# 5 Governance and transparency

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| Key points |
| * Default superannuation arrangements are subject to significant principal–agent relationships. Good governance arrangements are therefore critical to ensure the security of monies held in the form of superannuation, and to ensure superannuation funds operate in the best interests of members. * The Cooper Review found no significant evidence of systemic trustee governance failure, but found a number of areas in which governance arrangements needed to be improved. Conflicts of interest, and conflicts of duty, were seen as commonplace. * In response, as part of Stronger Super, the Australian Government is introducing a number of reforms including: new duties for trustees; stronger requirements with regard to conflicts of interest; increases in the standard of care, skill and diligence required of trustees; and an expansion of the covenants for which trustees must have regard. * Submissions to this inquiry supported the need to consider governance arrangements in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards, though there were different views about what constitutes good governance. * Considering that many of the Stronger Super reforms relating to governance have only recently been announced, and given the broad nature of these reforms, the Commission is not persuaded that additional prescriptive criteria are warranted. * The Commission considers, however, that governance practices — particularly the mechanisms put in place by fund trustees to deal with conflicts of interest — should be taken into account in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. |
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This chapter discusses the scope for additional criteria relating to governance and transparency to be applied in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. It begins with a discussion of the importance of having good governance arrangements in place. It then analyses, in the context of the Stronger Super reforms, the case for additional criteria relating to the key governance and transparency issues identified by inquiry participants.

## 5.1 The importance of good governance

In a system of compulsory superannuation — where people are unable to opt out of investing — it is especially important to ensure the security of monies held, and that the interests of fund members are paramount. Good governance arrangements are critical in this regard. The Cooper Review highlighted the importance of good governance in the context of compulsory superannuation:

It is sometimes overlooked that the superannuation industry is quite different from other businesses. It owes its existence to government policy and is underpinned by a social purpose that runs alongside many other economic and stakeholder considerations. Recognising this special purpose, the Panel believes that all those involved in the system need to have — and be seen to have — high standards of governance. In superannuation, just as in other areas of corporate activity, good governance plays a major role in promoting better decisions, greater accountability and in reducing unintended operational and investment risks. (Australian Government 2010b, p. 44)

Participants have similarly referred to the importance of good governance. The Australian Institute of Superannuation Trustees (AIST) said:

The links between improved governance and higher performance is well documented and we expect that with the improved level of governance come improved returns. (sub. 20, p. 15)

The Industry Super Network (ISN) stated:

Analysis of superfund performance suggests that governance affects performance, but that the loyalties and perceived role of directors are the crucial factors. (sub. 27, p. 25)

Default superannuation arrangements are subject to significant principal–agent relationships (chapter 3). The role of governance arrangements is to limit the ability of agents to act in a manner contrary to the interests of the principals, to ensure the interests of principals override other interests, and to promote overall transparency and confidence in the compulsory superannuation system. Studies have suggested good governance arrangements can increase annual returns by between one and two percentage points (Ambachtsheer, Capelle and Lum 2006).

The term ‘governance’ relates to how authority is exercised and controlled within superannuation funds, and how accountability is maintained. Governance practices include:

* procedures for dealing with conflicts of interest or duty
* ensuring trustees exercise care, skill and diligence
* procedures regarding related party transactions
* accountability and reporting to members
* prudential and risk management procedures
* performance monitoring
* board tenure policies
* remuneration policies (including links to risk management)
* procedures to ensure fair treatment of members
* use of committees.

Until recently, regulatory arrangements for the superannuation industry were contained in the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act), regulations under the SIS Act, the *Corporations Act 2001* (Cwlth) and were also based on other licensing requirements for superannuation entities. There were also a number of non‑binding guidelines produced by the Australian Prudential Regulation Authority (APRA). The Cooper Review found that a lack of coordination between these regimes led to a range of governance problems.

## 5.2 The Government’s response to the Cooper Review’s governance recommendations

In response to the Cooper Review, the Australian Government has proceeded with a number of reforms in the area of governance, including:

* introducing a duty for trustees and directors to give priority to the interests of fund members when that duty conflicts with other duties
* strengthening the requirements on individual directors in relation to managing conflicts of interest
* increasing the standard of care, skill and diligence required of trustees and directors of corporate trustees to that of a ‘prudent superannuation trustee’
* clarifying the duties applying to individual directors of corporate trustees to act honestly and to exercise independent judgement
* introducing a requirement for trustees to devise and implement an insurance strategy, and imposing a statutory duty on trustees to manage insurance with the sole aim of benefiting members (chapter 6)
* expanding the covenants to which APRA-regulated fund trustees must have regard to include expected costs, expected taxation consequences, and the availability of valuation information (Australian Government 2011a).

The Government will also require superannuation funds to publish on their websites information including:

* details of asset holdings to be updated every six months (with up to a three month lag)
* details of director and executive remuneration
* a product dashboard as proposed by the Cooper Review, with information on target returns, past performance, investment risk, liquidity and fees (chapter 4) (Shorten 2012a, 2012d, 2012f).

Further, the Government has foreshadowed that regulations will require other documents to be published on fund websites. These documents include:

* performance information for the past ten years
* trust deeds
* annual reports, and other financial and actuarial reports
* names of outsourced providers
* names and biographies of directors, trustees and people involved in the trusteeship of funds
* details of board meeting attendance by directors
* the proxy voting policies and procedures of funds, and their voting behaviour (Shorten 2012a).

APRA has been given the power to draft binding prudential standards for the superannuation industry for the first time, and has provided the industry with a draft version of these standards.[[1]](#footnote-1) Where possible, APRA is seeking to align them with the prudential standards applying to other financial institutions subject to APRA oversight (in line with APRA’s objective for greater regulatory convergence).

The Government has also, through the Australian Securities and Investments Commission, developed a new, centralised superannuation website, www.moneysmart.gov.au.

Not all of the governance-related recommendations of the Cooper Review were adopted by the Government. For example, it rejected the recommendation to remove the mandatory requirements for trustee boards of employer‑sponsored funds to have equal representation between employer and employee representatives. Recommendations that boards be required to have a ‘critical mass’ of independent (or ‘non-associated’) trustee directors were also rejected (Australian Government 2010d). These issues are discussed further in section 5.3.

#### Future of Financial Advice reforms

The Government has also introduced new Future of Financial Advice (or FOFA) laws which are designed to improve governance arrangements and transparency in all fields of financial advice. The reforms include:

* bans on conflicted remuneration structures, including commissions and volume payments, in relation to the distribution and advice of retail investment products including managed investments, superannuation and margin loans
* bans on up-front and trailing commissions and like payments for both individual and group risk insurance within superannuation
* a ban on soft-dollar benefits (monetary and non-monetary benefits) received by financial planning firms, representatives and associates in relation to both retail investment products and insurance within superannuation, where a benefit is $300 or more
* requirements for advisers to request retail clients to opt in (or renew) their advice agreement every two years, with the Australian Securities and Investments Commission being given the power to exempt advisers from the opt-in obligation where it is satisfied that the adviser is signed up to a professional code which obviates the need for opt in
* the introduction of a best interests duty so that advisers must act in the best interests of their clients, subject to a ‘reasonable steps’ qualification, and place the best interests of their clients ahead of their own when providing personal advice to retail clients.

#### Industry initiatives

In addition to these government initiatives, other bodies have also moved to improve disclosure. For example, AIST has announced new disclosure guidelines for its not-for-profit member funds. Under these guidelines, information that funds will be expected to disclose includes:

* remuneration for trustees and key senior executives
* details of each director, including their names, experience, who appointed them and who they represent
* trustee attendance at board and committee meetings
* a listing of ‘material’ service providers
* proxy voting policies
* a list of fund assets updated every six months with a three month lag (AIST and IFF 2012, AIST pers. comm. 17 September 2012).

The Financial Services Council (FSC) (an industry association representing retail funds) has also drafted a new *Superannuation Governance Policy*, which has been released for industry consultation. Key elements include:

* requirements for the Chair and the majority of directors to be independent
* preclusions on directors holding multiple and conflicting board positions
* disclosure of environmental and social risk policies
* requirements to publish proxy voting records (FSC 2012).

A previous proposed requirement to disclose remuneration has been superseded by the Government’s requirements in this area.

### Scope for additional criteria relating to governance and transparency

The Commission is supportive of the direction of the governance reforms contained in the Stronger Super package, and is also conscious that the reforms have only recently been announced. Therefore the Commission does not see it as appropriate to place additional governance and transparency criteria on funds beyond those envisaged under Stronger Super. In some areas, however, the Commission considers further consideration is justified in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

## 5.3 Superannuation board governance

A number of participants raised issues relating to the structure and practices of boards. There were, however, diverse views regarding what constitutes best practice governance. For example, many participants expressed a preference for boards which comprised equal representation of employer and employee representatives (the ‘equal representation’ model) while others suggested that the presence of independent directors on boards would lead to better governance. Others saw issues relating to board structure as being relatively unimportant.

The equal representation model is required by the SIS Act for non-public offer employer-sponsored funds — that is, corporate funds and a significant proportion of industry funds — with allowance for one additional independent trustee or director who is unable to exercise a casting vote.[[2]](#footnote-2) APRA can also approve additional independent directors through a licence variation.

The Cooper Review put forward a number of reasons to consider moving away from the equal representation model.

* The introduction of fund choice, and a move away from defined benefit funds, reduces the close relationship between employers and superannuation funds.
* Many employer and employee representatives on boards are appointed by third parties rather than being elected by employers and members. As a consequence, the democratic principle that equal representation was meant to reflect is not always observed in reality.
* The potential for perceptions that individual trustee-directors are dictated to by the organisations that appointed them.
* The large number of employers, employer organisations and employee organisations related to a fund can sometimes lead to larger boards than would be ideal.
* Equal representation can leave some groups ‘unrepresented’, such as members who are pensioners and members who have joined the fund because they exercised fund choice.

In summary, the equal representation model was seen by the Cooper Review to impose rigidity on fund governance practices and reduce accountability, without ensuring the representation objective on which it was predicated.

Further, the Cooper Review saw best practice in corporate governance as involving the presence of independent directors. The Cooper Review therefore recommended that a minimum number of independent trustee-directors should be on the boards of all funds, representing a ‘critical mass’ to ensure board decisions could be genuinely influenced.

### Scope for additional criteria relating to superannuation board governance

#### Participants’ views

The Commission, in its 2001 Review of the SIS Act (and other legislation), supported equal representation on boards:

The equal representation rules for trustee boards of standard employer-sponsored funds provide balanced representation of employer and employee interests. They are conducive to active member interest in the prudent management of these funds. This benefit exceeds the cost of finding and appointing members who are capable of undertaking trustee duties. (PC 2001, p. 113)

The Industry Funds Forum highlighted the advantages of the equal representation model:

Industry funds developed the current governance structure, which applies to regulated superannuation funds. Industry funds have from virtually the beginning had equal representation and a two-thirds majority for decision-making. This representative governance structure helps ensure that member interests come first, at the same time allowing key stakeholders [to] have a say in how the fund is run, with no one stakeholder or group of stakeholders having a controlling interest. (sub. 51, p. 9)

The Australian Council of Trade Unions (ACTU) also stated that the equal representation model — with representatives of fund members represented on boards — was consistent with the OECD’s governance guidelines for pension funds (sub. DR77). The relevant guideline relating to accountability states:

The governing body should be accountable to the pension plan members and beneficiaries, its supervisory board (where relevant) and the competent authorities. Accountability to plan members and beneficiaries can be promoted via the appointment of members of the governing body by pension plan members and beneficiaries or their representative organisations. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as benefit provider. In order to guarantee the accountability of the governing body, it should be legally liable for its actions which fail to be consistent with the obligations imposed on it, including prudence. In defined contribution plans, accountability calls for safe harbour rules that clarify the responsibilities and liabilities of the governing body. (OECD 2009, p. 2)

Some participants, including industry funds that have independent representation on their boards, supported broadening the structure of boards to include independent directors. Unions NSW said ‘a fund should have an equal representation of employer and employee representatives with an agreed independent chair’ (sub. 13, p. 6).

HOSTPLUS similarly stated:

HOSTPLUS … is now overseen by a Board made up of three representatives from the [Australian Hotels Association], three from United Voice and three independent Directors. The structure ensures the interests of employers and workers are met and provides the fund with a strong understanding of the intricacies and employment nuances of our sectors. (sub. 8, p. 2)

Jeremy Cooper highlighted the importance of having directors who could bring independent judgement to boards:

The key thing about looking after large amounts of other people’s money is that you have the necessary skills to do so. You particularly need to be able to bring independent judgment to the role, asking the right questions where necessary. You need to be able to act without fear or favour. It’s at this point where the super industry often gets caught up in arguments around terminology; whether or not someone is ‘independent’ or, alternatively, querying the need for independence in the first place. The desirability of independence in corporate governance is well established to the point of being beyond serious question. (sub. DR94, p. 1)

BT Financial Group noted that, outside of superannuation, there were requirements for financial services entities to have independent board members:

With the exception of superannuation, APRA currently requires that regulated entities have both an independent Chair and that the majority of directors are also independent. The Australian Stock Exchange also believes that independence of the majority of directors and the Chair is best practice. (sub. 46, p. 3)

The FSC saw independence as critical:

We believe that in keeping with contemporary governance standards and with the significance of the superannuation industry to Australians and the economy, independence is critical … We believe that moving to a model which enshrines independence in the board [would represent] the most appropriate governance structure for the superannuation industry as the trustees safeguarding Australia’s retirement savings. (sub. DR80, p. 31)

However, the ACTU questioned whether the case for independent directors was particularly strong:

We noted [the Cooper Review’s recommendation for independent board members] flowed from the review panel’s assertion that such a reform reflected ‘contemporary best practice in corporate governance.’ It did not arise on the basis of actual evidence that the equal representation model in Australia was failing and therefore required this particular reform. Nor did the panel’s report consider any of the evidence and debate generated by researchers in corporate governance which questions the extent to which non-associated or independent directors actually deliver better performance and governance in practice. In short, the panel opted for speculative assertion rather than evidence-based policy analysis. We therefore welcomed the government’s rejection of the Cooper panel’s recommendation and its view that the equal representation model worked well and should continue. (sub. 29, p. 7)

Cbus noted that independence can mean different things to different people:

‘Independent directors’ are supported by interest groups who variously consider ‘independent’ as independent of management, independent of sponsoring organisations, and subject matter experts. This creates an appearance of many voices in support of a concept, whereas in fact there is little consensus. (sub. DR81, p. 4)

Jeremy Cooper noted the potential governance benefits of bringing in directors from outside the superannuation industry:

It remains my view that the super industry would benefit from an increased participation by talented business people not directly connected to super, but with relevant skills. Such people bring the value of their reputations and have the option of resigning if they feel that they are not adding value or are not happy with the way things are going. This reflects the legal notion of the ‘disinterested’ director. (sub. DR94, p. 2)

In response to the Commission’s draft report, ISN disagreed with suggestions that the equal representation model becomes less attractive when industry funds begin taking members from outside their original industry:

Industry SuperFunds believe that the equal representation model has delivered superior performance and relevant products that meet the needs of both employers and employees. This view is supported by a significant body of independent research. We do not accept the views expressed in the draft report that representative arrangements become inappropriate when a fund accepts members from the public at large. (sub. DR62, p. 29)

A number of participants suggested board structure was an inappropriate criterion for assessment. For example, Cbus — suggesting governance practices were more important than structures — said:

Cbus submits that in applying this factor, [Fair Work Australia] should not focus on the composition of the Trustee Board. Nor should it artificially rate a fund as superior simply because it has a certain proportion of its Board independent of its sponsoring organisations. Rather than focus [on] Board composition … Cbus submits that the focus should be upon whether the governance structures, (including but not limited to Board composition) reflect an orientation towards a member-only focus. (sub. DR81, p. 4)

#### The Commission’s view

The Commission agrees that the equal representation model has generally operated well to date, and this is reflected in the performance of many of the funds operating under this model. However, some arguments for an equal representation structure become less compelling as funds actively broaden their membership beyond their traditional base. In particular, it is less certain that the ‘outside’ members would necessarily find the trustees under the ‘equal representation’ structure to be representative of their interests.

Although recent debate has centred around the governance of industry funds, arguments in favour of having a critical mass of independent directors apply to both retail and industry funds, albeit for different reasons. As highlighted by the Cooper Review, it is important for retail funds to have directors that are independent from management, while there are likely to be benefits from having independent directors of industry funds to introduce an ‘outsider’s perspective’, and to ensure the interests of those members who have exercised fund choice are taken into account.

For both retail and industry funds, there is the potential for independent directors to bring increased knowledge and expertise to superannuation boards. The Commission has previously noted the benefits of non‑aligned expert members in several of its other reports (such as the Commission’s 2005 Health Workforce Report).

The Deputy Chairman of APRA, Ross Jones, has expressed support for independent directors in media interviews, citing the additional expertise they can bring, and stating that their presence has added value in those financial industries where having independent directors is compulsory. Media reports have also suggested APRA is likely to recommend that funds have independent directors, seeing this as representing good governance, but that APRA will not require funds to have independent directors by law (possibly addressing the issue through the guidance notes to its prudential standards for superannuation) (Patten 2012a, Korporaal 2012).

Some calls for increases in the number of independent directors also stem from concerns that equal representation boards might find it difficult to remove unworthy directors. For example, experts such as Jeremy Cooper have highlighted that giving boards the power to dismiss directors could be quite problematic,[[3]](#footnote-3) and have suggested that having more independents would assist in encouraging unworthy directors to leave (Patten 2012b). That said, directors do not need to be independent to exert pressure on their poorly performing counterparts, and the Commission notes that recent issues surrounding controversial board members have been resolved without the presence of independent directors.

The Commission considers that issues relating to board structure are important. However, overall, there is a lack of compelling evidence to suggest that any one model of board structure should be viewed as clearly preferable in all cases. Therefore, the Commission does not consider it appropriate at this time for a particular structure to be mandated. Further, the Commission would not want to see restrictions placed on board structures without such restrictions having a sufficient evidentiary basis, particularly given the potential impact they could have on competition for default listing.

Rather, the Commission is broadly supportive of APRA’s approach of not mandating any particular structure for superannuation fund boards, while also highlighting potential benefits of having independent directors in cases where this is appropriate. The Commission anticipates that APRA would be likely to facilitate requests from industry funds for licence variations to allow additional independent directors, and the Commission would be supportive of this.

In relation to what constitutes an independent director, APRA has published guidelines that state that an independent director would be one who is not, and in recent years has not been:

* in an executive role with an employer–sponsor
* an official or representative of a body that has the right under the governing rules to nominate or appoint directors (or individual trustees) to represent either member or employer interests
* a director, employee or shareholder of a company related to either a standard employer-sponsor or to the fund licensee (other than in the case of a wholly‑owned subsidiary of the licensee)
* a director, employee or shareholder of a material service provider, whether related or not (APRA 2011).

The Commission considers that funds which intend to appoint independent directors should draw on this guidance.

While the Commission does not support mandating particular board structures, it considers that issues relating to board governance are highly important. However, as the Stronger Super reforms have dealt with many of the most pressing governance issues (such as those relating to conflicted loyalties, remuneration and the competence of trustees), there is no need to revisit many of these at this time.

In summary, the Commission considers that governance practices of trustees should be assessed in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards to ensure they are consistent with meeting the best interests of employees who derive their default superannuation product in accordance with modern awards. Given APRA’s recently enhanced role of developing and overseeing prudential standards relating to governance, it would be appropriate for the decision maker to be largely guided by APRA in this process.

In its draft report, the Commission suggested it could be timely to set up a panel of corporate governance experts to assess the appropriateness of board structures of default superannuation funds. However, in view of the lack of definitive evidence in favour of any particular board structure, it does not consider that this exercise would provide net benefits at this time. The Commission prefers that the impact of the Stronger Super reforms on governance be observed before recommending such a review.

## 5.4 Board tenure and renewal policy

One issue brought to the Commission’s attention is an area of contention under the Stronger Super reforms — the requirement for funds to develop a board tenure and renewal policy. The argument supporting this requirement is a perceived need to ensure that boards continue to remain open to new ideas and independent thinking.

APRA has not proposed specific tenure limits for directors or individual trustees, but rather that each fund have a renewal policy incorporating an explicit statement as to the maximum term the fund licensee considers appropriate for its directors. APRA states that funds can choose to develop policies that allow for flexibility for term extensions of individual directors ‘where appropriate and justifiable’ (APRA 2012h, p. 13).

#### Participants’ views

REST Industry Super considered tenure to be an inappropriate criterion for judging directors:

REST … holds the view that it is important to strongly advocate the benefits of long‑standing directors and what this brings to a fund’s board and its members. REST’s view is that tenure, by itself, is a poor measure to assess the appropriateness of a director. It is the contributions made to the Board through their collective skills, education, experience and participation that are more relevant. The REST Board is made up of individuals who have a wealth of retail industry and commercial experience in a corporate environment. Their long standing in-depth knowledge of the fund which can only be gained over a long tenure, together with their understanding of the industry adds huge value not only to the operation of the fund but also to the members and employers. (sub. 47, p. 24)

APRA’s current position is that directors should only be reappointed in relatively rare circumstances:

APRA considers that … licensees should have a clear approach for assessing, prior to the cessation of the term of an individual director, what would make it appropriate, at that time, to step outside their tenure policy. The presumption would continue to be that a director would leave office at the end of their term unless the RSE licensee could appropriately form a view on why that director should remain. (APRA 2012h, p. 13)

#### The Commission’s view

The Commission considers that there are important trade-offs between the benefits of renewal and the benefits of having experienced board members. On balance, it supports APRA’s policy, in that the policy allows for sufficient flexibility, while recognising that the status quo has seen some very long board appointments that might not have always been in the best interests of members. Accordingly, it would not be necessary to consider this issue in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards.

## 5.5 Managing conflicts of interest

The management of conflicts of interest is particularly important within the default superannuation system given the inescapable reliance on principal–agent relationships. This is not only to ensure agents’ interests can be aligned with those of members, but also to promote overall transparency and confidence in the system.

### Stronger Super reforms relating to managing conflicts of interest

As detailed above, the Stronger Super reforms seek to deal with conflicts of interest and make it clear that members are owed the highest duty by fund directors and trustees. APRA has proposed a new prudential standard SPS 521 to deal with this issue.

APRA (2011) notes that conflicts of interest can be actual, perceived or potential in nature. The new APRA standard does not seek to eliminate conflicts, but rather to ensure that funds are aware of them, and have measures in place to deal with them. This includes proposed requirements to have two registers: one that outlines all duties of the licensee and duties of each individual director; and the other that lists all material interests of individual directors and senior management (where interests include matters such as gifts, emoluments and benefits). APRA’s expectation is that conflict management frameworks should be appropriate to the size, business mix and complexity of a licensee’s operations.

### Scope for additional criteria relating to managing conflicts of interest

#### Participants’ views

NGS Super highlighted the importance of ensuring that members’ interests were paramount:

The introduction of MySuper brings with it increased fiduciary responsibilities for fund trustees … they will have to give priority to the interests of members in the case of a conflict or potential conflict of interest … it is clear that strong corporate governance focussing on the promotion of members’ best interests … is a priority. (sub. 18, p. 5)

The ACTU (sub. 29) and the Australian Manufacturing Workers’ Union (sub. 49) expressed particular concern about conflicts of interest among retail funds. The ACTU stated:

To many financial institutions our superannuation system is primarily an opportunity to accumulate private profit. The existence of a large number of customers who are compelled to participate in a market they often do not understand and are unable to influence has provided financial institutions with many opportunities to apply a raft of fees, charges and commissions at the expense of member benefits. This is evidenced by the fact that while retail funds have on average underperformed relative to most not‑for-profit funds in terms of net returns to members, they continue to charge significantly higher fees. This indicates that a major inefficiency in the Australian superannuation system … is the retail super sector. (sub. 29, p. 3)

ISN pointed to past performance to suggest that the governance structure of industry funds was best placed to deal with conflict of interest concerns:

Eliminating the pernicious effects of conflicts of interest — namely, the effects of conflicts of interest that undermine performance and otherwise undercut the ability of the fund to maximise retirement outcomes — is a critical part of [producing superior returns to members]. Accordingly, any consideration of governance in connection with naming default funds in modern awards should be tied to the available research, which demonstrates that the representative trustee model employed by not-for-profit funds has best served the public interest and member interests. (sub. 27, p. 26)

In response to the draft report, ISN expressed support for the Commission’s approach, seeing APRA’s draft prudential standard as largely addressing the issue:

ISN supports [the Commission’s] draft recommendation … which requires a consideration of the mechanisms put in place by trustees to deal with conflicts of interest and the transparency in disclosing those conflicts. These considerations apply to all large fund types and are addressed in detail within the proposed APRA prudential standard SPS 521 Conflicts of Interest. (sub. DR62, p. 29)

AustralianSuper also saw APRA as dealing adequately with conflict of interest issues:

Australian Super is of the view that [issues of scale, governance, conflicts and administrative efficiency] are being dealt with extensively under the Stronger Super reforms … or in the consultation stage. In addition, APRA has advanced its development of Draft Prudential Standards … APRA’s draft Standards deal extensively and substantively with issues relating to governance … and conflicts management. We are confident that … APRA will be appropriately equipped to deal with these issues. (sub. DR74, p. 3)

#### The Commission’s view

Many potential conflicts of interest are inherent in the superannuation industry, but it is important that funds and trustees seek to minimise their impact. When selecting and assessing superannuation funds for listing as default funds on an ongoing basis, conflicts of interest associated with superannuation and the mechanisms put in place by fund trustees in dealing with these conflicts should be considered. These decisions should be made on a ‘fund-by-fund’ basis rather than being based on any inherent assumption that particular governance structures deal best with conflict of interest issues. APRA’s prudential standard relating to conflicts of interest should be used to guide this process.

Recommendation 5.1

The selection and ongoing assessment of default superannuation products for listing in modern awards should include consideration of whether fund governance practices are consistent with meeting the best interests of members. In particular, consideration should be given to the mechanisms put in place by fund trustees to deal with conflicts of interest, and the transparency associated with disclosure of those conflicts.

## 5.6 Flipping of members

A large number of participants raised the issue of ‘flipping’. Flipping was defined in the Cooper Review as the practice of fund members ‘being automatically moved from one division of a fund to another … on cessation by the member of the particular employment to which the original fund division related’ (Australian Government 2010b, p. 24). Concerns about flipping emerge when members are transferred to a higher cost division of a fund, often without their knowledge or understanding of the consequences for their superannuation balance. This highlights potential principal–agent problems when the interests of members and fund managers do not align.

### Flipping measures under Stronger Super

Under the initial MySuper legislation, it was proposed that a core criterion for MySuper products would be that a member’s interest could not be transferred without the member’s consent *except* to another MySuper product within the fund (Shorten 2011b). Given the Government’s intention that MySuper products are ‘low cost and simple’ (Australian Government 2010d), this requirement would have made it much less likely that members would have been moved to a significantly higher cost product (but it would not have entirely eliminated the possibility). Almost all of the submissions to this inquiry were based on the initial version of the MySuper bill.

In the third reading version of the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2012 that passed the House of Representatives in August 2012, an amendment was included that should eliminate the possibility of members being flipped without their knowledge. This amendment, which is discussed in more detail below, has changed the Commission’s conclusions since the draft report.

### Scope for additional criteria related to flipping of members

#### Participants’ views

A number of participants considered that the practice of flipping should be addressed when considering the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. For example, HOSTPLUS (sub. 8) stated that only funds that demonstrate no (past) evidence of flipping should be eligible for nomination. ISN considered that ‘funds that actively flip their members into a higher priced MySuper product should not be eligible to be named as a default fund’ (sub. 27, p. vi), and AustralianSuper suggested that eligible MySuper products should be ‘prohibited from engaging in fund flipping’ (sub. 36, p. 5).

Some participants (including the ACTU, sub. 29, AustralianSuper, sub. 36, and ISN, sub. 27), expressed concern that the initial legislation before parliament left room for flipping to occur. For example, some employers (subject to having more than 500 employees) with award employees may negotiate a tailored MySuper product with the fund nominated in the relevant award. In these circumstances, an individual MySuper member, when they cease employment with the employer that negotiated the tailored product, could have been moved to the ‘mainstream’ MySuper product within the same fund. The concern predominantly related to the (potential) practice of a fund providing artificially low prices in its tailored products, with a view to recouping its losses and making additional profits when employees left their employer (and were ‘flipped’ to the fund’s non-tailored MySuper product).

The key concern here was that some funds could have adopted a business model targeting industries that had high employee turnover, for tailored products with discounted fees (potentially below cost). As the ACTU put it:

Retail funds will be able to offer ‘loss leading’ versions of their MySuper products to particular large employers on the basis that employee turnover will mean such losses are recouped over time. (sub. 29, p. 10)

Cbus stated:

Regrettably the incentives to create opportunities to engage in ‘sharp practice’ of flipping are high. High labour mobility and short job tenure in the construction industry expose workers to being unknowingly moved into funds with a high cost structure. (sub. 15, p. 6)

#### The Commission’s view

In the draft report, the Commission proposed including the likelihood of flipping as one of the factors to be considered in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. Funds with a reputation for flipping would therefore have been at a competitive disadvantage when seeking future inclusion as default funds.

A number of participants supported the Commission’s draft proposal. For example, Cbus said:

We welcome the draft finding that [Fair Work Australia] should address the likelihood of flipping, and that this would count against a fund being chosen as a default fund. Cbus accepts that there may be instances where the withdrawal of a fee-discount that is based upon an employee’s ongoing membership of a particular employment class is valid. However Cbus strongly believes that [Fair Work Australia] needs to be empowered to vigilantly guard against the possibility of price gouging, and we welcome the Commission’s draft findings in this regard. (sub. DR81, pp. 2-3)

Others still saw opportunities for poor practices. For example, in calling for funds that engage in flipping to be ineligible for selection as a default fund in a modern award, ISN stated:

[The Commission’s draft recommendation] will allow a continuation of current practice among retail funds, under which product providers will offer discounts to employers on a loss leader basis. When an employee leaves the employer there is nothing to stop their assets being transferred without approval to a more profitable product … As many members in default products are disengaged, the product the employee is transferred into need not be price competitive … Flipping is a significant issue in high turnover industries, many of which are heavily award dependent. (sub. DR62, p. 8)

The ACTU expressed a similar view:

While one option [for dealing with flipping] could be to mandate consideration of the likely ‘total costs’ to employees should they change employment and remain disengaged, the most effective way to tackle this problem is to prohibit flipping in the context of award default selection. This will remove uncertainty, build public trust in the new system, and send a clear signal to the industry that member disengagement in a compulsory system is not a legitimate source of private profit. (sub. DR77, p. 6)

Since the draft report, an amendment moved by Greens MP Adam Bandt was incorporated into the version of the Superannuation Legislation Amendment (MySuper Core Provisions) Bill 2012 that passed the House of Representatives. The effect of the amendment is to require the contemporary express agreement of a member before they can be flipped:

A beneficial interest of that class in the fund cannot be replaced with a beneficial interest of another class in the fund, unless the person who holds the interest consents in writing to that replacement no more than 30 days before it occurs. (s. 29TC(1)(g))

In view of this amendment — assuming it is passed by both Houses of Parliament — the Commission no longer considers it is necessary to include the likelihood of flipping as a factor to be considered in the selection and ongoing assessment of superannuation funds for listing as default funds in modern awards. The practice of flipping people without their knowledge will be prohibited with regard to MySuper products.

While the Commission agrees that flipping is a highly undesirable practice, in seeking to prevent flipping it is not desirable to dissuade funds from offering members attractive discounted tailored MySuper products where an employer can negotiate a good long-term outcome for their employees. If funds are prevented from shifting people into higher fee divisions of funds, they have a diminished incentive to offer discounted fee divisions. To the extent this removes the incentive to offer ‘loss leader’ products with the intention of shifting members to much higher‑cost products without their knowledge (leaving them significantly worse off in the long run than they would have been in other products), this is a desirable outcome.

However if, when an employee changes jobs, the fees they subsequently face are no higher than those applying for the standard product *and* the fees or other features remain comparable with other similar MySuper products, then this should not be considered a problem.

In response to the draft report, a number of participants agreed with the Commission on this point. For example, the Corporate Super Specialist Alliance said:

Some minor fee differentials may occur if an employee leaves the employment of a firm that has negotiated discounts on behalf of their staff and that this is an acceptable practice if the exiting member reverts back to a fee that is no higher than the standard fee for the MySuper product. (sub. DR56, p. 3)

The Commission therefore considers that the Government should monitor whether the ban on flipping has the unintended consequence of discouraging discounting of MySuper products. In the event that it does, the Government should consider dealing with flipping in another way (for example, by permitting funds to shift members from one division of a fund to another upon their changing jobs provided the fees applying were no higher than those applying for the standard product *and* the fees or other features remained comparable with other similar MySuper products).

1. APRA’s draft prudential standards cover governance, conflicts of interest, fitness and propriety, risk management, outsourcing, investment governance, operational risk requirements, audit requirements, business continuity management, insurance and matters specifically relating to defined benefit funds. [↑](#footnote-ref-1)
2. Under the SIS Act, public offer funds can either be bound by the equal representation requirements or have an ‘independent trustee’. Non-public offer employer-sponsored funds are bound by the equal representation requirements. [↑](#footnote-ref-2)
3. As it stands under Australian corporate law, it is up to shareholders to determine the composition of boards, and boards have no legal authority to remove individual directors even where there is a strong case for doing so. A concern with giving boards such authority is that it could lead to individual directors feeling they were unable to freely express their views at board meetings without fear of retribution in the form of dismissal. [↑](#footnote-ref-3)