26 August 2014

The Secretary
Financial System Inquiry
GPO Box 89,
SYDNEY NSW 2001

Dear Sir/Madam

Subject: ACSI Submission in Response to the Financial System Inquiry (FSI) Interim Report

The Australian Council of Superannuation Investors (ACSI) welcomes the opportunity to provide a submission in response to the FSI's July 2014 Interim Report.

About ACSI

ACSI is a collaboration between 33 Australian profit-for-members superannuation funds and 5 major international pension funds. The 38 long-term institutional asset owners use their collective ownership rights to improve the management of environmental, social and governance (ESG) investment risks and opportunities by Australian listed companies. ACSI was established in 2001, so is now in its thirteenth year of operation.

ACSI's Australian member funds in aggregate manage over $400 billion of superannuation assets on behalf of more than 8 million Australian superannuation fund members. Of this total, approximately 30% is invested in Australian listed equities, which translates to approximately 11% of the average ASX 200 listed company (and growing in accordance with the growth of the Australian superannuation industry generally).

Full details on ACSI and its research publications, policy positions and members are available on our website (www.acsi.org.au).

Focus of Our Submission

Our submission addresses three distinct areas of focus raised in the FSI's Interim Report, each of which we believe touches upon an issue of particular relevance to ACSI's role as a key influencer and linkage point between Australia's institutional investment and corporate sectors.

These are:

1. ***The implications of growth of superannuation funds as owners of public equity assets***, how this can be expected to shape the governance, regulation and stakeholder engagement environment for Australian corporations (broadly coming under the heading of "Superannuation - Future Trends" in Chapter 3 of the Interim Report);
2. ***Capital-raising practices of Australian listed companies*** (under the "Funding – Equity Markets" section, also in Chapter 3); and
3. ***The suitability of the Trust Law foundations of the Australian superannuation system*** (one of the specific questions raised on page 2-115 of the Interim Report, in Chapter 4 regarding Superannuation).

The following commentary addresses each of these issues in detail, and we would of course be happy to expand upon any or all of them in further discussions with the Review Panel or Secretariat as the Inquiry finalises its recommendations to Government.

Implications of growth of superannuation funds as owners of public equity assets

FSI Interim Report Reference: Section 2-28 to 2-85.

This Section of the Interim Report explores the macro-level trends and associated economic impacts relating to the growth of Australia's superannuation sector.

The main emphasis of the Section is on the implications of this asset growth for the *flow of funds* in the economy over the next few decades, particularly in the context of mounting demographic challenges and market innovations that will be needed to adapt to these (i.e. liquidity implications of investment choice, greater demand for longevity risk protection, likely shift to more defensive asset allocations and new capital market instruments that will be needed to address population ageing, etc.).

There can be no doubt that all of these issues all have profound significance for the superannuation industry, which we expect will be explored at length by many respondents to the Inquiry.

But there is another, we suggest equally important macro trend implicit in the growth of the superannuation sector that has not been aired as widely as these demographic and asset allocation factors, which ACSI submits should be recognised as a very significant contributor to the shape, direction and integrity of the financial system going forward.

That trend is the **growing significance of superannuation funds as owners of capital market assets**, and what that growth implies for the exercise of ownership rights, governance, risk management and accountability frameworks of investee assets. Whilst this trend in principle applies across all asset classes, for present purposes we will confine our comments to the core area of ACSI's expertise and activity, being shares in Australian publicly-listed corporations.

We understand from recent discussions with a member of the FSI Secretariat that this topic is of interest to Panel members, so we are pleased to provide the Panel with some contextual information as follows.

<u>The Notions of "Universal Ownership" and "Fiduciary Capitalism"</u>

The concept of major asset-owning institutions such as superannuation/pension funds and sovereign wealth funds as "universal investors" has been reasonably familiar in institutional investment circles since the mid-1990s when the phrase was first coined by prominent US corporate governance researchers Robert Monks and Nell Minnow, and subsequently further explored in a series of academic studies by James Hawley and Andrew Williams.[1]

In a nutshell, the universal investor proposition holds that large fiduciary institutions, once they collectively hold a significant enough proportion of the assets in a given economy, are in effect inextricably bound to the overall performance of that economy, notwithstanding that they also typically seek to vary their exposures to individual asset classes, sectors or securities within that economy's financial system to optimise their overall financial performance.

The universal ownership concept has a number of important corollaries for large fiduciary investors, including that:

- They are inevitably exposed to the costs of *externalities* that are borne by the broader economy, but which are not necessarily captured in the valuation of individual companies or sectors - for example, the economic impacts of natural resource depletion, pollution, technological disruption, or major corporate governance or probity failures;
- Because of this, fiduciary investors have a direct financial interest in the long-term health and wellbeing of the society in which they operate, and in minimising negative externalities (and maximising positive ones);
- In investment parlance, this means they have a vital interest in improving the underlying 'beta' of the market, whether or not they then seek to supplement this with additional excess returns or 'alpha';

[1] Monks, Robert A.G. and Nell Minnow, *Corporate Governance*, (1995); James Hawley & Andrew Williams, *The Rise of Fiduciary Capitalism* (2000).

- These motivations are present and justified purely from the perspective of long-term *financial value creation* in the interests of end-beneficiaries; i.e. leaving aside any additional motivations some institutions or their beneficiaries may have for broader socially responsible or 'values-based' outcomes;
- Whilst typically highly dependent upon a lengthy supply-chain of other investment intermediaries to give effect to various component parts of their portfolios (fund managers, brokers, asset consultants etc.), fiduciary investors are by definition serving a broader mandate than what is delivered by the sum total of the outputs of these external suppliers;
- This broader mandate may be manifested in many ways, including the increasing trend to direct ownership of private equity and infrastructure assets, and in some cases establishment of significant in-house investment capacity – but most importantly (for present purposes), in an increasingly active role in the exercise of *ownership rights* over equity assets held in their portfolios;
- The universal ownership paradigm in turn means that asset owing institutions are ultimately focused on delivering absolute, real investment returns to their beneficiaries/members, rather than playing the same relative performance 'game' as other financial services institutions. This factor promotes collaboration and reduces free-rider impediments to action that would otherwise inhibit competitor organisations achieving collective influence over companies in which they invest.

Implications for Capital Formation and System Stability

Far from seeing the universal ownership phenomenon as a source of increased systemic risk or instability, many leading commentators have highlighted the opportunities it offers to fundamentally improve the economic performance and accountability mechanisms of the financial system. This conception sees universal ownership as a direct counter-force to the 'agency capitalism' that has dominated much of the financial services sector over recent decades, driven by more short-term oriented and transaction-focused financial intermediaries.

For example, one recent opinion piece by the Global CEO of the CFA Institute segmented the 70 year period since the end of the Second World War into three distinct phases, culminating in a new era of "Fiduciary Capitalism", which is currently in its early phases, and driven by sophisticated institutional investors motivated by an agenda that necessarily takes account of a long-term, cost-oriented approach to ownership of assets.

This analysis concludes:

> *"Fiduciary capitalism may well supplant 30 years of finance capitalism as a driving force in the global economy. An era of fiduciary capitalism could shape the global economy for many years, as did the era of finance capitalism that preceded it. ... The future of finance needs to be less about leverage, financial engineering, and stratospheric bonuses and more about efficiently and cleanly connecting capital with ideas, long-term investing for the good of society, and delivering on promises to future generations. In the public policy arena, governments that promote long-term savings, reduce taxes on long-term ownership, and require transparency and good fiduciary governance can help hasten this welcome change in our financial markets".* [2]

Another recent analysis by eminent international pension fund governance expert Roger Urwin states:

> *"Universal owners are asset owners who recognize that through their portfolios they own a slice of the whole economy and the market. They adapt their actions to enhance the return prospects of their portfolios, and hence the prospects for the whole economy and the market as well. This approach is a logical but ambitious interpretation of investing sustainably. Universal owners focus their actions particularly on active ownership practices and active investment strategies that integrate environmental, social, and governance considerations. They also collaborate with other asset owners to produce network benefits. Externalities such as resource degradation and depletion, greater complexity, and connectedness make the methods of universal owners increasingly important. The challenge now is to adapt the roles of the state and the market. By fostering a better-*

[2] John Rogers, CFA, *A New Era of Fiduciary Capitalism? Let's Hope So* (Financial Analysts Journal, May/June 2014) (http://blogs.cfainstitute.org/investor/2014/04/28/a-new-era-of-fiduciary-capitalism-lets-hope-so/) The other 2 post-war eras postulated in this paper were: (1) an era of "Industrial/Managerial Capitalism" from 1945 to 1980, characterised by major corporate debt-issuers and conglomerates, with minimal governance controls; and (2) an era of "Financial Capitalism", extending from around 1980 to 2010, when the finance sector in effect became an "end unto itself" rather than its proper role as an enabling function for the real economy.

balanced collaboration between the two, universal owners would increase both their legitimacy and effectiveness in pursuing actions that are value-enhancing for their beneficiaries and for society."[3]

Relevance for Australia's Financial System

Given the scale and growth (both historical and projected) of its superannuation industry – and, as we discuss below, the existing well-established framework for representation of institutional investors' ownership rights via ACSI and other like collaborative organisations - Australia is in many respects at the global forefront of this "fiduciary capitalism" phenomenon.

Citing the FSI's own figures, Australia now has a superannuation sector of some $1.8 trillion, which now exceeds the total market capitalisation of the ASX at around $1.6 trillion at March 2014, and has increased in relative size from 50% to 60% of the total assets of the Australian banking system between 1997 and 2013[4].

Another common method for measuring the scale of the superannuation/pensions industry in a relative context – as a proportion of annual economic output per national economy - has the Australian industry currently weighing in at approximately 1.05 times the nation's GDP at December 2013, the fifth highest in the world on that metric, and the 4th highest in terms of absolute dollars under management (at US$1.56 trillion equivalent). Australia has also been the world's fastest growing pension market over the ten years to December 2013 (with a CAGR of 14% p.a. over that period), and with further growth locked in due to the planned increase in superannuation guarantee contribution rates to 12% of salary by 2022 – estimated to take the industry to US$7.6 trillion equivalent or 1.8 times national GDP by 2033.[5]

All of these figures are of course further accentuated once offshore fiduciary investor holdings in Australian assets are factored in. In the case of listed equities, this significantly increases the superannuation/pension investor base to being a dominant force in the share registries of most domestic listed companies.[6]

The figures indicate that Australia's capital markets are now well and truly in the "zone" envisaged by the international research cited above as signifying the shift to a universal owner or fiduciary capitalist model for capital formation, governance and corporate accountability.

Where ACSI Fits In

Against this backdrop, Australian superannuation funds have been pioneers in collaborative approaches that embody the universal ownership principle and seek to have a constructive and cost-effective impact on the long-term value of the public assets they hold in their portfolios.

Of particular note has been the work of the ACSI since 2001 as a mechanism for profit-for-members superannuation funds to exercise shareholder ownership rights efficiently on behalf of their members, and to engage constructively with Boards and management of listed Australian companies on important governance, shareholder value and long-term investment risk issues.

ACSI, which is itself a not-for-profit provider, is financed and guided by 33 Australian and 5 international asset owners in the not-for-profit superannuation/pension fund sector. The 33 Australian funds collectively manage over $400 billion in superannuation assets (around 25% of total superannuation system assets), and the members of those funds total over 8 million Australian super fund members. Of these total assets, approximately 30% are invested in public listed equities, which from our most recent calculations translate to approximately 11% of the average market capitalisation of companies in the benchmark ASX200 Index.

---

[3] Roger Urwin, "Pension Funds as Universal Owners: Opportunity Beckons and Leadership Calls" (*Rotman International Journal of Pension Management* Volume 4, Issue 1 (2011) pp. 27-33.

[4] APRA, ASX and ABS data cited in *FSI Interim Report* July 2014, p. 2-82.

[5] Towers Watson, *Global Pension Assets Study* 2014.

[6] An exact quantification of total ASX pension assets attributable to pension funds is difficult owing to complexities in institutional ownership structures and market data reporting conventions. However, the ASX's *Annual Australian Cash Equities Market 2013* report identifies "Pension Funds and Insurance Companies" collectively as holding 29% of the ASX market ($369 billion) at September 2012, with a further 10% ($125 billion) held by "Other Financial Institutions" 46% ($547 billion) by the "Rest or World". It is highly likely that a significant proportion of these "other" categories are ultimately attributable to pension funds and other large institutional asset owners (e.g. sovereign wealth funds). (http://www.asx.com.au/documents/professionals/australian_cash_equity_market_2013.pdf)

A key foundation for our company engagement work is the *ACSI Corporate Governance Guidelines*, first published in 2003 and now in their sixth edition. These Guidelines are designed as a reference for chairpersons, directors and senior executives of listed companies on the contemporary governance expectations of superannuation fund investors. They also provide a framework by which superannuation fund trustees and their executives and service providers can assess the ESG practices of investee companies, particularly when exercising their ownership rights.

ACSI maintains an ongoing targeted research program, aimed at ensuring that there is a sound empirical evidence-base for the company engagement and advocacy activities we undertake on our members' behalves. We are an active participant in key industry forums shaping the corporate disclosure and risk management environment in Australia and internationally, including the ASX Corporate Governance Council, the Business Reporters Leadership Forum (BRLF), and the International Corporate Governance Network (ICGN). We are also a signatory to the United Nations-backed Principles for Responsible Investment (PRI), a global network of investors responsible for some US$8 trillion of assets under management, and are responsible for management of the PRI country network in Australia and New Zealand.

Some Highlights

Some of the benefits that this industry collaboration has contributed to the transparency and integrity of Australia's capital markets over the past thirteen years since ACSI's establishment include:

- The **articulation and evolution of best corporate governance practice for Australian listed companies,** through development of authoritative guidelines (noted above) detailing the reasonable expectations of asset owners for governance standards that should be adopted by listed investee companies, and under which sustainable long-term investment can prosper;
- Creation of a **constructive model of engagement** between Boards of major listed companies and their superannuation investors (on present activity levels this engagement process runs to around 130 in-face interactions with ASX200 company boards per annum, as well as written interactions with all 200 in key areas such as sustainability reporting practices, company proposals that were not supported at the most recent AGM, and exposures to material ESG investment risks identified in ACSI's research program);
- Securing of **significant public policy and self-regulatory reforms** in key governance areas including executive remuneration, termination pay for departing senior executives, disclosure of material non-financial risks, capital raising practices and proxy voting administrative processes;
- Development of **a sound evidence base on material Environmental, Social and Governance (ESG) investment risks** facing Australian companies and how these might be better managed (recent topical examples include the exposure of Australian corporations to significant risks in their expanding offshore operations, notably bribery and corruption and supply chain labour and human rights abuses; and exposure to carbon asset risks in the face of impending climate change scenarios); and
- **Active participation in significant cross-sector collaborations** including the ASX Corporate Governance Council, and in key international forums including the International Corporate Governance Network (ICGN) and UN-backed Principles for Responsible Investment (PRI).

ACSI also collaborates closely with industry bodies representing institutional investors outside its membership base, such as the Financial Services Council, with peer investor representative bodies such as Regnan and Hermes, and with major institutional investors outside the superannuation sector, such as public sector investment agencies and commercial investment managers. Collectively these organisations today represent a formidable 'buy-side' voice and source of thought leadership in the Australian corporate governance and engagement realm.

Critically, (a point we are confident would we affirmed by leading corporate representatives) the culture of engagement that has evolved between major corporates and their superannuation investors in Australia is one of mutual respect, discretion, factual evidence base and focus on material investment risk issues. This stands in marked contrast to the more adversarial and litigious approaches that prevail in some other markets, and which can serve to inhibit meaningful dialogue and change at either an individual company or broader market level.

This level of openness and sophistication in the institutional investor/corporate relationship is a key strength of the Australian corporate governance landscape and, we believe, a significant indicator of the maturity of the profit-for-members superannuation sector in this country. It is also a widely commended model in international governance circles, and one that we believe will stand our market in good stead for the very significant fiduciary investment challenges of the future.

<u>Conclusion</u>

ACSI strongly encourages the Inquiry to recognise the evolution of a sophisticated 'fiduciary capitalism' model in Australia as one of the key positive long-term trends associated with the growth of the profit-for-members superannuation sector in Australia over the past several years.

We also submit that this trend should be recognised as a significant contributor to the restoration of public confidence in, and sustainability of, Australia's financial system, and its realignment with its core fiduciary purpose of maximising the risk-adjusted returns delivered to superannuation fund members.

We would hope that recognition of this key industry trend and existing significant progress achieved will help elevate the level of Government and public understanding of the superannuation industry's contribution, beyond its functional attributes (price, cost, short-term performance) which, whilst obviously important, do not fully capture the value delivered by fiduciary investors in responsibly exercising ownership rights over investee assets on their members' behalves.

Capital Raising Practices of Australian Listed Companies

FSI Interim Report Reference: Section 2-93

Section 2-93 of the Interim Report discusses the issue of access by retail investors to new equity offers issued by Australian companies, and quotes the Australian Shareholders' Association (ASA) submission stating that retail investors were diluted out of $10 billion of value through non pro-rata capitals raisings after the 2007–2008 financial crisis.

Among the "Policy Options for Consideration" arising from this is whether Australia should "introduce additional protections for investors in relation to use of private placements and non-renounceable rights issues".

ACSI shares the concerns about dilution of incumbent shareholders during capital raisings, but would like to add that institutional shareholders (and in turn their underlying beneficiaries i.e. superannuation fund members) have also been significantly diluted through selective placements and non-renounceable rights issues by many companies under Australia's capital-raising framework. For both retail and institutional shareholders alike in this situation, the value loss is two-fold: there is a reduction in the proportional voting interest in the company and also a transfer of value from existing to new shareholders when placements are undertaken at a discount.

It is important to note that, despite the common legal heritage, Australia's capital-raising framework lacks an equivalent to the UK's principle of 'Pre-emption Rights' that serve to preserve the entitlements of incumbent shareholders by creating a presumption in favour of pro-rata entitlements where companies issue new shares, and creating clear investor guidelines where companies seek to use placements and other non-prorated capital raisings

To address this gap, ACSI's general policy for many years, expressed in the *ACSI Corporate Governance Guidelines* has been:

> *"Equity capital raisings have the potential to dilute the investments of shareholders. As such, companies should respect the pre-emptive rights of existing shareholders by endeavouring to raise new equity capital in such a way that all existing shareholders have an opportunity to maintain their interest, or be compensated for the dilution of their interest."*

At the same time, we recognise that certain conditions (e.g. unusual financial duress) may require issuers to make trade-offs between the need to raise capital quickly and the cost and access issues for existing providers of capital that arise when new issuances are placed selectively and/or at a discount. One example of such a time was during the GFC, when the success of some companies in re-capitalising their businesses through truncated placements, and the availability of a significant pool of superannuation assets to fill them, were key contributors to the avoidance of financial difficulties on a scale experienced in many other economies at the time.

Recognising the need for flexibility in this area, ACSI's recommended approach is that where a capital raising is undertaken other than on a pro-rata basis, more effective *disclosure* of the basis on which that decision was taken can enable investors to assess whether it was reasonable and sufficiently protected their interests.

To this end, ACSI routinely queries companies directly on the following questions in relation to non pro-rated capital raisings:

- How the board oversaw the capital raising process.
- How the capital raised was priced.
- Why it was necessary to waive pre-emptive rights.
- The identity of advisers and underwriters.
- The fees paid to advisers, underwriters and a differential in the fees paid to underwriters and those paid to any sub-underwriters.

ACSI submits that additional mandatory disclosure by companies would enable investors themselves to monitor the effectiveness and equity of their capital raising activities more effectively, along the lines of the Recommendations in the shaded area below. We note that the ASX Listing rules may be more appropriate for implementation of these measures than the Corporations Act.

<u>Disclosure of fees</u>

In June 2014, ACSI published a research paper on underwriting fees, which analysed 63 underwritten rights issues conducted by S&P/ASX300 member companies between 2010 and 2012 and compared the amount they paid for underwriting against a benchmark value. The study found:

- Over $300m was paid for underwriting (net of advisory fees) in these 63 rights issues.[7]
- In aggregate, companies appear to be paying more than twice as much for these underwriting fees than the benchmark value of the relevant underwriting services. On a simple average basis, the excess is almost 50%.
- This suggests that companies have paid underwriters (typically investment banks and stockbroking groups) a premium of more than $170 million, or an average of around $2.7 million per raising, above the benchmark value.
- Average underwriting fees are more than 60% higher than they were 20 years ago. This is despite innovations that, among other things, have dramatically reduced the time required to complete a rights issue, thereby decreasing underwriting risk.

Based on this research, ACSI made a number of recommendations for investors, company directors and ASX. There were no recommendations for any statutory changes to the Corporations Act, but for the information of the FSI Panel, our recommendations for the ASX were:

- The ASX Listing Rules should be modified to require disclosure of underwriting fees for share placements in the same way as currently applies to rights issues. This improved transparency will allow analysis (such as ACSI's research above) to be applied to placements, not just rights issues.
- ACSI supports ASX continuing in its efforts of shortening the rights issue timetable, since shorter timetables should mean less costly underwriting.

[7] ACSI, *Underwriting of Rights Issues 2010-2012*, at www.acsi.org.au/researchreports.html

Greater access to capital markets for smaller companies

The consultation asks "Is there a need to introduce differentiated markets to allow greater access to equity markets by smaller companies?"

ACSI's general view is that there are already sufficient additional capabilities for smaller listed companies to raise capital. There are four reasons for this:

- Under the current ASX Listing Rules, companies can already raise up to 15% of their shares on issue every 12 months. These rules are less restrictive compared to some jurisdictions. For example, both UK law and the Singapore Exchange listing rules prohibit *any* non pro-rata capital raising without prior shareholder approval.
- Only in 2012, the placement cap already was extended to an additional 10% for placements by ex-ASX300 sub-$300m market cap companies subject to shareholder approval at the AGM.
- The ability already exists for any ASX listed company to raise capital in excess of the standard 15% annual threshold by seeking specific approval from its shareholders at an AGM or EGM. This gives existing shareholders the ability to compare, on a case-by-case basis, potentially giving up their ability to participate (or allowing a large shareholder onto the share register) versus giving the company additional access to external capital.
- Companies can issue additional shares beyond any cap without shareholder approval through a pro rata rights issue. If there is insufficient demand from existing shareholders, the rights can be sold through a bookbuild process similar to a placement. This allows companies to access outside investors while compensating existing shareholders for any dilution they suffer.

Conclusion

With this background, we offer the following recommendations relating to the consultation question on p. 2-94 of the Interim Report, on whether to "introduce additional protections for investors in relation to use of private placements and non-renounceable rights issues".

***Recommendation 1**: The ASX should introduce a Listing Rule to require disclosure of underwriting fees for share placements in the same way as currently applies to rights issues. This is a precondition for an effective and transparent market for capital raising in Australia.*

***Recommendation 2**: Since few announcements regarding placements address the question of why a placement was chosen over a rights issue – and in most cases it is unclear because most placements by large companies in the post-GFC period have not been a result of financial distress - there should be a requirement for companies to provide meaningful disclosure, in the announcement, as to why a placement was preferred over a rights issue. In other words, why it was necessary to waive pre-emptive rights.*

(Note: the ASX has recently added this requirement, but only in relation to companies undertaking placements under Listing Rule 7.1A, which applies only to ex-ASX300 sub-$300m market cap companies. ACSI recommends that the same requirement should apply to raisings be larger capitalisation companies as well).

***Recommendation 3**: Companies undertaking placements should disclose what percentage of the placement was offered pro-rata to eligible existing shareholders[8] as part of the company's oversight of the capital raising.*

ACSI would expect companies to know this information and would expect a reasonably large proportion to be offered to existing institutional shareholders.

[8] The intent of the proposed requirement for disclosure on a "pro-rata" basis in this context is to stop companies from offering a large piece to a nominal shareholder and claiming it was an existing shareholder. The term "eligible" is required because foreign and retail shareholders are generally not eligible or able to participate in placements, and inclusion of this proviso would enhance comparability between companies.

Trust Law Foundations of Australia's Superannuation System

FSI Interim Report Reference 2-107-116

In the chapter on Superannuation (pp 2-107-116), the Interim Report poses the question of whether the Trust Law structure is best placed to meet the needs of superannuation fund members in a cost-effective manner.

This question is raised somewhat tangentially, in the context of a discussion about fees, short-termism, agency costs and competition in the industry – the implication being that trust law might itself be a contributor to the actual or perceived problems the industry is experiencing in these areas.

The Interim Report does not specify what the alternative models for superannuation system regulation might be if Trust Law were to be removed as the founding premise. However, we assume that those alternatives would be either, or a combination of: (a) a regulatory framework that attempted to define the relationships between suppliers and customers of superannuation services in strictly *contractual* terms; or (b) some form of *statutory codification* of the fiduciary duties and other responsibilities of superannuation providers. Both of these approaches have analogues in other pension markets, in some cases (e.g. the UK) as alternative forms of pension provision standing alongside (and competing with) traditional common law law-based pension schemes.

We do not propose to offer a comprehensive legal analysis of every dimension of this question, but offer the following points assist the Inquiry in its future deliberations and recommendations to Government.

<u>The Value of the Trust Law System to Super Fund Beneficiaries</u>

In common law jurisdictions like Australia, the legal concept trust has evolved primarily through the avenue of judge-made law in Equity, which (whilst perhaps lacking the certainty and predictability of more black-letter approaches) has historically been interpreted very expansively in the interests of *beneficiaries* than those of the institutional providers of financial services.

By contrast, as soon as regulatory frameworks have moved into the more 'certain' realm of contract law, the legal emphasis has tended to move to a more narrow interpretation of each party's rights, generally on the basis of the *caveat emptor* principle and the presumption that each counterparty has equal access to (and ability to process) relevant information, and equal bargaining power. In many cases, arguably not least in the case of a broad-based, compulsory 2nd-pillar pension system such as the Australian superannuation system, this assumed coordinate status of the counterparties does not reflect the reality. Consequently, both in principle and in practice, this dynamic typically works to the disadvantage of the weaker party to the commercial arrangement in question.[9]

To our minds this creates a significant problem in an industry like superannuation, in which participation by all working Australians is mandated, and where the information asymmetry between providers and consumers (especially those in default funds) is typically very large.

Other respondents with explicit expertise in financial system design will no doubt give a more comprehensive view of the advantages and disadvantages of trust-based and contract-based approaches, but in ACSI's view it is critical that the superannuation fund trustee/member fiduciary relationship should not be reduced to a standard 'supplier/customer' frame as might be the case with other financial products or services that are acquired by individuals on a fully discretionary basis.

A further high-level comment we would like to make is that, in the overall regulatory framework for the financial system in Australia and elsewhere, a key goal is to strike a suitable balance between principles-based and more formal rules-based regulatory approaches. This theme is apparent in numerous sections of the FSI's

---

[9] For a detailed explanation of how this dichotomy has played out in the UK with the recent advent of contract-based pension schemes there, see Molinari, C., "The Future of Fiduciary Obligation", in Hawley, J., Hoepner, A., Johnson, K., Sandberg, J. & Waitzer, E. (ed.), *The Cambridge Handbook of Institutional Investment & Fiduciary Duty* (Cambridge University Press, 2014). Beyond this specific topic alone, this recently-released *Handbook* is a very useful compilation of the state of play in pension fund fiduciary oversight and investment issues generally and therefore commended to the FSI as a highly useful contemporary resource for its further investigation of these issues. Another very contemporary UK exploration that we would commend to the FSI in this context is the UK Law Commission's comprehensive report on Fiduciary Duties of Investment Intermediaries, published in June 2014 – in particular Chapters 3-6 concerning the legal basis of trust law fiduciary duties and how these are reflected in investment responsibilities of trustees and management of ESG investment risks.

Interim Report, not just those relating to the superannuation sector specifically. Australia's financial regulatory framework currently has a blend of both principles-based and rules-based approaches, with the trust law foundations of the trustee system providing much of the key principles-based content for the superannuation sector.

On the whole we believe this balance has worked well, and that tipping the balance too far towards a rules-based contract law or statutory approach would risk creating a proliferation of new micro-level rules and requirements, and promote a culture of conformance rather than performance and active focus on end-members' interests.

The Importance of Governance and Stewardship Oversight

A further issue, echoing our comments earlier in this submission, is that the corporate governance and stewardship 'space' in which ACSI operates is a key example of how a fiduciary-focused approach is fundamentally different from more commercially-oriented forms of financial intermediation such as banking, investment management or wealth management.

Most examples of successful collaboration to address system-wide governance or sustainability issues that would be overwhelming for individual market participants to address on their own (or acting in competition), have been driven out of the asset-owner community and its sense of fiduciary responsibility to the ultimate beneficiaries of the capital invested. As noted earlier, this relationship is especially vital in a complex financial system with a high degree of information asymmetry between the providers of capital (in this case, superannuation fund members) and the provider of the service (their Fund) – a compulsory 'second pillar' pension system such as Australia's superannuation system being a prime example.

In this regard, ACSI submits that the emergence of a productive and successful 'fiduciary capitalist' model depends fundamentally on the asset-owning institution being held to a fiduciary standard, of which trust law is the highest form of expression in a common law jurisdiction like Australia. It is out of this fiduciary investment culture that organisations like ACSI – and leading international bodies such as the International Corporate Governance Network (ICGN)[10] and Principles for Responsible Investment (PRI)[11] – have emerged, and now form a critical part of the global dialogue on corporate accountability, efficient capital formation and financial system stability.

The crucial system-wide challenges related to agency theory and market failure addressed by initiatives such as ACSI, ICGN and PRI are unlikely to be improved by even the largest single institutional investor acting independently. The collaboration and leadership shown by institutional investors through these initiatives has led to meaningful positive impacts for ultimate beneficiaries. It is difficult to see how such a model could ever have emerged, or succeed in the future, in an industry that was serviced only by commercially-oriented providers of retirement savings products.

[10] The ICGN is investor-led organisation of governance professionals that seeks to promote effective standards of corporate governance to advance efficient markets and economies world-wide. ACSI and a number of other Australian industry bodies from the institutional investment, superannuation fund and corporate communities are members of ICGN and active participants in its policy-setting committees. Key ICGN policy documents that relate to the fiduciary oversight role of superannuation funds as asset owners are its Global Corporate Governance Principles (2014), and Statement of Principles for Institutional Investor Responsibilities (2013), both available at www.icgn.org.

[11] The PRI is an international network of investors working together to put into practice the six Principles for Responsible Investment, formulated under the auspices of the United Nation in 2006. It currently has 1260 signatories globally among asset owners, asset managers, and investment industry service providers, collectively representing approximately US$8 trillion of asset under management. There are currently 121 Australian signatories to the PRI, including 33 asset owners (primarily superannuation funds). ACSI is responsible for managing the PRI Secretariat function in Australia and New Zealand. Current PRI projects that are especially relevant to the long-term fiduciary investment challenge are research collaborations on Operationalising Long-Term Investment Mandates and Policy Frameworks for Responsible Long- Term Responsible Investment; further details available at http://www.unpri.org/areas-of-work/policy-and-research/

Conclusion

ACSI submits that great caution should be taken before considering any move away from trust law as the legal underpinning of Australia's superannuation system. From ACSI's perspective, the fiduciary climate has been a crucial catalyst for our work to reduce the agency and intermediation costs experienced by the beneficiaries of long-term asset owners such as super funds.

In the absence of a full assessment of the costs/benefits, broader capital market impacts (including in the areas of governance and stewardship) and other potential pitfalls of any alternative approaches, ACSI recommends that the trust law system remain in place as the foundation of Australia's superannuation system.

Closing Comments

In finalising our submission, our key message to the FSI Panel is that many of the best aspects of Australia's current superannuation and institutional investment system have been borne out of an active and engaged fiduciary mind-set on the part of key participants in the industry including ACSI and its members.

In particular, we submit that:

- Active ownership by long-term asset owners of the entities in which they invest has been a key component of Australia's enviable capital market stability and integrity.
- These practices have made a major contribution towards Australia evolving into one of the world's most sophisticated markets for the prudent exercise of shareholder ownership rights and for productive engagement with corporations about material long-term investment risk issues.
- One example of this has been oversight by super funds of the capital raising practices of listed corporations, such as access, dilution and the value delivered by the fees paid by issuers to their advisers and underwriters.
- The positive force of 'fiduciary capitalism' is reliant upon a positive duty of care from the institutional asset owner to the ultimate beneficiary. Consequently, a very high standard of proof should be required before seeking to dismantle or dilute the current foundations for fiduciary oversight of the superannuation system in this country.

ACSI would be delighted to expand upon the comments and recommendations made in this submission in discussion with the FSI Panel and/or Secretariat as the Inquiry moves into its final stages of reporting to Government[12].

By all means contact me or my colleague Paul Murphy, ACSI's Executive Manager of Institutional Investment & Policy (pmurphy@acsi.org.au or 03 8677 3987) should you wish to pursue these issues with us, or if we can assist the Inquiry in any other way.

Yours sincerely

Gordon Hagart

Chief Executive Officer

[12] This discussion could, if required, extend to issues addressed in the Inquiry in which ACSI has an interest but which we have chosen not to comment upon specifically in this submission, including, inter alia:

- Competition for equity market platforms and clearing & settlement services (an issue upon which we have previously been approached for comment by the Council of Financial Regulators) – discussed in Section 2-33 of the FSI Interim Report
- Whether there should be more 'ring-fencing' of investment banking from mainstream banking activities – Section 3-18; and
- Any interest the FSI may have in policy proposals previously raised by ACSI on capital market structure and integrity issues, including reform of Australia's proxy voting administration system, and ongoing concerns over the impact of High Frequency Trading & Dark Liquidity.