seen as critical for more long-term appointments such as the judiciary,[58] auditors-general,[59] and the

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54 Nick Coates and Sasha Vidler, 'Superannuation Policy: Commentary on an Interview with Paul Keating, Former Prime Minister' (2004) 53 *Journal of Australian Political Economy* 9.

55 M Scott Donald, 'The prudent eunuch: Superannuation trusteeship and member investment choice' (2008) 19 *Journal of Banking and Finance Law and Practice* 5. But cf Joshua Fear and Geraldine Pace, "Australia's Choice of Fund Legislation: Success or Failure" (2009) 2(2) *Rotman International Journal of Pension Management* 26.

56 Note, this result can accommodate consideration of risk also. Accuri and Dari-Mattiaci contend that the enhanced return in systems in which decision-making is widely distributed, rather than concentrated, may compensate for the increased frequency of local risks; Alessandra Accuri and Giuseppi Dari-Mattiacci, 'Centralisation versus Decentralization as a Risk-Return Trade-Off' (2010) 53 *Journal of Law and Economics* 359. A similar sensibility, focused only on the risk dimension can be found in M Scott Donald, Hazel Bateman, Ross Buckley, Kevin Liu and Rob Nicholls, 'Too connected to fail: the regulation of systemic risk within Australia's superannuation system' (2015) *Journal of Financial Regulation* Online. For an alternate view, see Wilson Sy, 'Toward a national default option for low cost superannuation' (*APRA Working Paper*, August 2008).

57 Section 52(2)(c), *SIS Act*.

58 Bingham Centre, *The Appointment, Tenure and Removal of Judges under Commonwealth Principles: A Compendium and Analysis of Best Practice* (2015) xv.

59 *Auditor-General Act 1997* (Cth), s 8(1) provides that the Auditor-General is an 'independent officer of parliament' with 'complete discretion in the performance or exercise of his or her functions and powers'. Schedule 1 provides that the Auditor-General is appointed, for a term of 10 years, by the Governor-General on advice from the executive.

ombudsmen,[60] in order to demonstrate integrity. Similarly, a number of professions assert that independence is integral to their role. It is claimed, for example, that independence 'defines the lawyer as a professional',[61] and lawyers' conduct rules require adherents 'to avoid any compromise to their integrity and professional independence'.[62] Health professionals are also informed by their codes of conduct that 'patients or clients rely on the independence and trustworthiness of practitioners'.[63]

Legitimacy is especially important in the Australian superannuation system because individual participation is effectively compulsory and all benefits are preserved (i.e. unable for most practical purposes to be enjoyed) until the individual reaches retirement age. Such individual agency as people have is therefore quite constrained. Individuals can choose the level of contributions they make (if necessary by contributing personally, in addition to the amounts contributed by their employer), subject to certain minima and maxima. In addition, in most cases they can choose into which fund their contributions are placed and what investment strategy will be applied to those monies.[64] However they have no say in whether to contribute or not, and many express either an inability or a disinclination to invest in acquiring the expertise to manage their superannuation balances themselves.[65] Rather, they rely on the implicit warranty of expertise embedded in their fund's default arrangements.[66] Those 'defaulting' members choose, then, to trust a system in which they are forced to participate.

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60 The Commonwealth Ombudsman is appointed under the *Ombudsman Act 1976* (Cth) by the Governor-General with some security of tenure, *Ombudsman Act 1976* (Cth) ss 21, 22, and 28.

61 Susanna M Kim, 'Dual Identities and Duelling Obligations: Preserving Independence in Corporate Representation' (2001) 68 *Tennessee Law Review* 179, 247; see also Suzanne Le Mire, 'Testing Times: In-House Counsel and Independence' (2011) 14(1) *Legal Ethics* 21, 22.

62 See, for example, Law Society of South Australia, Australian Solicitors' Conduct Rules

63 See, for example, Dental Board of Australia, Code of Conduct, (2014) 8.11, given force by Division 3 of the National Law enacted in each state and territory: *Health Practitioner Regulation National Law Act 2009* (NSW); *Health Practitioner Regulation National Law (Victoria) Act 2009*; *Health Practitioner Regulation National Law (ACT) Act 2010*; *Health Practitioner Regulation (National Uniform Legislation) Act 2010; Health Practitioner Regulation National Law (Tasmania) Act 2010; Health Practitioner Regulation National Law (South Australia) Act 2010; Health Practitioner Regulation National Law (WA) Act 2010*.

64 Donald, above n 55. Sometimes this is illustrated by the frustrations evinced by those who are denied even this level of individual agency; Sally Rose, 'Grown Woman with PhD Wants to be Allowed to Pick her Own Super Fund', *Sydney Morning Herald*, 22 January, 2016. The government has also announced plans to extend the application of the Choice of Funds regime that permits employees to nominate specific funds into which their superannuation contributions are to be paid; www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Extending-superannuation-choice-to-enterprise-agreements-and-workplace-determinations.

65 See for instance, Paul Ali, Malcolm Anderson, Martin Clark, Ian Ramsay and Chander Shekhar, 'No thought for tomorrow: young Australian adults' knowledge, behaviour and attitudes about superannuation' (2015) 9(2) *Law and Financial Markets Review* 90; Hazel Bateman, Jeanette Deetlefs, Loretti I Dobrescu, Ben R Newell, Andreas Ortmann and Susan Thorp, 'Just interested or getting involved? An analysis of superannuation attitudes and actions' (2014) 90 *The Economic Record* 160; Diana Beal and Sarath Delpachitra, 'Community Understanding of Superannuation; (2004) 11 *Agenda* 127.

66 Adam Butt, M Scott Donald, Doug Foster, Susan Thorp and Geoff Warren, 'Delegation, trust and defaulting in retirement savings: Perspectives from plan executives and members' (2015, *CFIR Working Paper 065/2015*).

The system's legitimacy is likely to be enhanced when those empowered to act on behalf of members (the trustee and, to some extent, the regulator) are perceived to be actively loyal to the interests of members. The formal regulatory regime, and the *SIS Act* in particular, has a role to play in this. The imposition, and enforcement, of the rules against conflicts,[67] and a duty to act in the best interests of members,[68] buttress analogous general law principles designed to promote loyal and faithful execution of the trustee's duties.[69] The perception of loyalty can be engendered by regulation that incorporates transparency and board appointment processes that are either pro-member or neutral, and focused on the attributes of the appointees. Crucially, members' perception of loyalty, and the legitimacy of the system as a whole, can be destroyed by conduct that casts that loyalty into doubt.

The motivation for seeking and adopting independence will influence regulatory regimes. While the two drivers for independence may well both be assisted by an adoption of independence regulation, the kind of independence regulation required may vary depending on which goal is being pursued. So, for example, the adoption of measurable criteria for independence may be particularly significant if the second aim, that of enhancing legitimacy, is being sought. Four possible ways of constructing independence are described below.

2.2 Approaches to Independence

The use of independence as a mode of regulation is pervasive across both private and public (government) sectors. Shapiro argues that the development of impersonal agency relationships has spawned a number of structural constraints that are used to mimic contractual provisions or personal trust that might otherwise exist between parties.[70]

> Impersonal trust arises when social-control measures derived from social ties and direct contact between principal and agent are unavailable, when faceless and readily interchangeable individual or organizational agents exercise considerable delegated power and privilege on behalf of principals who can neither specify, scrutinize, evaluate, nor constrain their performance.[71]

In the corporate sector, for instance, the relationship between directors and shareholders is based on impersonal trust. There are a number of structural constraints that are typically used to support the trust implicitly granted to boards by shareholders. The presence of independent members on a board is one such constraint; it is designed to establish a narrative that supports impersonal trust and enhances the perception of legitimacy.[72]

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67 Section 52(2)(d) and section 52A(2)(d), *SIS Act*.

68 Section 52(2)(c) and section 52A(2)(c), *SIS Act*.

69 M Scott Donald, 'Regulating for Fiduciary Qualities of Conduct' (2013) 7 *Journal of Equity* 142.

70 Susan P Shapiro, 'The Social Control of Impersonal Trust' (1987) 93(3) *American Journal of Sociology* 623.

71 Ibid 634.

72 Ibid 639.

There are however a wider variety of approaches to regulating for independence than is typically recognised. The four ways to approach the regulation of independence are capacity, status, power and structural barriers. Each is briefly unpacked and considered from a regulatory perspective.[73]

2.2.1 Capacity

The 'classic' way of obtaining independence is by choosing a person with the capacity to act independently. Le Mire and Gilligan have argued that a capacity for independence 'can protect independent thought and action even when there is exposure to influences that would otherwise threaten independence'.[74] This avenue requires careful selection of the individual and assumes that independence is a characteristic that can be identified and that is stable across time and circumstance. That is, once achieved, the capacity for independence renders the person invulnerable to pressure. Descriptions such as 'independence of mind'[75] and 'independent in character and judgment' capture something of the capacity idea. From a regulatory perspective the kinds of regulation that suggest a capacity approach has been adopted are those that prioritise a particular expertise or experience. The 'fit and proper 'requirement attaching to RSE licensees and their officers is one such measure. Sometimes the possession of expertise is of itself used as a proxy for the capacity for independence. Edward Rubin has argued that expertise can assist independence in two ways.[76] First, by increasing a person's ability to withstand inappropriate pressure and secondly by building credibility that discourages others from exerting pressure. To draw on Rubin's example, it is unlikely that a non-engineer will attempt to, or be able to, sway an engineer's prescription of the correct way to build a bridge.[77] As such, expertise can stand in to some extent for independence, which is of itself a difficult characteristic to identify.

2.2.2 Status

The second way to regulate for independence is to allocate a designated independent status to the person or body. Such an allocation signals, both outwardly to audiences and inwardly to the body or person concerned, that an important feature of their role is independence. This is perhaps most powerful when it is expressed, such as with 'independent counsel' or 'independent director', but can also become so intertwined with the nature of the role that it is widely understood, as with judges. Where independent status is more tenuous, the party or body may be left to claim independence, sometimes in situations where there is a competing narrative of partisanship. So, for example, in-house counsel are expected by their professional conduct rules to exercise independent judgment, but may well be expected by their employer client to employ unqualified loyalty.[78] The regulation of independent directors of listed company boards effectively adopts this 'status' approach by requiring the relevant boards to indicate whether they have sufficient numbers of designated 'independent directors'.[79] The status allocated to such directors ensures they can inspire confidence

[73] A more expansive discussion of the four avenues to independence can be found in Suzanne Le Mire and George Gilligan, 'Independence and Independent Company Directors' (2013) 13(2) *Journal of Corporate Law Studies* 442.

[74] Ibid 450.

[75] Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Institutions* (2009) 12.

[76] Edward L Rubin, "Independence as a Governance Mechanism" in S B Burbank and B Freidman (eds), *Judicial Independence at the Crossroads: An Interdisciplinary Approach* (Sage Publications, 2002) 56, 67.

[77] Ibid 81.

[78] Suzanne Le Mire, 'Testing Times: In-House Counsel and Independence' (2011) 14(1) *Legal Ethics* 21, 23.

[79] *ASX Guidelines* Box 2.1.

in stakeholders that decisions that might otherwise be viewed as compromised by conflicts of interest have in fact been made appropriately.[80]

2.2.3 Power

Power provides a third avenue for independence regulation. This approach, drawing on Steven Lukes' work advocating a nuanced perspective about power,[81] can assist understanding of the extent to which independent directors can drive an objective agenda. As such it prompts moving beyond considering the 'inputs' to a decision-making process, and shifts to contemplate 'concrete observable behaviour' as critical to understanding and allocating power,[82] in this context, to act independently. Lukes argues that power is complex and includes the capacity to drive decision-making, to determine agendas, contrary to the interests of others, and to shape the perceptions of others as to their interests.[83] Regulation that takes this approach may require a majority of independent directors on the assumption that this will assist in driving an independent agenda. For decision-making bodies, other elements that may flow from a power analysis include requiring that the chair be independent, mandating separate meetings of independent decision-makers to promote cohesion and coordination and allowing independent persons to contribute to the agenda.[84]

2.2.4 Structural barriers

The final way that independence can be regulated is by conceiving and mandating specific structural barriers that identify and prohibit connections thought to threaten or be inconsistent with independence. This option provides a measurable way of defining and regulating independence. It is theoretically possible to consider the context within which a person operates and identify the persons or relationships that might threaten their objectivity. For example, a close connection between a judge and a litigant may undermine that judge's ability to exercise impartial judgment. Furthermore, as noted earlier, this approach to regulation has a distinct advantage if the motivation for the independence initiative is to demonstrate governance legitimacy to a stakeholder audience. As it is amenable to (relatively) straightforward assessment, it provides a shorthand way of asserting that independence has been embraced.

2.2.5 Two 'stings in the tail'

There are, however, two stings in the tail if excessive reliance is placed on this approach. That is, first, the identification of a comprehensive and appropriate list of threatening relationships is difficult. It is likely that such a list would need to include a range of both soft (social) and hard (contractual) relationships but, while the hard ones may be easy to capture, the soft ones are less so. Should it extend to beyond immediate family to more distant connections? Is the 'old school tie' capable of exerting influence? Does a commitment to a common charity undermine objectivity? Each of the decisions on these points attempts to conflate a matter of infinite human variety into a bright line test.

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[80] JD Cox, 'Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel' (2003) 48 *Villanova Law Review* 1077.
[81] Steven Lukes, *Power: A Radical View* (Palgrave Macmillan, 2nd ed, 2005).
[82] Ibid 17.
[83] Ibid 38-40.
[84] See, for example, each of these features in the *ASX Guidelines*.

The second sting is provided by the fact that while the list may theoretically ensure independence is adequate at the commencement of the appointment, it may place the independent party into a threatening relationship from the moment of appointment. For example, in the listed company sector the regulatory regime provides that those formally appointed as independent may not have had a recent appointment (within past three years) as senior management for the relevant corporation. This cooling off period is intended to ensure that directors are not too close to those they will have to monitor. While the director may well be a cleanskin from that perspective, they then commence their role owing their position to the CEO and from that point having to work cooperatively with the CEO and other senior managers.

Despite these drawbacks, identifying and mandating structural barriers is a common way to regulate for independence and is characterised by an identification of problematic connections. This is then followed by a requirement for some ongoing assessment, and usually periodic declaration, of the existence and nature of any compromising relationships.

2.2.6 Regulating for Independence

While the four approaches to regulating for independence discussed above may exist in isolation, it is more likely that there be some attempt to regulate using more than one approach. It is arguable that the most critical of the four is capacity, as if a person has the capacity to act independently any gaps and flaws in the regulation will fall away. The following table indicates the kinds of regulation that might be considered in order to deliver meaningful independence.

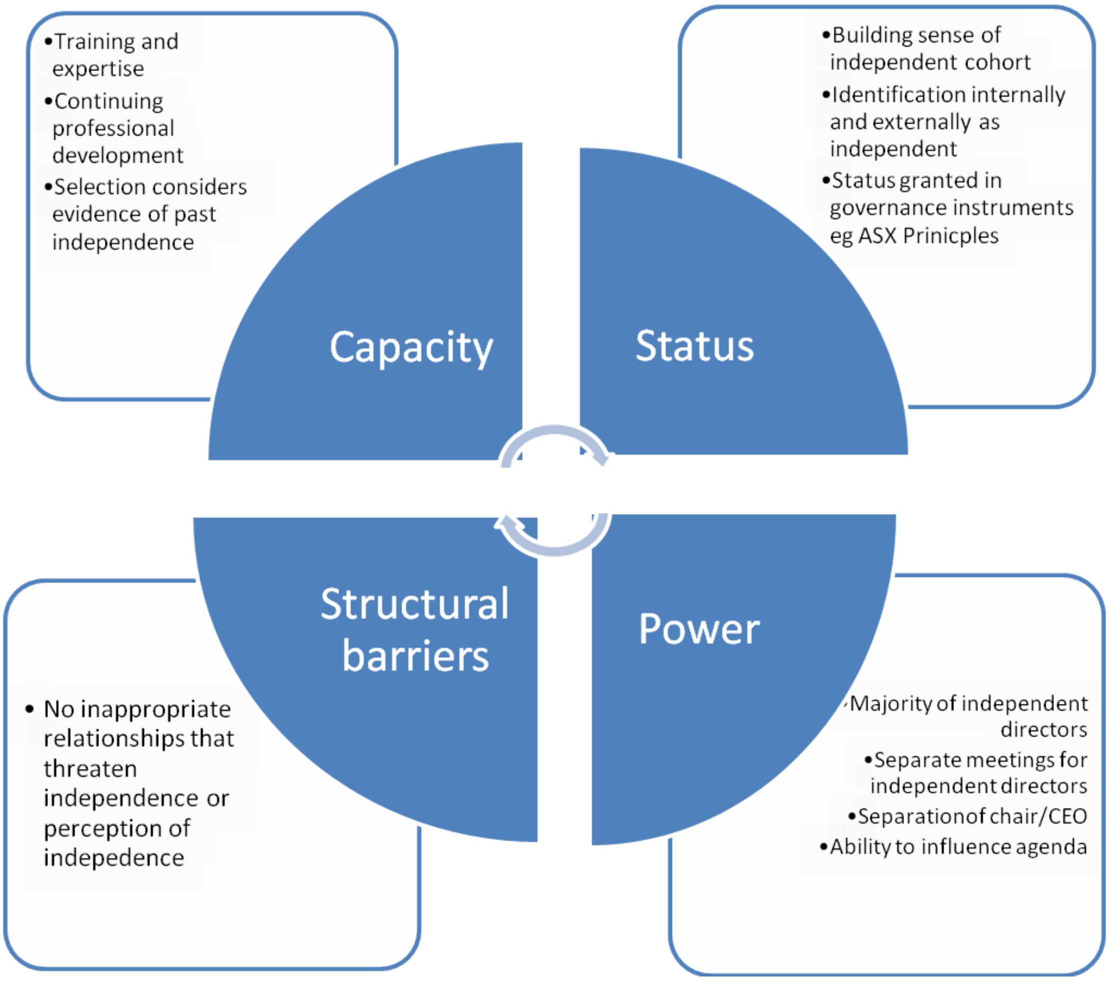

Figure 1: Regulating Independence[85]

In the diagram independence is represented as having four quadrants. Radiating outwards from each are the associated regulatory techniques that could address each approach.

Whilst this provides an overview of approaches to independence and ways it might be achieved it also makes a case for considering independence in context, with reference to its aims. The next section will turn to the superannuation context and consider the ways independence has been and could be operationalised.

3 Independence in the current regulatory regime

The *Superannuation Industry (Supervision) Act 1993 (Cth)* ('*SIS Act*') is the centrepiece of the regulatory regime shaping the superannuation system. It primarily regulates the structure and conduct of the trustees of superannuation funds other than self-managed superannuation funds ('SMSFs').[86] The *SIS Act* is formally buttressed by Regulations[87] and by a set of Prudential Standards[88] determined by APRA which are formally designated as legislative instruments. Both the Regulations and the Prudential Standards are intended to support APRA's prudential supervision of entities in the sector. Importantly, this complex legislative regime relies on, and hence presupposes, the existence of a variety of privately negotiated arrangements, including a trust instrument (usually a deed) and a variety of contracts appointing agents to assist the trustee in the administration of the trusts that together comprise the superannuation fund. This multiplicity of legal sources is a deliberate design feature of the overall regulatory regime.[89] Indeed section 350 of the *SIS Act* expressly preserves the law of all States or Territories (which would include the general law related to trusts) to the extent that those laws are capable of operating concurrently with it. Consistent with this, most superannuation fund trust deeds expressly (albeit redundantly) recognise the existence and pre-eminence of the legislative regime in clauses that subject the terms of the arrangement (whether deed or contract) to any relevant legislation. The different sources of law therefore not only co-exist, they are specifically designed to be complementary and together constitute the regulatory regime that shapes the institutions and interactions that make up the superannuation system.[90]

3.1 The legislative framework

The formal legislative framework is a sensible starting point from which to work. The *SIS Act* contains a definition of the term 'independent director'. Section 10 defines an independent director of a corporate trustee of a fund as a director who:

(a) is not a member of the fund; and

85 This diagram is drawn from Le Mire and Gilligan, above n 73, 459.

86 A self-managed superannuation fund is a fund with fewer than five members in which the members act either as the trustees of the fund or as directors of a corporation acting as trustee of the fund: section 17A *SIS Act*. For a description of this increasingly common phenomenon see Josephine Castillo, 'The SMSF trustee-members' (2012) 40 *Australian Business Law Review* 177.

87 *Superannuation Industry (Supervision) Regulations 1994* (Cth), ('*Regulations*').

88 Pursuant to Part 3A, *SIS Act*.

89 Donald, above n 69; Daniel Mendoza-Jones, 'Superannuation trustees: Governance, best interests, conflicts of interest and the proposed reforms' (2012) 30 *Company and Securities Law Journal* 297.

90 Donald, above n 69, 156-162.

(b) is neither an employer-sponsor of the fund nor an associate of such an employer-sponsor; and
(c) is neither an employee of an employer-sponsor of the fund nor an employee of an associate of such an employer-sponsor; and
(d) is not, in any capacity, a representative of a trade union, or other organisation, representing the interests of one or more members of the fund; and
(e) is not, in any capacity, a representative of an organisation representing the interests of one or more employer-sponsors of the fund.[91]

These definitions have application in Part 9 of the *SIS Act.* That Part contains the rules that provide for the 'equal representation' model of governance for employer-sponsored superannuation funds. Under those rules, a fund can have an independent director if there are an equal number of directors designated as employer-appointed and member-appointed.[92] There is no requirement that there be an independent director. There is also no provision for more than one independent director to be appointed. With one minor exception, the notion of independence is not applied elsewhere in the *SIS Act* and the *SIS Regulations*.[93] More importantly, however, Part 9 does not apply to funds that are not employer-sponsored, such as the 'retail' funds offered by financial institutions to the public.[94]

As a preliminary point, the use of legislation represents an initial departure from the approach adopted in the listed company sector. As discussed earlier the listed company regulation of independence is contained in a 'soft law' instrument.[95] Generated by the ASX Corporate Governance Council, the ASX Principles fall into the category of self-regulation in that they are developed by a coalition of industry representatives but implemented with state sanction. The Australian Securities Exchange Listing Rules place a stock exchange requirement on listed companies to comply with the principles or explain their non-compliance.[96] Accordingly the company can decide not to comply with the independence recommendations and simply explain their non-compliance. A further discretion is afforded to listed company boards in that they can, despite a director not meeting the independence definition, resolve that that director is in fact independent and explain why this is the case.[97]

These 'soft' approaches to independence regulation can be contrasted with those adopted through the *SIS Act*. There the definition is mandatory. Those funds that wish to claim an independent director must meet the definition in section 10. One curious aspect of the current legislative regime

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91 An analogous definition applies to individuals acting as trustees in the small number of APRA-regulated funds that do not have a corporate trustee. For simplicity the discussion below is expressed purely in terms of the overwhelmingly common corporate trusteeship.

92 Section 89(2), *SIS Act*. Section 91, *SIS Act* specifies the circumstances in which funds for which there are multiple employer sponsors can establish policy committees with the same equal representation structure required of standard employer sponsored funds.

93 Section 108, *SIS Act* regulates the removal of independent directors and trustees, and is buttressed by Regulation 4.07, *SIS Regulations* which prescribes an additional set of circumstances in which an independent director or trustee can be removed from office.

94 'Retail' funds are one of the four main types of APRA-regulated funds identified in APRA, *Classification of superannuation entities* (May 2005). The others are public sector funds, industry funds and corporate funds, which collectively are most frequently described as 'not-for-profit' funds.

95 *ASX Principles*.

96 ASX Listing Rule 4.10.3 and ASX Principles, 3 (describing the regime as taking an 'if not, why not' approach).

97 *ASX Principles*, Recommendation 2.3(b).

is, however, the absence of legislative requirements that there be independent directors. As noted earlier the inclusion of one independent director on equal representation funds is permitted under section 89(2) and APRA chimes in to indicate that chairs of the fund can also chair remuneration and audit committees if they meet the independent definition. Funds can apply to APRA to increase the numbers of independent directors.[98] Independence in the *SIS Act* therefore seems to be something of a stalking horse: mandatory in expression but tentative in effect.

It is also notable that the definition draws heavily on structural conceptions of independence. The definition lists connections that are inconsistent with independence. It makes no mention of capacity and does not deliver significant power to independent directors. In the listed company sector the primary regulatory technique is also a structural one with the ASX Principles identifying and listing problematic connections.[99] However there is greater attention paid to capacity in that the ASX Principles require attention be paid to a 'director's capacity to bring an independent judgement to bear on issues before the board'.[100] Further support for the capacity approach has been introduced in the most recent edition of the ASX Principles in its recommendation that all companies develop and disclose a 'skills matrix'. This attempt to increase the attention paid to expertise seems to be driving a desire that the capacity and skills of independent directors be improved. The recommendations around the nomination process involving independent nomination committee also seem to be enhancing the Principles' focus on capacity. Further the issue of power is addressed through the recommendations that all boards have a majority of independent directors, that the chair should be independent as well as the careful placement of independent directors on key committees.[101] The status element is present as the ability to label a director as 'independent' is common to both regimes.

The nature of the *SIS Act* definition of independence appears to see the threats to independence differently from those identified in the listed company sector. It mandates distance from employer-sponsors and bodies, such as trade unions, that represent members. To be independent an individual may not be the employer sponsor or an associate or employee of an employer sponsor. Similarly the person may not be 'in any capacity, a representative of a trade union, or other organization, representing the interests of one or more members of the fund'.[102] As stated in the Explanatory Memorandum associated with the *Bill*:

> the current definition of "independent director" under the SIS Act is designed to achieve independence from stakeholders (i.e. employers and members and their representative organisations) rather than independence from management, service providers and advisers.[103]

98 APRA, *Superannuation Circular No. III.A.2* (2000) 61.
99 *ASX Principles* Box 2.3.
100 Ibid.
101 *ASX Principles*, Recommendations 2.4, 2.5, 2.1, 4.1 and 8.1.
102 Section 10, *SIS Act*.
103 Parliament of Australia, *Explanatory Memorandum: Superannuation Legislation Amendment (Trustee Governance) Bill 2015*.

The *SIS Act* definition makes no mention of previous roles as an executive with the fund, or relationships with customers or suppliers. Both these aspects feature in the listed company definition.[104]

The definition also precludes membership of the fund.[105] This suggests financially aligning directors with the interests of the members would compromise independence. By contrast the listed company definition only steps in once the director's shareholding is 'substantial'.[106] Even this requirement has been subject to critique on the basis that 'it is hard to justify continuing to view an SSA [substantial shareholder affiliated] director whose affiliation is not with a controlling shareholder as non-independent'.[107] Hanrahan and Bednall argue that having a director with 'skin in the game' who is independent of management is likely to advance the interests of members.[108]

The analysis of independence for superannuation funds as crafted in the *SIS Act* reveals a particular version of independence that is strongly focused on perceptions of legitimacy. There is little reason to expect that its implementation would change the quality of decision-making due to the lack of power granted to the independent director and the very limited focus on capacity. The single independent director who may be appointed can only be expected to add another voice and perhaps a cleaner process for deliberation should they operate as chair of the board and committees. However the labelling of directors as independent, the identification of some of the more obvious threats to independence and the mandatory nature of the definition all appear to signal legitimacy to a wider audience.

APRA's Prudential Standards currently rely on the notion of independence only sparingly. *SPS-510: Governance* provides that the Chairperson of the Board can only Chair the Remuneration or Audit Committees of the Board if he or she is independent within the definition in section 10 of the *SIS Act*.[109] However it seems quite likely that even if the *Bill* is not passed, standards related to independence will feature more prominently in *SPS-510* in the not-too-distant future. Indeed APRA has indicated that it will re-issue *SPS-510* at some point in 2016, irrespective of whether and in what form the *Bill* is ultimately passed.[110]

In addition to these specific rules relating to independence, each super fund trustee is required by the *SIS Act* to hold an RSE Licence issued by APRA. One of the requirements of such a licence is that that the licensee assess whether the individuals involved in key positions, which would include the directors of the trustee board, are 'fit and proper' to hold those positions.[111] An assessment of whether an individual is fit and proper necessarily includes assessing whether their taking on the duties of the position would give rise to a conflict of interests and/or duties.

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104 ASX Principles Box 2.3.

105 Section 10, *SIS Act*.

106 *ASX Principles* Box 2.3. Substantial is defined as a 5% or greater shareholding: *Corporations Act* s 9.

107 Pamela Hanrahan and Tim Bednall, 'Independence Of Directors Affiliated with Substantial Shareholders: Issues of Law and Corporate Governance' (2015) 33 *Company & Securities Law Journal* 239, 254.

108 Ibid.

109 APRA, *Prudential Standard SPS-510: Governance*, (November 2012).

110 See letter to all RSE licensees from APRA Deputy Chair Helen Rowell. Accessed at http://www.apra.gov.au/Super/Documents/Letter%20to%20RSE%20licensees-Governance%20arrangements-Outcomes%20of%20consultation-December-2015.pdf on 17 January 2016.

111 Part 2A, *SIS Act*.

Finally, in addition to these rules designed to impose limited 'structural' independence on superannuation fund boards, the *SIS Act* embeds a covenant requiring de facto, or 'cognitive,' independence on the part of the key decision makers into the governing rules of each fund. Specifically, the covenant imposed by section 52A(2)(d) provides that:

> where there is a conflict between the duties of the director to the beneficiaries, or the interests of the beneficiaries, and the duties of the director to any other person or the interests of the director, the corporate trustee or an associate of the director or corporate trustee:
>
> (i) to give priority to the duties to and interests of the beneficiaries over the duties to and interests of other persons; and
>
> (ii) to ensure that the duties to the beneficiaries are met despite the conflict; and
>
> (iii) to ensure that the interests of the beneficiaries are not adversely affected by the conflict; and
>
> (iv) to comply with the prudential standards in relation to conflicts'

Unusually for a regulatory provision, section 52A(2)(iv) does not create a statutory duty *per se*.[112] Rather it indelibly inscribes the duty, which is substantively similar (though not identical) to that which would otherwise pertain at general law, into the governing rules of the fund. The purpose of this covenant is therefore to thwart any attempt by the trust deed to circumscribe the operation of the general law prohibitions on conflicts of interest and duty. It aims to hold the directors accountable for any departures from the exacting standard of loyalty expected of someone in a fiduciary position. From a certain perspective, then, the legislative measures described above which were designed to impose structural independence on superannuation fund boards are an adjunct to this more basic, fiduciary proscription, for if the fiduciary proscription was fully effective in practice (and was recognised to be so), then the measures imposing structural independence would be unnecessary.

3.2 The 'Self-regulatory' framework

A number of membership associations operate in the superannuation system. Each seeks to influence their members in respect of governance matters, though only one, the Financial Services Council, seeks directly to regulate member conduct. It is also the only association to impose any rules in relation to director independence.

3.2.1 Financial Services Council ('FSC')

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and Public Trustees. Many of its superannuation fund members would be outside the ambit of Part 9 of the *SIS Act*. The FSC's Standard with respect to governance has two main strands.[113] The first is a series of rules concerning the make-up of the Board. The Standard requires that the Chair of the board of a trustee company must be independent, that the Board must comprise a majority of independent directors and that Board meetings require a majority of independent directors to be quorate. Independence is defined to exclude current (or recent) employees of the trustee company, any related companies, or any material professional providers. Perhaps surprisingly for a membership organisation, failure

112 See Donald, above n 69.

113 Financial Services Council, *FSC Standard No. 20: Superannuation Governance Policy* (March 2013).

to comply with a Standard by an FSC member can lead to public or private censuring of the member concerned, suspension from membership, or, in extreme cases, even expulsion from membership.

The FSC has adopted a definition of independence that more closely parallels that used in the ASX Principles.[114] This perhaps reflects that the FSC's constituency of retail funds tend to sit comfortably with the listed company model. Clearly part of the aim of this regulation is to demonstrate the quality and integrity of decision-making within retail funds. The adoption of sanctions for members that fail to meet the standards indicates the level of commitment to this aim. However the more nuanced regulation of independence also appears to indicate a desire to improve the quality of decision-making. Notably the requirement that the board have a majority of independent directors and be chaired by an independent director[115] seems to adopt a power perspective. The question of capacity is addressed in a less definitive manner. The Standard includes a 'Model Governance Statement for a Relevant Licensee' and this can be adopted and adapted to suit the needs of the licensee.[116] It provides that

> The Board has formed the view for the reporting period that there are no relationships/none of the relationships could reasonably be perceived to materially interfere with the director's ability to act in the best interests of the relevant RSE's beneficiaries.[117]

While this makes a gesture towards a consideration of the characteristics of the particular director its placement outside the main document and tentative expression suggests that capacity is not a regulatory priority for the FSC.

3.2.2 The Australian Institute of Superannuation Trustees ('AIST')

AIST is an advocacy body representing trustee directors and staff involved in the not-for-profit sector. AIST does not impose specific governance rules on its membership. It does however publish guidelines for members including *A Fund Governance Framework for Not-for-Profit Superannuation Funds.*[118] This document has some focus on the capacity of the trustee director. It notes that trustee directors have a duty to exercise independent judgement[119], and places a responsibility on directors, 'irrespective of who nominates … to exercise a high degree of 'independence of mind' when discharging their duties as directors'.[120] No attempt is made to identify or preclude any relationships that might compromise independence. AIST and Industry Funds Australia have recently commissioned a formal Review of the governance arrangements of not-for-profit superannuation funds with a view to developing a best practice Governance Code for its members.[121]

3.2.3 The Association of Superannuation Funds of Australia ('ASFA')

ASFA describes itself as the peak policy, research and advocacy body for Australia's superannuation (super) industry. It has both individual and corporate members drawn from all industry sectors.

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114 Ibid 10-1.
115 Ibid 4.
116 Ibid 22.
117 Ibid 23.
118 AIST, *A Fund Governance Framework for Not-for-Profit Superannuation Funds* (3rd ed, April 2014).
119 Ibid 7.
120 Ibid 8.
121 See Media Release dated 18 December 2015 accessed at https://www.aist.asn.au/media/15591/The%20Fraser%20Governance%20Review%20Announcement%20181215.pdf on 17 January 2016.

ASFA also does not impose specific governance rules on its membership. It does however publish Best Practice papers that capture and express the organisation's view of what is expected of trustees. None of these are enforceable on members by ASFA, a position that in part reflects ASFA's position as a policy, research and advocacy body rather than a standards-making body.

ASFA has not adopted a definition of independence. Its *Policy Principles* do consider fund governance but are largely concerned with maintaining fund discretion as to their governance arrangements. So the Principles state:

> ASFA believes that in order to achieve effective governance of superannuation funds by trustees the following are required:
> - a strong framework for effective governance (including removal of any impediments to effective governance);
> - trustees have the skills and competencies to discharge their fiduciary duty; and
> - the Regulators must be able to properly supervise the system.
>
> Once these three elements are present, there is no need for an overly prescriptive approach and superannuation fund trustees should be left free to exercise their fiduciary duties under trust law to act in the best interest of their fund's members.[122]

The retention of discretion as to governance arrangements is not unheard of in the listed company sector. The 'comply or explain' approach in the ASX Principles also retains scope for boards to choose their own regime.[123] The distinctions are, however, twofold. First, the ASX Principles directs board attention to specific issues that the Council has resolved are significant for good governance and, second, the compulsion placed on listed companies to explain their choices enhances their accountability and transparency to stakeholders. The more austere ASFA approach may focus board attention on the general quality of decision-making but does little to enhance stakeholder perceptions of the legitimacy of the system.

3.3 Private ordering

Despite the legislative and other incursions described above, the actual governance structure of each superannuation fund depends on two key sources: the governing rules expressed in the trust instrument and the constitution of the corporation acting as trustee.

Donald[124] identifies that the APRA-regulated funds that are the subject of this paper can be loosely classified into a taxonomy containing four main operating models:

1. Multi-employer Not-for-profit DC funds ('not for profit funds');
2. Retail DC funds ('retail funds');
3. Wholesale master DC funds ('master funds'); and
4. Single employer hybrid DB/DC funds ('hybrid funds').[125]

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[122] ASFA, *ASFA Policy Principles* (September 2010) 13.

[123] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations* (3rd ed, 2014), 3.

[124] M Scott Donald, 'A Servant of Two Masters? Conflicts of duty in the superannuation fund context' (2016) *CLMR Working Paper* 16-2. This classification re-organises APRA's four-way classification to reflect the development and evolution of the institution of the superannuation fund over the past decade; APRA, *Classification of superannuation entities* (May 2005).

[125] Note many of these are operated on what is taken to be a 'not-for-profit' basis and hence they are typically grouped with the other funds attracting that description. However the governance challenges

The relevance of this observation for present purposes is that the governance structure most common within each of the operating models faces different challenges with respect to the cognitive independence of board members. Unlike the more familiar listed corporate environment in which the primary axis of dependence against which structural independence measures are directed is common (ie management), in the superannuation environment the point of origin of the threat to cognitive independence will depend on the operating model followed by the fund. Member interests may come into conflict with those of the union or employer groups represented on the boards of not-for-profit funds, by the interests of the parent financial institution in a retail or master fund, or the interests of the employer in a hybrid fund. This complicates the task of identifying a single set of structural independence measures that can apply universally, but still relevantly and appropriately, to all funds present in the system. Any single legislative measure intended to quarantine board decision-making from distraction from these conflicting interests must necessarily accommodate that diversity.

Any such legislative measure must also recognise, and be effective notwithstanding, the considerable diversity of nomination processes present across different funds. Direct member elections are rare. Rather, most directors on superannuation fund boards are nominated by an external body; often a union or employer group in the case of not-for-profit funds, the parent financial group in the case of retail and master funds, or the employer in a hybrid fund. However in a minority of cases individual directors, or even groups of directors, may be appointed as a result of a collective decision taken by a multiplicity of external bodies. Independent directors on the other hand are typically appointed by the board itself, or, in the case of retail and hybrid funds, the parent financial group or employer sponsor respectively. Further complexity arises because some of these nomination processes are specifically embedded in the trust instrument, some are embedded in the constitution of the corporate trustee and some occur pursuant to a written policy of the trustee company. Different funds also have different sub-committees, whose purpose, formal powers and composition can vary.

This diversity poses a challenge for legislators and regulators but ought also to be recognised as a predictable outcome of a system design which is 'government sponsored but privately managed.'[126] It represents a dynamic organic response; a form of regulatory dialectic in which institutions seek actively and recursively to behave and organise themselves in light of the regulatory and competitive environment in which they find themselves. It means that simple 'command and control' modes of regulation are likely to fail, and that more sophisticated, multi-valent regulatory regimes, employing multiple modes and layers of regulation working together, will be required.

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they face are distinct from those confronting the trustees of purely DC plans, and in any case the financial impact of the funding liability on the employer sponsor does represent a form of 'profit' objective, albeit different from the objective animating the providers of retail funds.

126 Coates and Vidler, above n 54, 12.

4 Imposing structural independence on superannuation fund governance

The memetic quality of the concept of independence means that its arrival in the domain of superannuation fund governance should be no surprise. Like all memes, however, it acquires new content and significance in its new application. It 'evolves'. Some of this has already been encountered above: the definition of independence in the *SIS Act*[127] for instance is a bespoke application of the concept, tailored to the specific role it plays in the provisions of the Act in which it appears.

The government's intention, manifested in the *Bill,* to employ independence more actively in the superannuation context represents a further 'evolution'. However unlike modes of meme-propagation in which the evolution occurs organically from popular usage, in this case the government is attempting to act strategically, forcibly redefining the content of the concept of independence in this context by proposing a bespoke definition of independence in the *Bill*. In so doing, it is attempting to harness the widespread support for independence as a virtue in support of a highly tailored, policy-driven version of the concept.

Of course the government's plans are not without precedent. In 2010 the *Review into the Governance, Efficiency, Structure and Operation of the Superannuation System*[128] recommended that the boards of superannuation funds contain at least one-third 'non-associated' directors if following an equal representation model and a majority if not.[129] Non-associated directors were to be:

> 'free of connections to, or associations with, employer sponsors, the appointor (other than by reason of the appointment itself), entities related to the trustee, employer groups, unions, service providers and should not be current or former executives of the fund or a related entity.'[130]

It was a wide definition, tailored to the circumstances and chosen to avoid confusion with the term 'independent director' already employed in the *SIS Act*. Indeed it was so wide that there were doubts how many suitably qualified individuals would qualify as 'non-associated' in practice. In fairness, the recommendation was partly inspired by a lack of alternative models. The Review needed a constructive alternative to a model of fund governance (the equal representation model) that it found had become increasingly dysfunctional. In particular, it found that entrenched directors and nominating bodies had become a constraint on both talent acquisition by boards and on fund consolidation. A tailored form of independent directors was a pragmatic response that was seen to have a foundation in governance practice and theory.

The recommendation was one of the few that the government of the day did not accept.[131] However the Financial System Inquiry ('FSI') returned to the issue in 2014, recommending that superannuation fund boards be required to have a majority of independent directors and an independent Chair.[132] The FSI's rationale for the reform was that:

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127 Section 10, *SIS Act*.

128 For details see www.supersystemreview.gov.au.

129 Super System Review, *Final Report - Part One: Overview and Recommendations*, (July 2010), Recommendations 2.6 and 2.7.

130 Super System Review, *Final Report - Part Two: Recommendation Packages*, (July 2010), 55.

131 Commonwealth of Australia, *Stronger Super*, (2010); Accessed at www.strongersuper.treasury.gov.au/content/Content.aspx?doc=publications.htm on 9 February 2016.

132 Financial System Inquiry, *Final Report* (November 2014), Recommendation 13.

> 'Including independent directors on boards is consistent with international best practice on corporate governance. Independent directors improve decision making by bringing an objective perspective to issues the board considers. They also hold other directors accountable for their conduct, particularly in relation to conflicts of interest.'[133]

The FSI also noted that:

> 'Although there is little empirical evidence about the relationship between quality of governance in Australian superannuation funds and their performance, high-quality governance is essential to organisational performance.'[134]

It concluded that

> '[g]iven the diversity of fund membership, it is more important for directors to be independent, skilled and accountable than representative.'[135]

The *Bill*, then, represents an amalgam of these recommendations: a tailored definition of independence and a minimum of one third independents, with an 'if not, why not?' disclosure regime for those boards with less than a majority of independent directors.

The articulated aim of the *Bill* is to transition superannuation funds from an equal representation model to 'best practice in corporate governance'.[136] In support of this change the government claims that the reform will

> '[enable] boards to benefit from a diversity of views and providing a check on management recommendations'.[137]

The changes are also supported by a desire to increase the diversity of boards and manage conflicts of interest.[138] As such the Bill appears to be crafted with a view to addressing both legitimacy and decision-making quality concerns. There also appears to be widespread belief that the reforms will permit funds to attract new, more expert individuals to serve on their boards, which would further enhance decision-making. However there is nothing in the current drafting that expressly requires or encourages this development and for the moment this remains simply an example of the way in which the government's use of a memetic concept allows it to harness the enthusiasm people have for it, without clarifying that its use of the term does not connote all that some audiences might assume.

The *Bill* has two main aspects. The first creates a requirement for all APRA-regulated funds to have at least one third independent directors, with one of those acting as Chair.[139] Further, the proposed amendments seek to re-define independence.[140]

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133 Ibid 134.

134 Ibid 133. Notably they went on to cite the work of Ambachtscheer described in fn 13 above.

135 Ibid 135.

136 Parliament of Australia, *Explanatory Memorandum: Superannuation Legislation Amendment (Trustee Governance) Bill 2015,* 1.14.

137 Ibid 1.10.

138 Ibid 1.11-2.

139 *Superannuation Legislation Amendment (Trustee Governance) Bill 2015*, Schedule 1, Part 1, item 1, paragraphs 86(1)(a) and (b).

140 *Superannuation Legislation Amendment (Trustee Governance) Bill 2015*, Schedule 1, Part 1, item 1, paragraph 87. The Bill also sets up a process where funds can apply to APRA for a declaration that a

Self-evidently, then, the *Bill* relies heavily on structural conceptions of independence. The definition in the *Bill* of the circumstances in which an individual will be deemed not to be 'independent' depends on whether or not the director, in addition to his or her role as director, plays one or more specified roles in a party external to the trustee and as a result owes potentially conflicting duties to that party. The relationships are specifically tailored to the various operating models of the superannuation fund. So for instance a director or executive officer of the employer-sponsor, nominating trade union or employer organisation, or a related company of the RSE Licensee would not be regarded as independent. Nor would a director or executive officer of a service provider to the RSE Licensee, or an employee of a service provider who was directly involved in the provision of the service.

This approach is quite distinct from the Exposure Draft of the *Bill*, in which the definition of independence relied on the absence of any material distracting influence. Critics of the more open textured approach taken in the Exposure Draft were concerned that it was too vulnerable to self-assessment. On the other hand, the Exposure Draft did regulate for cognitive independence more directly than does the test present in the *Bill*. For instance the definition in the *Bill* ignores the possibility of those external parties relieving the individual of their duty by informed consent or by subsequent ratification, an opportunity which exists in the general law in relation to the avoidance of conflicts.

The *Bill* also takes account of the power conception of independence by allowing for the creation of three coalitions in employer-sponsored funds.[141] This potentially creates a 'balance of power' position for the independents where they could mediate between the member and employer representatives. This attempts to replicate the listed company approach in that it uses the number of independents to counterbalance the threat to independent decision-making. In the listed sector the threat is assumed to come from management, suggesting outnumbering them with a majority is the answer, and in the superannuation sector, it is assumed to come from those put forward by the employer-sponsors or member representatives. Whether the requirement to have a third of the board as independent would actually play out in similar ways is as yet unknown.

Crucially however the *Bill* does not harness the central conception of independence: capacity. Although the attraction of greater expertise to superannuation boards is commonly advanced as a benefit of the reform, there is nothing in the new rules that requires or even promotes that end beyond creating the potential for new members to be invited to join a newly constituted board as an independent. No attention is given to the nomination or selection process, thus opening the possibility that capacity will not be a focus for appointment. As for the status conception, a very limited approach has been taken. The definition and labelling of persons as independent is a gesture towards signalling status. There is, however, no supporting regulation that gives that status some

particular person is independent; *Superannuation Legislation Amendment (Trustee Governance) Bill 2015* Schedule 1, Part 1, item 1, paragraphs 88 and 90.

141 Notably the removal of the equal representation rules means that the non-independent directors need no longer be arrayed in equal employee/employer numbers. Whether practical means exist whereby a fund could move to a different arrangement will depend crucially on the way the governing rules are framed. It does seem however that the RSE Licensees of master trusts will be able to abolish the equal representation advisory committees required under Part 9 of the *SIS Act*, albeit there may be contractual and disclosure issues determining the pace at which this could happen in individual cases.

content. The listed company approach of recommending separate meetings and describing the role of these directors has not been adopted.

Concluding Remarks

The government has expressed an intention to impose a degree of structural independence on the boards of all APRA-regulated superannuation funds. The analysis in Part 1 of this Paper reviewing the research literature relating to superannuation fund governance provides little support for the substance of that policy. There simply is little empirical evidence that governance reforms of the type anticipated in the *Bill* have delivered measurable improvements in the investment performance of pension funds in other countries. The absence of evidence (in either direction) however ought not be seen as fatal. Independence theory offers a rich set of potential advantages of independence from which the government drew only sparingly when promoting the *Superannuation Legislation Amendment (Trustee Governance) Bill 2015*. There is therefore an opportunity for the government to fashion a more sophisticated, nuanced and ultimately more compelling narrative justifying the imposition of structural independence on superannuation fund boards than it has in the past. The discussion in Part 2 highlights that independence can make a positive contribution not just in potentially enhancing decision processes (as hard as that may be to measure) but also in enhancing stakeholders' perceptions of the legitimacy of a system in which they are forced to participate but in which they may feel under-prepared or disempowered.

The analysis in Parts 2 and 3 also introduced the potential for the government and its regulators to harness a wider variety of regulatory techniques to achieve what we take to be their underlying policy objective of entrenching cognitive independence. These are outlined and described in more detail in the second part of the research resulting from this Grant. The techniques include attention to the remuneration and nomination process for directors, to policies on tenure and removal of directors, and to the formal and informal powers possessed by APRA. Each of the techniques has its strengths and shortcomings. It does seem however that the most robust means of justifying any new measure in relation to independence ought first to identify clearly the mix and relative importance of the different attributes of independence; enhanced decision-making and legitimacy in particular, before moving to identifying the mode of regulation most likely to promote achievement of that balanced objective.

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