SUPERANNUATION FUND GOVERNANCE POST-HAYNE: PART ONE

22 February 2019 | Australia
Legal Briefings

INSTITUTIONAL STRUCTURES

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was charged with inquiring into, and reporting on, 'whether any conduct of financial services entities might have amounted to misconduct and whether any conduct, practices, behavior or business activities by those entities fell below community standards and expectations.' Not surprisingly therefore, its Final Report contains considerable discussion on the contribution of the 'governance' of the entities under investigation towards the misconduct identified. It also contains a number of recommendations designed to render such misconduct less likely in the future.

This short article is the first of three in a series that considers the Commissioner's recommendations with respect to the governance of trustee companies in the superannuation context. Specifically, it evaluates what the Final Report had to say, and the recommendations made, concerning the institutional structures and processes present in the industry. Parts Two and Three consider the topics of Conduct and Culture (Part Two) and Community Expectations and the Sole Purpose of Superannuation (Part Three).

VERTICAL INTEGRATION IN THE FINANCIAL SERVICES INDUSTRY

The financial services industry in Australia exhibits considerable vertical integration. Entities that are a part of broader corporate groups dominate most segments of the market. This is most obviously true in respect of the major banks and their ownership of insurance, superannuation and wealth management (personal financial advisory) operations, but it is also true today of many of the larger not-for-profit superannuation funds. This phenomenon should come as no surprise; it arises in part because there are economies of scale in some aspects of the production process, and in part as a result of regulatory pressure.

The frequency with which Counsel Assisting the Commissioner returned in the Public Hearings to case studies in which individuals and entities acted in ways that appeared to favour related parties ahead of their customers encouraged some commentators to forecast that the Commissioner would take a strong stance against vertical integration.

On its face, that forecast proved wrong. The Commissioner did not recommend a Glass-Steagall-like separation of fiduciary and non-fiduciary businesses, or of ‘sales’ from ‘production’ operations, of proprietary from advisory businesses or of ‘tied’ from ‘independent’ businesses. Indeed the rationale advanced by the Commissioner for not recommending a ban on vertical integration was noticeably weak – that it would affect a great many members (but so would many of the recommendations he was prepared to make) and that members could choose to move funds if they consider it in their interests to do so (a mechanism available in respect of other sources of dissatisfaction also). The proposition that members in choice products might have made that choice specifically because of the role played by related parties (for instance in the investment management of the fund) was alluded to but not developed, despite its obvious harmony with the choice architecture upon which the superannuation system is based. The Commissioner’s assessment of other possible arguments is not disclosed.

Instead, and this was clearly by design, the Commissioner directed his attention to the ‘management’ of conflicts of interest, the risks of distraction from competing duties and the threat posed by ill-designed regimes of executive remuneration. The preference for ‘behavioral’ rather than structural approaches that this betrays is a recurrent feature of the Final Report. Although there are examples of structural measures in the list of recommendations (such as prohibiting super fund trustees from undertaking other responsibilities), the majority are either behavioral (such as the need to avoid conflicts and the prohibition on hawking) or product related (for instance the banning of advice fees being paid from MySuper accounts and the cap on commissions on add-on vehicle insurance).

THE MANAGEMENT OF CONFLICTS OF INTEREST

The inability of individual actors and the firms that employ them to resist the temptation to pursue their self-interest to their customers’ detriment is the leitmotif of both the Interim and Final Reports. The Commissioner in particular took aim at the industry-wide view that conflicts of interest can be ‘managed’. He said (at 45):

> ‘There must be recognition that conflicts of interest and conflicts between duty and interest should be eliminated rather than “managed”.’

That proposition is, of course, an accurate description of the general law. However it masks a more complex reality. Across the regulatory regime shaping the superannuation system there are a variety of rules dedicated to addressing the presence of conflicting duties and interests. In some circumstances the rule is formally articulated not in terms of avoidance or elimination, but rather in terms of prioritisation (see further below) or management. Ironically this latter usage is particularly common in rules and guidance issuing from APRA and ASIC.

The Commissioner's enthusiasm for the exacting standard of the general law over the regulator's preferred standard of 'managing' conflicts has to be seen in the light of his reluctance to recommend a complete structural solution to the conflict-tainted decision-making described in the Final Report. One way to resolve the apparent inconsistency is to argue that unlike an individual, an organisation can arrange its structure and processes in such a way as to ensure that decision-makers are insulated from the distraction of competing interests or duties. Examples would include information barriers, boards of subsidiaries without overlapping members and the isolation of trustee duties in distinct subsidiaries. Consistent with that, one structural recommendation that the Commissioner does make is to require the trustees of superannuation funds to eschew all other responsibilities and be focused solely on the administration of one or more superannuation funds.

The attention to conflicts of interest and duty is not restricted to the superannuation sector. Indeed, nine of the seventy six recommendations made in the Final Report relate to conflicts of interest in one form or another. In the superannuation sector, however, the Commissioner links the conflicts proscriptions to the best interests duty deemed to be part of the governing rules of each fund by the covenant contained in section 52(2)(c) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**). With respect, closer attention to the structure of the full set of covenants contained in section 52(2) might have inspired a different conclusion. In particular it is inconsistent with the presence amongst the covenants of section 52(2)(d) which requires that the trustee prioritise the interests of members over its own and others to whom the trustee owes a duty. If the best interests duty is simply a re-articulation of the general law position, then section 52(2)(d) is otiose because the duty it imposes is less exacting. That might come as a surprise to the Parliamentary draftsman and to the governmental enquiry (the Cooper review) which recommended its addition to the SIS Act almost ten years ago.

THE INFLUENCE OF REMUNERATION STRUCTURES

In addition to concerns about the presence of conflicted remuneration in various parts of the financial services industry, the Commissioner was also concerned about remuneration practices that were inadequately sensitive to risk, calibrated in too mechanistic a manner to numerical measures, and insensitive to compliance and misconduct issues. Importantly, the Commissioner noted (at 335) that:

> 'remuneration and incentives tell staff what the entity values'

which, in turn, both influences and reflects the culture of that entity.

Not content to rely on community and shareholder pressure to inspire meaningful changes in this area, the Commissioner made three recommendations designed to bolster the way APRA polices the design and implementation of remuneration structures. One was that APRA should have as one of its aims the sound management of not only financial risk but also misconduct, compliance and other non-financial risks.

The Commissioner was also concerned to ensure that organisations implement effective claw back mechanisms to permit them to sanction employees whose shortcoming was not detected until after the employee had moved on to another role or another employer. This may have interesting implications for the process that firms adopt in dealing with former employees. It also may hinder organisations moving to a culture where staff feel comfortable to "speak up" if they are aware that current or former colleagues may be financially punished as a result.

THE PROHIBITION ON HAWKING

The Commissioner was clearly concerned to discover that hawking, the practice of making unsolicited approaches in relation to a product, continues to occur in the superannuation and insurance industries. He recommended that hawking be banned in both contexts, except in limited circumstances. The main rationale for this recommendation appears to be the fact that the individuals approached will not have had an opportunity to prepare for the discussion and may feel pressured to make a decision before they have had an opportunity to consider it fully. If implemented, the recommendation would seem to add another layer of practical complexity to the general advice/personal advice debate ventilated most recently (and now appealed) in *ASIC v Westpac Securities Administration Limited* [2018] FCA 2078.

SUPERANNUATION FUND BOARD COMPOSITION

One issue in respect of which the Commissioner declined to make concrete recommendations was the hotly-contested question of whether the current equal-representation paradigm for employer sponsored superannuation funds ought to be replaced. Rather, (at 244) he rehearsed the largely impotent homily that:

> “[a]ll directors of the trustee of an RSE owe the same duties, including, to perform their duties and exercise their powers as directors of the trustee in the best interests of the beneficiaries: the members.’

Again, with respect, this places considerable weight on the somewhat nebulous concept of best interests, including potentially recasting it as an objective test, and on the essentially remedial architecture of the courts to uncover, assess and address aberrant behavior. Structural or other procedural methods of achieving cognitive independence and loyalty to members have their shortcomings, but the Commissioner’s apparent failure to consider whether Board structures in both the retail and not for profit sector contributed to the decisions criticised in the Interim and Final Reports is more than a little surprising.

CONCLUSION

There is no doubt that institutional structures influence corporate behavior, encouraging and facilitating certain types of conduct and impeding others. On the whole, though, the Commissioner declined to recommend regulation of the structure of the industry or its participants. Rather the Commissioner recommendations seek to influence the behavior of participants. In particular, the Commissioner's Interim and Final Reports remind us that financial services organisations have to consider the behavioral consequences of their conflicts of interests and remuneration policies specifically in the context of their particular institutional structures and unique regulatory obligations. Light-touch 'management' of conflicts will in many cases be insufficient to discharge those obligations. In this regard it is useful to recall the principle described over 120 years ago by Lord Herschell in *Bray v Ford* [1896] AC 44 at 51, a case cited by the Commissioner in his Final Report:

> "It is an inflexible rule of a Court of Equity that a person in a fiduciary position, such as the respondent's is not … allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, **human nature being what it is, there is danger, in such circumstances of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect**." (emphasis added)

It is also the case that the relationship operates in the reverse direction as well; that organisational structure is a reflection of the culture and beliefs of an organisation. The Commissioner's findings and recommendations in respect of culture and conduct are discussed in Part Two of this three part series.

Click here to read Superannuation Fund Governance Post-Hayne: Part Two

Click here to read Superannuation Fund Governance Post-Hayne: Part Three

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

MICHAEL VRISAKIS

SCOTT DONALD

PARTNER, SYDNEY

+61 2 9322 4411
Michael.Vrisakis@hsf.com

EXTERNAL CONSULTANT, SYDNEY
+61 2 9225 5640
scott.donald@hsf.com

LEGAL NOTICE