Governance working group

Issues paper on trustee and director duties

March 2011

PROPOSED REFORM

The Government's response to recommendation 2.1 of the Super System Review included in principle support for heightened trustee duties. The response also noted the review's recommendation to create a new statutory office of 'trustee-director', intended to consolidate all statutory duties applying to the directors of corporate trustees.

The review supported high standards of governance for Australia's compulsory superannuation system, and noted that good governance plays a major role in promoting better decisions, greater accountability and in reducing unintended operational and investment risks.

RATIONALE

Australia has adopted a trust structure for governance of superannuation funds. Trustees have fiduciary and statutory obligations to manage the assets of the trust on behalf of its beneficiaries, and in the beneficiaries' best interests.

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

The review found that trustee governance structures had not kept up with developments in the industry. It suggested there were difficulties for trustees (and directors of corporate trustees) in understanding what is expected of them and that, as the industry consolidates, conflicts of interest and conflicts of duty arise regularly.

To address these concerns the review proposed, among other things, the creation of a new office of 'trustee-director' with all statutory duties set out in the *Superannuation Industry (Supervision) Act 1993* (SIS Act); a detailed, specifically tailored conflicts policy to be required for all trustees; and the development of a code of trustee governance to set out 'best practice' principles for trustees and trustee-directors.

Key to enhancing a trustee's duty to place member interests above the interests of all others were proposals to: address potential conflicts through a precise set of 'conflict' duties (including that a director of a corporate trustee put member interests above the interests of shareholders, and avoid potential conflicts with other superannuation funds or service providers); and a requirement to act with the care, skill and diligence of a 'person of business'.

ISSUES

Issue 1 – Amalgamation of trustee and trustee director duties

Trustee duties can be established through trust law (as equitable duties), set out in trust deeds, or specified as statutory duties in legislation. An example of the latter are the specific covenants set out in the SIS Act, which are automatically taken to be incorporated into the governing rules of all superannuation funds.

Many of the covenants contained in the SIS Act set out existing equitable duties imposed on trustees by trust law. However, the covenants do not encompass all the equitable duties placed on trustees. In some cases the covenants are wider, and in others more restrictive, than the common law duties. The extent to which covenants override the common law is unclear.

Further, most (but not all) superannuation fund trustees of Australian Prudential Regulation Authority (APRA) regulated funds are 'corporate trustees'. Where a superannuation fund's trustee is a corporation, the directors of the corporate trustee must also comply with the duties imposed on directors more generally by the *Corporations Act 2001*.

As a corporate trustee is both a superannuation fund trustee and a corporation, the duties of the corporate trustee and its individual trustee directors are set out across the SIS Act, the Corporations Act, State and Territory legislation and the common law.

The review recommended articulating existing and additional trustee and corporate director duties in the SIS Act through the creation of a distinct new office of 'trustee-director', to capture all statutory duties (including those which would otherwise be in the Corporations Act) (recommendation 2.1).

The Government noted the recommendation to establish a new office of trustee-director and indicated it would consider whether the proposed arrangements would achieve a more accountable and efficient trustee governance regime.

Analysis

In an ordinary corporation the overriding duty of directors to the shareholders and those with a stake in the company is reasonably clear. In the Corporations Act, directors' duties are three pronged: general duties under section 180; a duty not to trade while insolvent under section 588G; and a duty to keep books and records.

Replicating the Corporations Act directors' duties in the SIS Act would consolidate applicable duties for the directors of corporate trustees in one location, and may therefore be considered to be more transparent.

The review commented that if the directors' duties in the Corporations Act were replicated in the SIS Act:

> 'the Corporations Act would no longer have any relevance to trustee-director duties, but (the Australian Securities and Investments Commission (ASIC)) would continue its regulatory responsibilities for trustee-directors; those duties would simply be found in the SIS Act, rather than the Corporations Act.'

This raises the potential for confusion among trustees as to the roles and responsibilities of the two regulators, APRA and ASIC, under the SIS Act. For example, would APRA enforce breaches of duty by the corporate trustee, and ASIC enforce breaches by directors of the corporate trustee?

Further, consolidation may create consistency problems between the duties in the respective Acts and, over time, result in unintended regulatory divergence. This may create uncertainty for people who are both a director of a corporate trustee and a director of another corporation, as to the differences in the requirements of directors' duties that are applicable to their respective roles. In this way, it may create an undue regulatory burden on directors.

In addition, only the statutory duties of these directors that arise from Commonwealth legislation would be subject to this consolidation. Other trustee duties, arising from trust law or State and Territory legislation, would potentially still apply. The same issue arises in respect of director duties.

Question 1.1 What are some examples of practical problems that have arisen from a superannuation fund trustee's statutory duties being set out in separate pieces of Commonwealth legislation?

Question 1.2 To what extent would creating a distinct new office of 'trustee-director' achieve a more accountable and efficient trustee governance regime?

Question 1.3 To what extent would consolidating trustees' statutory duties improve the level of certainty and overcome identified problems?

Question 1.4 It is possible that creation of a new office of trustee director would give rise to other problems. What are you views on these concerns?

Issue 2 – Heightened trustee duties

In general, the review considered the requirements placed on trustees and directors of corporate trustees to be appropriately formulated. However, it saw a need to formulate additional duties for trustees who are also directors.

Additional duties recommended by the review for directors of corporate trustees were:

- to act solely for the benefit of members, including and in particular, to give priority to the duty to members when that duty conflicts with the director's duty to the trustee company, its shareholders or any other person (recommendation 2.1(a)(ii)); and
- to exercise the degree of care, skill and diligence as *an ordinary prudent person of business* would exercise in dealing with the property of another for whom the person felt morally bound to provide (recommendation 2.1(d)).

Issues related to these recommendations (and recommendations relating to the management of potential conflicts of interest), are discussed below.

Additional duties for all trustees (that is, for both individual and corporate trustees), recommended by the review include formulating and giving effect to the fund's investment strategy, having regard to the whole of the circumstances of the fund including the expected costs of the strategy and the taxation consequences of the strategy. These duties are considered in the related paper on investment governance.

Also relevant is the Government announcement that it will give APRA the ability to issue prudential standards in relation to superannuation, consistent with its existing powers in relation to the banking and insurance industries (recommendation 10.2). Prudential standards will be a form of subordinate legislation which will expand on prudential matters in the SIS Act.

Issue 2.1 – Duty to give priority to the interests of members

In a superannuation context, tension may arise for directors of corporate trustees between their duty to the members of the fund and their duties to other parties. This may be particularly relevant in the case of a conglomerate group. An example is where directors have an interest (or directorship) in a service provider or investment vehicle used by the trustee. In recognition of this, the SIS Act currently requires trustees and directors to ensure that their duties and powers are used in the best interests of the beneficiaries.

Recommendation 2.1(a)(ii) sought to clarify this requirement for the directors of corporate trustees. The recommendation proposed that these directors give priority to the duty to members when that duty conflicts with the directors duty to the trustee company, its shareholders or any other person.

Statutory precedent for this type of duty can be found in respect of registered managed investment schemes, in the Corporations Act (paragraph 601FC(1)(c) of Chapter 5C), and in respect of life insurance, in the *Life Insurance Act 1995* (subsection 48(3)).

As with the SIS Act provisions, the duties placed on the responsible entities of registered managed investment schemes by Chapter 5C of the Corporations Act are essentially a restatement of duties (some common law and equitable, some statutory) that applied to the trustees and investment managers of collective investment schemes before the introduction of the *Managed Investments Act 1998*.

However, Chapter 5C also includes a number of additional elements not included in the SIS Act covenants. These duties include an explicit obligation to give priority to members' interests where there is a conflict between the interest of the responsible entity and that of the members. This obligation would resolve conflicts of interest that exist where trustees have to invest funds under management through an interposed trust structure.

The Corporations Act imposes broad requirements on directors to disclose actual or perceived conflicts of interest. For example, directors of public companies generally must disclose to other directors any material personal interest[1] in a matter that relates to the affairs of the company and may not vote on such matters at board meetings, unless the other directors or ASIC approves[2]. However, this may not address any tension between the interests of the corporate group and the interests of fund members, which the provision in the Life Insurance Act does address.

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1 The Corporations Act does not require the disclosure of certain interests (see subsection 191(2)).

2 In the case of a proprietary company, a director with a material personal interest in a matter that relates to the affairs of the company does not require the approval of the other directors or ASIC in order to be able to vote on the matter, so long as he or she discloses the nature and extent of the interest and its relation to the affairs of the company at the directors' meeting. This provision operates as a *replaceable rule*, which means that it is deemed to be included in the constitution of a proprietary company unless the constitution specifically provides otherwise.

APRA guidance on the requirement in section 48 of the Life Insurance Act (Prudential Practice Guide LPG 260) indicates that the Act is more stringent than the general duties of directors under the Corporations Act: each director individually owes this duty to policy owners; the duty is owed to the interests of those policy owners as a group; and the duty is not limited to owners of participating policies. A director of a life insurance company may be personally liable to compensate a life company for losses resulting from a breach of the duty by that director.

Recommendation 2.1(a)(ii) proposed a duty on a superannuation trustee director similar to that which the Life Insurance Act imposes on directors of a life insurance company, to give priority to the interests of the fund member where those interests conflict with the interests of shareholders.

The specific circumstances of a superannuation fund, along with uncertainty in practice with the application of the current 'best interests' test, seem to warrant a similar approach to that of life insurance companies. However, the requirement to act only for the benefit of members should not operate to the exclusion of all others, for example, the directors' duty to the company.

Question 2.1.1 What, if any, would be the practical differences between adopting the Life Insurance Act provision compared to the equivalent Corporations Act provision?

Question 2.1.2 Has the relevant Life Insurance Act provision given rise to practical issues for life company directors in respect of their responsibilities to policy owners?

Question 2.1.3 What practical issues may arise from adopting the Life Insurance Act model for trustees of superannuation funds?

Issue 2.2 – Managing conflicts of interest

With regard to the management of conflicts of interest and duty, the framework proposed in the review would:

- require licensees to set and follow a conflicts policy (recommendation 2.17);
- establish regulatory non-exhaustive standards setting out what constitutes a conflict of interest or duty (recommendation 2.16);
- establish voluntary practices (supporting the regulatory standards referred to above) for trustees to develop an enhanced conflicts handling policy and affected decisions register (recommendation 2.18(d));
- require directors who are on the boards of multiple corporate trustees to attest to APRA that there is no reasonably foreseeable conflict between their duty to the members of each fund and their duty to each trustee company (recommendation 2.13); and
- require trustees, directors and management to maintain a record of all gifts, emoluments and benefits for disclosure to members and APRA (recommendation 2.15).

Also relevant is recommendation 2.16, which proposes the development of a prudential standard setting out particular examples of conflicts of interest and conflicts of duty. This is being considered by APRA.

Establishing a conflicts policy

Adequate conflict management arrangements will assist trustees to ensure that they either avoid putting themselves in a position of conflict of interest or duty or, where such conflicts exist, there are transparent and pre-determined arrangements to manage them. Adequate arrangements include documenting the policy for conflicts of interest, and monitoring, acting upon and disclosing compliance with the policy.

Comparable requirements exist in similar licensing schemes. For example, ASIC Regulatory Guide 181.44, in relation to Australian financial services licence (AFSL) holders, states:

> '... for conflicts management arrangements to be adequate, they need to be documented. This generally involves having a written conflicts management policy.'

In addition to a requirement to follow a conflicts policy, the review proposed a code of trustee governance (considered in a related paper on a code of trustee governance), which could include an enhanced conflicts-handling policy (recommendation 2.18(d)). However, it may be simpler if the proposed APRA prudential standard in relation to conflicts of interest (recommendation 2.16), were drafted to cover all conflicts handling requirements.

With regard to the issue of multiple trusteeships (recommendation 2.13), the Government considers it is primarily a matter for individual boards to determine whether it is appropriate to have a director who is also a director of another APRA-regulated fund. A code of trustee governance could provide guidance on how to consider whether a multiple trusteeship creates a conflict of interest. Where a multiple trusteeship occurs, this would be one of the matters considered by an annual board review and reported publicly (recommendation 2.18(g)).

Question 2.2.1 Under the current system, how have trustees managed conflicts of interest or duty?

Register of gifts and benefits

To support increased transparency and to assist with managing potential conflicts of interest or duty, the review also recommended that trustees keep a register of all gifts, emoluments and benefits (subject to an appropriate materiality threshold) provided to trustees, directors and management, and disclose the register to APRA annually as well as in the annual fund report to members and on the fund's website (recommendation 2.15).

The Government's response noted it would consult on disclosure requirements and materiality thresholds in relation to the implementation of a gift register.

This recommendation reflects good practice which would assist trustees and the directors of corporate trustees to demonstrate that decisions and other actions are not conflicted. It would contribute towards trustees and directors meeting their obligation to avoid conflicts of interest and duty.

The proposed requirement to maintain a register of gifts, emoluments and benefits could also be included in an industry code. The code could set out principles for disclosure in the register, as this would help to promote transparency and to identify potential conflicts of interest. Adequate systems would assist to ensure the ongoing veracity and completeness of the list and the consequences for non-disclosure. The record could be provided to APRA upon its request.

Question 2.2.2 What are the practical differences between placing the requirement for the register in an APRA prudential standard, compared with placing the requirement in an industry code of governance?

Issue 2.3 – Exercise care, skill and diligence to standard of a 'prudent person of business'

Trustees are generally held to a 'prudent person' standard in regard to meeting their fiduciary responsibilities, although investment, legal, and other professionals can be held to a higher standard commensurate with their higher expertise.

Current SIS Act requirements bind trustees to exercise the same degree of care, skill and diligence as an ordinary prudent person in managing the fund. Other aspects of trust law (such as State and Territory legislation) set out that, if the trustee's profession, business or employment is or includes acting as a trustee or investing money on behalf of other persons, the trustee must exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the affairs of other persons. If the trustee's profession is not as a trustee or investment advisor, the trustee must exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons – not a prudent person of business.

The Government supported in principle recommendation 2.1(d), which called for all superannuation trustees to exercise their duties to the higher standard of a prudent person of business. A 'prudent person of business' is not a legally defined term, however, in general terms, a prudent person of business would ensure they are properly informed, have adequate professional knowledge, exercise due care, and are diligent and skilful.

On this basis, it is reasonable to expect directors of a trustee company should be able to meet this standard. Such directors may or may not necessarily hold any relevant expertise or experience that could immediately or readily allow them to meet such a test, but could given adequate training, ongoing professional development and appropriate support.

The SIS Act sets out the operating standard for trustees in relation to fitness and propriety. The current operating standards identify attributes that enable the trustee to properly discharge their duties in a prudent manner including: character, competence, diligence, experience, honesty, integrity and judgement; and educational or technical qualifications, knowledge and skills relevant to the duties and responsibilities of a trustee. These operating standards may be replaced by prudential standards when APRA has the power to issue prudential standards in relation to superannuation issues (recommendation 10.2).

Question 2.3.1 Are there practical difficulties in requiring all trustees to exercise their duties as a prudent person of business, for example in the case of self managed superannuation funds? If so, what are they?

Issue 3 - Selection of service provider

A superannuation fund's trustees may face an actual or potential conflict between their interests and those of the fund's members where the fund employs service providers, such as investment managers, that are related parties of the fund's trustee.

For example, some trust deeds require a trustee to invest or outsource within the corporate group, without the power to amend the trust deed. This creates a tension between the commercial objectives of the group and the scope of the trustee's duty to act in the best interests of members, given that the conflicts of interest are inbuilt.

The review recommended amending the SIS Act to override any provision in the governing rules of an APRA-regulated fund that requires the trustee to use a specified service provider in relation to any services in respect of the fund (recommendation 2.14).

A provision of this nature in the governing rules of a fund would appear to fetter the discretion of the trustee to choose a service provider in the best interests of the members. Service provision should be a matter for the trustees to consider in the context of its duty to members.

The Government supported in principle the position that trustees should be able to select service providers, but indicated it would consult on design and implementation issues.

The SIS Act currently sets out the operating standard for trustees in relation to outsourcing requirements. These operating standards may be replaced with prudential standards when APRA has the power to issue prudential standards in relation to superannuation issues (recommendation 10.2).

To assist trustees in making decisions about choosing a service provider, the review's proposed code of trustee governance could include a principle to guide best practice for tendering and benchmarking service providers (recommendation 2.18(i)). As noted earlier, this is considered in the related paper on a code of trustee governance.

Implementing recommendation 2.14 would not necessarily require a trustee to change an existing service provider, provided the trustee has made a considered decision that the use of that service provider was in the best interests of members. A review of service provider arrangements would apply to all new contracts.

It has been argued that many members choose their fund based on arrangements with a particular service provider and therefore changing service providers alters the basis on which their decisions were made. It is questionable whether most members actively decide which superannuation fund they contribute to and, where they do make an active decision, it is questionable whether the member is aware of which service provider services the superannuation fund and consequently makes their decision on this basis.

Question 3.1 How prevalent are tied service provider arrangements?

Question 3.2 What practical transitional issues arise in terminating tied service provider agreements?