Governance News

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Mark Standen
Partner

T +61 2 9921 4902 | **M** +61 412 104 902

Siobhan Doherty
Partner

T +61 2 9921 4339 | **M** +61 413 187 544

Kate Hilder
Consultant

T +61 3 8608 2907 | **M** +61 411 418 172

For queries or to subscribe/unsubscribe to Governance News updates, please contact: kate.hilder@minterellison.com

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Boards and Directors

Disclosure of cybersecurity expertise at board level on the cards for US boards? New legislation — *S 536, the Cybersecurity Disclosure Act of 2017* — has been introduced into the US Senate.

New legislation, which if enacted would require disclosure of cybersecurity experience at the board level — S 536, the Cybersecurity Disclosure Act of 2017 — has been introduced into the US Senate and was recently considered by the Committee on Banking, Housing, and Urban Affairs.

If enacted, the Bill would require the Securities and Exchange Commission (SEC) to issue rules requiring each reporting company to disclose in annual reports or annual proxy statements:

- 'whether any member of the governing body, such as the board of directors or general partner, of the reporting company has expertise or experience in cybersecurity and in such detail as necessary to fully describe the nature of the expertise or experience;' and
- 'if no member of the governing body of the reporting company has expertise or experience in cybersecurity, to describe what other cybersecurity steps taken by the reporting company were taken into account by such persons responsible for identifying and evaluating nominees for any member of the governing body, such as a nominating committee'.

The legislation also proposes that SEC, in consultation with the National Institute of Standards and Technology (NIST) will define what constitutes 'cybersecurity expertise or experience' such as 'professional qualifications to administer information security program functions or experience detecting, preventing, mitigating, or addressing cybersecurity threats, using commonly defined roles, specialities, knowledge, skills, and abilities, such as those provided in NIST Special Publication 800–181 entitled "NICE Cybersecurity Workforce Framework", or any successor thereto'.

Existing SEC guidance on board oversight of cybersecurity risk/disclosure: In February 2018, the SEC issued guidance on disclosure of cybersecurity risk. The guidance states that companies are already required under existing rules to disclose the extent of the board of directors' role in the risk oversight of the company, 'such as how the board administers its oversight function and the effect this has on the board's leadership structure'. SEC adds that this disclosure should include disclosure of any 'important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company'. There is no explicit requirement for the board to disclose board level cybersecurity expertise.

Australian position

- There is no parallel reporting requirement in Australia.
- At a high level Australia's financial regulators have both identified cyber risk as a key focus: for example, cyber risk is identified in The Australian Securities and Investment Commission's (ASIC's) Corporate Plan as a key priority over the period 2017-2021 and the Australian Prudential Regulatory Authority has said that it is a key focus for 2018. APRA has also recently completed consultation on its first, cross-industry prudential standard on information security management, in response to the growing threat of cyber-attacks.
- From a board skills perspective, Recommendation 2.2 of the current (and of the proposed new version of) the *ASX Corporate Governance Principles and Recommendations* states that listed entities should have and disclose a board skills matrix setting out the mix of skills the board has or is looking to achieve in its membership. Proposed amendments to the commentary accompanying the recommendation, include changes reflecting the increased importance of cybersecurity as a board-level issue. More particularly, the ASX Council proposes to amend the commentary to include that the skills matrix should cover the skills needed to address existing and emerging governance and business issues such as cyber risk (among other risks). In addition, the Council proposes an amendment to recommendation 2.6 (director induction and professional development) and the accompanying commentary to reflect the importance of ensuring boards have the necessary skills to

address new or emerging issues including cyber risk, that regular reviews of board skills be undertaken and that professional development programs address any skills gaps.

- Australian boards appear to be increasingly aware of cyber risk? The most recent annual MinterEllison *Perspectives on Cyber Risk* report found that there was an increase from a 'fair' understanding of cyber risk (45%, up from 35% in 2016) and 'very good' understanding (24%, up from 15% in 2016) of cyber risk.

[Sources: S.536 - Cybersecurity Disclosure Act of 2017; US Securities and Exchange Commission Statement and Guidance on Public Company Cybersecurity Disclosures 26/02/2018]

In Brief | The ACTU has reportedly passed a resolution mirroring a UK conservative government promise for worker representation on boards? The AFR reports that the ACTU has passed a resolution calling for a future Labor government to install employee representatives on private and public company boards including, appointing a union representative to the RBA board.

[Note: The UK government has since abandoned the promise and mandatory employee board representation is not included in the most recent edition of the UK Corporate Governance Code released on 16 July 2018. The new Code and initial industry responses to it are discussed in separate posts in this issue of Governance News.]

[Sources: [registration required] The AFR 19/07/2018; 18/07/2018]

In Brief | The Federal Court has dismissed a challenge to a four year disqualification imposed by ASIC on a former company director. The basis of the challenge was that ASIC failed to properly serve the Notice of Disqualification in accordance with s206F(3) of the *Corporations Act 2001* (Cth). In dismissing the former director's claim, Colvin J found that ASIC had met the requirements because it was clear on the facts that Notice had been personally served.

[Sources: ASIC media release 20/07/2018; Carter v Australian Securities and Investments Commission [2018] FCA 1064]

Diversity

United Kingdom | 2020 gender representation deadline in doubt? Two separate reports have highlighted the issue of female under representation in FTSE 350 companies and more particularly have highlighted the fact that progress on improving the gender balance in the leadership pipeline has stalled.

According to the latest report from The Pipeline: *Women Count 2018: Role, Value and Number of Female Executives in The FTSE 350* progress on gender diversity in the leadership of the UK's largest listed companies has stalled for the past two years. Chair of the Treasury Select Committee, Nicky Morgan comments that this raises questions over whether government-backed gender representation targets (33% women in leadership roles) can be met by the 2020 deadline.

Key findings

- **Zero progress in getting women onto executive committees**: The report found women accounted for only 16% of executive committees at FTSE 350 companies at mid-April this year — unchanged since 2016. Nearly a quarter of FTSE 350 companies have zero women on their executive committees and 63% of companies have no women in roles with profit and loss responsibilities (P&L roles). In The FTSE 350, 5% of P&L roles on executive committees are held by women. This is significant as these roles are 'springboard jobs for advancement to CEO' according to the report.

- **Women remain underrepresented in other leadership positions:** According to the report, 95% of the Chairs of main boards are men. Only 6 companies in The FTSE 100 have women Chairs. This is of significance the report comments, as where women hold key leadership positions (CEO, Senior Independent Director (SID), Chair of the Remuneration Committee, Chair of main board) the company is likely to have a larger number of women on executive committees than if the positions were held by men.

- **Gender pay gaps are greater without women executives and CEOs:** According to the report companies with higher numbers of women executives have lower median pay gaps. For example, the median pay gap between women at men at companies with a female CEO is 11% as compared with 17.4% where their CEO is male.

- **Younger employees expect gender diversity at work:** 62% of people aged below 35 agree that having a balance of men and women at all levels in the workplace matters to them, decreasing to 35% in the 65+ age group. Over 50% of women of all ages believe that increasing the number of women in senior roles at work would give them more role models (a view also shared by the majority of 16-34 men).

- **Correlation between profitability and more women in senior roles:** According to the report, FTSE 350 companies with zero women on their executive committee achieved an average 8.9% net profit margin as compared with a 13.9% profit margin in companies were there is 25% female representation on executive committees. The report states: 'There is a £13bn gender dividend on offer for UK plc, if all FTSE 350 companies performed at the same level as those with women on their executive committees'. Commenting on this Chair of the Treasury Select Committee Nicky Morgan urged businesses to rethink their approach stating that they are 'failing to meet their full potential'.

The report concludes that 'Urgent and far-reaching change is required if FTSE 350 companies are to meet the Government's target for 33% of their executive committee members and their direct reports to be women by 2020. Carrying on as before is not an option'.

[Sources: The Pipeline: Women Count 2018; Summary; [registration required] The FT 16/07/2018]

Second report mirrors the finding that women remain underrepresented in executive positions in The FTSE350: The latest annual report by the Cranfield University: *Female FTSE Board Report* has also recently been released and among things, confirms the finding that the percentage of female executive positions has 'flatlined'. According to the report, though the percentage of female Nonexecutive Director (NED) positions is at the 'all-time high' of 35.4%, the percentage of female executive positions 'has flatlined at 9.7%'. Like the Pipeline report, the Cranfield report suggests that this presents 'challenging conditions for meeting the 33% target in 2020.'

[Source: Cranfield School of Management media release 15/07/2018; The Female FTSE Board Report 2018; The Times 15/07/2018]

Remuneration

Top Story | ACSI's 2018 CEO pay survey has found CEO pay is at record levels.

The Australian Council of Superannuation Investors (ACSI) has released its 17th annual survey CEO remuneration in ASX200 companies: *CEO Pay in ASX 200 companies: ACSI Annual Survey of S&P/ASX200 Chief Executive Remuneration July 2018*. According to the report, average realised CEO pay outcomes are at the highest levels in four years and bonuses paid to ASX100 CEOs reached their highest levels since the survey commenced 17 years ago. ACSI attributes the upswing in part to strong capital market performance (ie CEOs benefiting from the value of equity awards) but highlights 'persistent and increasing bonus payments' as a key factor. 'Across the sample, bonus persistence was strikingly apparent – most ASX100 CEOs received a bonus at a significant proportion of their maximum entitlement – and its quantum increased' ACSI writes.

Key findings

- **'CEO pay has hit record highs'** with reported pay for ASX100 CEOs at the highest levels it has been in the 17 years of the study. Median realised pay for an ASX100 CEOs rose 12.4% to $4.36 million, and increased 22.1% to $1.76 million for ASX101-200 CEOs.

- **Base pay for ASX100 CEOs, showed little growth** ACSI found. ACSI attributes this to the fact that incumbent CEOs received modest pay increases and new CEOs are being appointed on lower fixed pay than their predecessors.

- **Bonus payments increased:** According to ACSI bonuses increased more than 18%. The median bonus awarded to an ASX100 CEO was at 70.5% of their maximum entitlement.
- **Bonuses 'resemble variable fixed pay'** ACSI writes, commenting that CEOs appear more likely to lose their jobs than their bonuses. According to the findings, in FY17, 74 of the 80 CEOs eligible for a bonus received one, and the median outcome was 70.5% of maximum (FY16: 68.6%). There were 10 Top 100 CEOs who departed their roles in FY17. Commenting on this, ACI CEO Louise Davidson said that the fact that bonuses have 'become such a sure thing' is an issue that if not addressed may 'need legislative intervention to give shareholders a greater say – such as we have seen in other markets, like the United Kingdom'. Ms Davidson added that bonus outcomes would be a focus for ACSI in the upcoming reporting season and that ACSI would recommend members vote against remuneration reports where ACSI considers they are 'not transparent and reflective of performance'.
- **Topping the list of the highest paid CEOs was Domino's Pizza Enterprises CEO** Don Meij ($36,837,702) followed by Peter and Steven Lowy of Westfield Corp ($25,906,960) and Nicholas Moore of Macquarie Group ($25,191,040).
- **Too few women to be able to analyse gender pay equity:** ACSI writes that there were too few female CEOs in the ASX 200 to enable an analysis of gender pay equality to be conducted with 4 female CEOs in the ASX 100 and 5 in the ASX 101-200. ACSI comments that 'There were more CEOs called Andrew in the ASX100 sample than women'.

Out of step with 'investor expectations'?

Commenting generally on the survey results, ACSI CEO Louise Davidson said: 'The increase in pay levels for CEOs occurs at a time when public trust in business is at a low ebb, and wages growth in the broader economy can best be described as anaemic. Against this background, decisions to significantly increase bonuses appear not only tone-deaf but also make me wonder whether boards have lost sight of the link between community and investor expectations, and a company's social licence to operate'.

The survey has received wide media coverage. The Australian comments that the report is significant because it demonstrates the disparity between CEO earnings and average annual earnings, noting that overall, CEOs are earning 52 times average (83,000) earnings. The article also points out that the for the first time in the survey's history there is no 'bank boss' in the top 10 ranking.

[Source: Australian Council of Superannuation Investors media release 17/07/2018; CEO Pay in ASX 200 companies: ACSI Annual Survey of S&P/ASX200 Chief Executive Remuneration July 2018; ; The Guardian 17/07/2018; [registration required] The Australian 17/07/2018; [registration required] The AFR 16/07/2018]

Time to consider binding votes on CEO pay? The AFR reports that speaking at the ACTU national conference Australian Labor Party President Wayne Swan commented that: 'Ten years on this year from the GFC, when exec pay was completely out of control and part of the reason for collapse of global economy, we are back to the point when executive pay was higher than it was then'. According to The AFR, Mr Swan suggested that to address the issue, shareholders should 'agitate for a binding vote to cap CEO pay'.

Separately, ACTU secretary Sally McManus is also quoted by The AFR as stating that remuneration levels will be a focus for superannuation trustees when making investment decisions.

[Source: [registration required] The AFR 18/07/2018; 18/07/2018]

Shareholder Activism

Global study has found activist activity is at record levels: Activist activity over H1 2018 has reached record levels both in terms of capital deployed and campaigns initiated according to Lazard's latest quarterly review of trends in shareholder activism.

Lazard's has released its latest quarterly review of trends in shareholder activism: *Lazard's Review of Shareholder Activism — Q2 2018*. Overall, the review found that activist activity 'reached record levels' in the first half of 2018 both in terms of capital deployed and campaigns initiated.

Key Findings include the following.

- **Activist activity is at record levels**
  - According to the report, Q1 2018 and Q2 2018 were the two most active quarters ever, resulting in a record 145 new campaigns launched against 136 companies in H1 2018.
  - Over $40.1bn of capital was deployed by activists in new campaigns during the period, representing a 6+% increase over the same period last year.
  - 104 investors (including 20 'first timers') launched new campaigns during the period. Elliott remaining the 'most active activist' initiating 17 new campaigns so far in 2018, 11 more than the next 'most active' ValueAct with 6.
- **Activists have won 119 board seats in H1 2018, which** is more than the total number of seats won in the whole of 2017 (100 seats). Lazard's comments that activity 'on pace to significantly surpass' 2016's record level (145 seats) by year end. The report adds that the majority of board seats (101 of 119 seats won) were won by settlement rather than vote.
- **'Long-slate' nominations 'spiked' in H1 2018:** According to the report, the frequency of long-slate campaigns — campaigns in which an activist seeks to replace at least 50% of the board — accounted for 33% of all board nomination campaigns in the period, the highest level since 2014 (44% for the full year).
- **Board change remained the key activist objective:** Overall, Lazard's found that board change remained the key objective of most (37%) activist campaigns over the period commenting that this remains the preferred means for an activist to effect change and to pursue the advancement of other objectives.
- **Board change tactics**: In H1 2018, activists utilised high profile withhold campaigns (ie an activist lobbying votes against incumbent directors without proposing their own replacement nominees) and challenges to nomination deadlines where activists sought to nominate directors after formal deadlines had expired to facilitate board change.
- **After board change, M&A objectives – whether catalysing a sale, opposing the terms of an existing deal or pushing for a break-up – were the most common in 1H 2018** with 34% of campaigns aimed at achieving these objectives. This is on par with 2017 levels.
- **Activism in Europe remained robust (and is on the increase globally):**
  - European targets accounted for nearly one-quarter of all activist capital deployed and campaigns launched in 1H 2018, which is in line with the 'record levels' seen in 2017.
  - UK companies remained by far the most targeted, representing 55+% of all activity in Europe.
  - Elliott's 10 campaigns launched against European targets alone accounted for 3+0% of all campaigns in Europe.
  - Outside Europe there are signs that activity is on the increase globally with 'notable activity' by US activists in South Korea (Hyundai Motors), Japan (Olympus) and India (Fortis Healthcare).
- **Influence of passive investors continued to increase as their ownership concentration increases**: According to the report Vanguard (7.4%), BlackRock (6.4%), and State Street (4.5%) now own just over 18% of the S&P 500 vs 14.4% in 2012 and 9.1% in 2002.

[Sources: Lazard's media release; Lazard's Review of Shareholder Activism — Q2 2018; [registration required] The WSJ 12/07/2018]Is there a case for rethinking the current shareholder resolution framework? The Governance Institute in partnership with LexisNexis have released a green paper outlining the Governance Institute policy position, the results of recent research on the need for change and seeking stakeholder views on whether reform of the current framework should be considered.

The Governance Institute and LexisNexis have released a green paper outlining the findings of recent research into the need (or not) to reform the current shareholder framework, and the form that such reform might take, the Governance Institute's position on the issue and seeking feedback on the need (or not) for review of the current framework.

Context: The green paper is being released in response to the issues and the options for reform raised in the Australian Council of Superannuation Investors (ACSI) report: *Shareholder Resolutions in Australia: Is there a better way? October 2017 (see:* Governance News 03/11/2017)

ACSI's four options for reform of the shareholder resolution framework: The ACSI report found that the current shareholder resolution framework is flawed and recommend reform 'to give shareholders a greater voice on ESG'. The four options for reform of the shareholder resolution framework set out in the ACSI report were:

a) A general right to move non-binding proposals on a broad range of topics;

b) A non-binding vote on the annual report;

c) A non-binding vote on a sustainability or ESG report and

d) A right to move binding, directive proposals. Of these options, Option a) A general right to move non-binding proposals overall, received the most support and is the option recommended in the report.

Research indicates that there are a diversity of views on the need for reform: The Governance Institute writes that though ACSI maintains that its asset managers strongly believe that the current system is not optimal, this is not reflected in research (in the form of roundtable discussion and debate and a survey) conducted by the Governance Institute and LexisNexis. Commenting on the results of the roundtable discussion Governance Institute CEO Stephen Burrell said '…despite robust discussion and debate, the roundtable did not achieve consensus either about the case for change or what that change might look like'. He added that 'There was some feeling that the current system needs streamlining, but no consensus on what form that streamlining might take, indicating that significantly more engagement and consultation is required to ensure the right policy settings are in place to adequately address this significant shift in shareholder engagement'. Likewise, a survey of members revealed a diversity of views on the issue.

Governance Institute position: Overall, Governance Institute Executive Manager, Policy and Advocacy Catherine Maxwell summarises the Governance Institute's position as follows: the 'Governance Institute's policy position is that there is no pressing need for legislative change to provide shareholders with greater scope for passing non-binding resolutions at AGMs. While many members support the underlying aims of these resolutions and the desire for greater transparency and better access to companies to engage on non-financial risks, they question whether ACSI's proposals will achieve these aims.'

Ms Maxwell adds that Governance Institute members' preferred approach on ESG disclosure is the 'if not, why not' [as put forward in the proposed amendments to the ASX Corporate Governance Principles and Recommendations] and query whether changing the law to enable these resolutions on AGM agendas is likely to achieve better ESG disclosure'.

Timeline: The Governance Institute has requested submissions by 10 August 2018.

[Source: Governance Institute media release 17/07/2018; [registration required] Shareholder resolutions: Is there a case for change?, [registration required]; [registration required] Governance Directions: Catherine Maxwell, Shareholder resolutions: Is there a case for change?]

Other Shareholder News

2018 UK Corporate Governance Code

Top Story | 2018 UK Corporate Governance Code released.

Following consultation, the Financial Reporting Council (FRC) released a revised 'shorter, sharper' Corporate Governance Code (Code) on 16 July 2018. The final version appears largely consistent with the version circulated for consultation in December of 2017 and outlined previously in Governance News (see:

Governance News 15/12/2017) though some changes to clarify FRC expectations (with respect to the respective roles of the board and remuneration committee and FRC expectations of workforce engagement) and to provide more 'flexibility' in meeting some requirements (among others) were made.

A high level overview of the key post-consultation changes to the Code is below.

A more in depth overview of the post-consultation changes is covered in a separate post in the 23/07/2018 issue of Governance News.

Key post-consultation changes to the Code

Post-consultation changes included the following (among others).

- Clarification of the respective roles of the board and the role of the remuneration committee with respect to remuneration. The FRC states that its intention was to broaden the role of the remuneration committee in a manner consistent with a 'non-executive role'. On this basis, various amendments were made to clarify the boundaries of the remuneration committee's remit
- Clarification that it is not the role of the remuneration committee to set remuneration beyond the 'first layer below board level'.
- Removal of language that could be 'perceived to be encouraging Long Term Incentive Plans (LTIPs).
- Clarification that the FRC does not expect companies to implement one of the three methods for workforce engagement set out in the draft version of the Code circulated in December, but that if the board has not chosen one or more of these methods, 'it should explain what alternative arrangements are in place and why it considers that they are effective'.
- Flexibility in determining the independence of the Chair: The final Code has 'reverted to the approach in the current Code for the chair to be "independent on appointment".
- Flexibility on Chair tenure: The Chair tenure period (9 years) may be extended for the purpose of facilitating succession planning.
- Board and committee composition: The small company exemption has been retained but some 'flexibility' for smaller companies has been incorporated.
- Reporting on the Code — clarification of reporting requirements: The Code has been amended to clarify that requirements obliging companies to report on 'information that would enable shareholders to assess how the directors have performed their duty under *section 172 of the Companies Act 2006* (the Act) to promote the success of the company' do not override or provide an 'interpretation of the statutory directors' duties under the Act.'

Overview: Key changes from the previous Code

- The FRC highlights, the focus on workforce and stakeholder engagement; culture; succession and diversity and remuneration as key changes.
- Sir Win Bischoff, Chairman, FRC, said: 'Corporate governance in the UK is globally respected and is a framework trusted by investors when deciding where to allocate capital. To make sure the UK moves with the times, the new Code considers economic and social issues and will help to guide the long-term success of UK businesses. This new Code, in its new shorter and sharper form, and with its overarching theme of trust, is paramount in promoting transparency and integrity in business for society as a whole.'
- Commenting on the changes, FRC Executive Director of Corporate Governance and Reporting, Financial Reporting Council Paul George highlights the following as of particular significance: the requirement for directors to report on how *s172 Companies Act 2006* obligations have been met (which complements requirements in secondary regulations); increased emphasis on board engagement and shareholder engagement; 'new measures requiring that remuneration committees should take into account workforce remuneration policies and practices when setting director remuneration, and, importantly, to step back from formulaic calculations of performance-related pay

awards and apply discretion when the resulting outcome is not justified' (among others as key changes).

[Note: The secondary legislation referred to is: *The Companies (Miscellaneous Reporting) Regulations 2018*. See: Governance News 15/06/2018.]

Timeframe: The new Code applies to all companies with a premium listing whether incorporated in the UK or elsewhere and to accounting periods beginning on or after 1 January 2019. Therefore, The FRC writes, apart from reporting on significant votes at shareholder meetings which 'will be appropriate to report on during 2019' and changes to existing remuneration policies, unless companies decide to adopt all or part of the new Code early, the first reporting will not be seen until 2020.

[Note: The post-consultation changes made to the Code, are discussed in more detail in a separate post below.]

[Sources: FRC media release 16/07/2018; UK Corporate Governance Code 2018; Guidance on Board Effectiveness July 2018; Feedback Statement: Consulting on a revised UK Corporate Governance Code July 2018; FRC blog 16/07/2018; Feedback statement annex: UK Corporate Governance Code; Key Highlights of the Code; FRC blog 16/07/2018]

Further detail — overview of the post-consultation changes made to the 2018 FRC Corporate Governance Code.

Though the final version of the FRC Corporate Governance Code released on 16 July, is largely consistent with the draft version circulated at the end of 2017, some changes were made in response to consultation. A high level overview of the changes is above. The post below outlines the post-consultation changes made to the Code in further detail.

[Note: According to the FRC 'there is little change' in Section 4 — Audit, risk and internal control and only minor amendments as a result of the consultation process. Therefore, I have not included a more detailed outline of changes below.]

- **Reporting on the Code — clarification of reporting requirements**: The Code has been amended to clarify that requirements obliging companies to report on 'information that would enable shareholders to assess how the directors have performed their duty under *section 172 of the Companies Act 2006* (the Act) to promote the success of the company' do not override or provide an 'interpretation of the statutory directors' duties under the Act.'

Post Consultation Changes made to Section 1: board leadership and company purpose

- **Methods for engagement with the 'workforce' — proposed changes too prescriptive?** The FRC writes that it received feedback that the wording in provision 5 outlining the three methods for companies engaging with the workforce — 'a director appointed from the workforce, a formal workforce advisory panel, a designated non-executive director' — could be read, as it was worded in the draft, as a requirement that companies use one of the listed methods for engagement and as such was 'too restrictive'. In response the FRC writes that it 'supports the Government's three primary options for engaging with the workforce while also recognising that there may be other effective methods along with those already in place in companies which achieve such engagement'. On this basis, the wording of Provision 5 (of Section 1) was amended in the final version of the Code to read: 'For engagement with the workforce, one or a combination of the following methods should be used: a director appointed from the workforce; a formal workforce advisory panel; or a designated non-executive director. If the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective'. The Provision also stipulates that the board should keep 'engagement mechanisms under review so that they remain effective'.
- **Whistleblowing — 'workforce should be able to raise any matters of concern':** The wording of principle E of the Code has been amended to remove reference to members of the workforce being able to raise 'matters of concern in relation to management and colleagues where they consider that conduct s not consistent with the company's values and responsibilities'. Instead, a broader wording was adopted in the final version: 'The board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce

should be able to raise any matters of concern'. The FRC writes that the change was made in response to concerns that the words 'management and colleagues' could result in a narrow interpretation of the whistleblowing Principle. Provision 6 has also been amended to state that the board should not only have a means for the workforce to raise concerns in confidence/anonymously, but should 'routinely' review and report on the operation of these measures.

- **'Manage' rather than 'eliminate' conflicts of interest:** Instead of taking action to identify and eliminate conflicts of interest, Provision 7 has been amended to state that the 'board should take action to identify and manage conflicts of interest…'
- **Linking remuneration to long-term success, and behaviours aligned with the company purpose, values and strategy:** The board's responsibility for workforce policies and practices was moved from the Section 5 (Remuneration) to Section 1 of the new Code and now focuses on linking the company's long term success with behaviours aligned with the company purpose, values and strategy and executive remuneration. Provision 2 now also includes the statement that the board 'should include an explanation of the company's approach to investing in, and rewarding its workforce'. This reflects the FRC view 'the responsibility for exercising discretion over executive remuneration outcomes lies with the remuneration committee'.

Post-consultation changes to Section 2: Division of responsibilities

- **'Independence' of the Chair and limiting their term to nine years (though Chair tenure may be extended for the purpose of facilitating succession planning)**: The FRC said that concerns were raised in relation to the proposals that the chair should be independent throughout their time on the board and that independence would be deemed to end after nine years for both the chair and independent non-executive directors (subject to 'comply or explain'). Observing that the 'nine year' 'de facto tenure period' is already in use by many companies and investors, the FRC states that the change has been retained on the basis that it is necessary in the interests of 'encouraging board refreshment and diversity'. However, in recognition of the 'special role of the chair, the close involvement with the company and close relationship with the executive throughout their tenure', the final Code has 'reverted to the approach in the current Code for the chair to be "independent on appointment" and amended Principle F second sentence to read – 'The chair should demonstrate objective judgement [rather than independent and objective judgement] throughout their tenure…'. In addition, Provision 10, which sets out the circumstances which are likely to impair independence now includes the statement that 'where any of these or other relevant circumstances apply, and the board nonetheless considers that the non-executive director is independent, a clear explanation should be provided'. Provision 19 in section 3 also states that Chair tenure may be extended for the purpose of facilitating succession planning.
- **Board and committee composition — small company exemption retained but some 'flexibility' for smaller companies:** The FRC explains that the smaller company exemption from meeting overall board composition requirements has been retained in the new Code, to 'encourage sufficient independent challenge' but notes that the final version has returned to the current Code wording in relation to overall board composition which says that 'at least half' rather than 'the majority' of the board need to be independent non-executive directors; and reverted to the membership of the audit and remuneration committees remaining as two independent non-executive directors to permit flexibility for smaller companies.
- **Overboarding**: In response to comments concerning non-executive directors holding multiple directorships ('overboarding') the FRC notes that amendments were made to Provision 15 to require that 'When making new appointments, the board should take into account other demands on directors' time. Prior to appointment, significant commitments should be disclosed with an indication of the time involved. Additional external appointments should not be undertaken without prior approval of the board, with the reasons for permitting significant appointments explained in the annual report. Full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or other significant appointment.'

Post consultation changes to section 3: composition, succession and evaluation

- **Chair tenure can be extended for the purposes of facilitating succession planning:** Provision 19 has been amended to state that the 'chair should not remain in the post beyond nine years from the date of their first appointment to the board. To facilitate effective succession planning and the development of a diverse board, this period can be extended for a limited time, particularly in those cases where the chair was an existing non-executive director on appointment. A clear explanation should be provided.'
- **External evaluations:** The FRC writes that in order to reinforce the independence of the audit committee, the element of the Provision enabling independent chairs of smaller companies to be a member has been removed. Changes were also made to the wording of Provision 21 'to encourage all chairs to consider the use of externally facilitated board evaluations rather than make it an absolute requirement for smaller companies. This is a response to concerns that there is insufficient capacity in the current board evaluation market'. For all companies that have external board evaluations, more detailed reporting requirements have been added (Provision 23).
- **Diversity reporting by the nomination committee:** According to The FRC, the 'overwhelming majority of respondents' supported the proposal to extend reporting on the gender balance of the executive committee and their direct reports, to all companies with a premium listing on the basis that focus on the executive pipeline is 'critical to improving the diversity of leadership in UK companies and reaping the benefits of having more women leaders'. Given the overall positive response to the approach taken to diversity in Section 3 of the revised Code, limited changes were made. Provision 23 has been amended to include that annual reports on the work of the nomination committee should include 'the policy on diversity and inclusion, its objectives and linkage to company strategy how it has been implemented and progress on achieving the objectives'.

Post consultation changes to section 5: Remuneration

In the response to feedback document released with the new version of the Code, The FRC states: 'There appears to be a widespread perception that executive remuneration is failing to act as a tool to incentivise performance and that the complexity of the system is creating a growing reputational risk for companies and investors alike'.

- **Clarification of the role of the remuneration committee in setting remuneration:** The main area of concern raised in relation to this point concerned the depth and breadth of the remuneration committee's role with respect to workforce remuneration. The FRC said that many respondents sought clarification about the boundaries around the remuneration committee's role, with some expressing concern that the term 'oversight' could mean the remuneration committee would be expected to set and approved workplace policies, 'effectively being drawn into a quasi-executive function and blurring the distinction between the board and management'. Overall, The FRC states that there was a 'strong preference' in responses to the consultation for the focus of the remuneration committee's role to be limited to remuneration related matters. In response to these concerns, The FRC writes 'We are clear that the responsibility for exercising discretion over executive remuneration outcomes lies with the remuneration committee and the need to do so should be considered in the course of its annual decision-making process'. On this basis, The FRC explains, Principle R and Provision 37 have been amended to 'remove the suggestion that the responsibility lies with the board'.
- **Not the role of the remuneration committee to set remuneration beyond the 'first layer below board level':** The FRC confirmed that 'The definition of senior management in the new Code was a conscious choice. We do not consider it appropriate to include direct reports in the definition used in the new Code other than for the purposes of reporting on gender diversity in the executive pipeline (Provision 23). It is not the intention that the board and its committees should be involved in the appointment or remuneration of those individuals who report directly to the first layer of management below board level'.
- **Broadening of the remuneration committee's remit**: The FRC states that its intention was to broaden the role of the remuneration committee in a manner consistent with a 'non-executive role'. On this basis, various amendments were made to clarify the boundaries of the remuneration

committee's remit. In particular, Provision 33 clarifies that the remuneration committee only has responsibility for remuneration-related matters and that its remit will be limited to reviewing 'workforce remuneration and related policies'. Principle E now assigns the overarching responsibility for 'oversight of workforce policies and practices' to the board, therefore removing this from the remuneration section of the new Code. The board will monitor the implementation of workforce policies including those related to remuneration, as part of its monitoring of culture under Provision 2.

- **Removal of language that could be 'perceived to be encouraging Long Term Incentive Plans (LTIPs):** The FRC writes that it considers that the Code should be 'non-prescriptive on the structure of remuneration schemes and should avoid encouraging companies, explicitly or through implication, to adopt any one form of scheme over others'. On this basis, The FRC states that the final version of the Code includes amendments 'to remove language which could be perceived to be encouraging LTIPs' as well as several changes to allow 'flexibility for companies to design bespoke arrangements while also encouraging innovation and alternatives to the commonly adopted base pay, bonus, LTIP approach'.

  - **Shares:** Provision 36 now reads: 'Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. In normal circumstances, shares awards granted for this purpose or other forms of long-term incentives should be released for sale on a phased basis and be subject to a total vesting and holding period of at least five years or more. The remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares'.

  - **Pensions:** Provision 38 clarifies expectations with respect to pensions to make 'clear that executive pension contributions should be in line with those available to the rest of the workforce: 'Only basic salary should be pensionable. The pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce. The pension consequences and associated costs of basic salary increases and any other changes in pensionable remuneration, or contribution rates, particularly for directors close to retirement, should be carefully considered when compared with workforce arrangements and be aligned to the pension arrangements for the workforce as a whole.'

  - **Executive accountability for poor performance**: Provision 39 has been amended to state that '…The remuneration committee should ensure compensation commitments in directors' terms of appointment do not reward poor performance. They should be robust in reducing compensation to reflect departing directors' obligations to mitigate loss.'

  - **Design of remuneration policy and practice:** Provision 40 now includes risk as a factor to be addressed in scheme design and asks remuneration committees to think about limits and discretions when addressing predictability: 'risk – remuneration arrangements should ensure reputational and other risks from excessive rewards, and behavioural risks that can arise from target-based incentive plans, are identified and mitigated'. A specific reporting requirement has been added to Provision 41 to encourage remuneration committees to explain how they have addressed the factors in Provision 40.

- **Avoidance of 'formulaic outcomes':** Reference to 'the board' has been removed from provision 37 but the reference to 'discretion' has been retained: 'Remuneration schemes and policies should enable the use of discretion to override formulaic outcomes. They should also include provisions that would enable the company to recover and/or withhold sums or share awards, and specify the circumstances in which it would be appropriate to do so.' The FRC explains that in' view of the statutory requirement and other checks on the remuneration committees, such as board endorsement, the need to treat executive directors fairly and to retain credibility with shareholders, the FRC considers the risk that remuneration committees will regard discretion as unlimited to be low. We are also aware that some FTSE 100 companies have already embedded the concept of reasonable discretion in their remuneration policies. We have therefore decided not to qualify discretion in Provision 37'.

Changes to the Guidance
The FRC writes that concerns were raised that the language in the Guidance was too prescriptive in some parts, leading to concern that it might be viewed as a set of requirements.

Otherwise, the majority of the comments received were on section one of the Guidance. Themes that came through most strongly related to the balance between the focus on strategy versus the focus on stakeholders and culture, and the interpretation of section 172 of the Companies Act. Other areas that received particular attention were board evaluations and remuneration.

Key changes that have been made in response include: changes to the language so that the tone is 'less prescriptive'; changes to the introduction to emphasise the importance of the Guidance in promoting high standards and to encourage its use of alongside the new Code as well as changes to the structure of the Guidance in line with changes to the Code.

[Sources: FRC media release 16/07/2018; UK Corporate Governance Code 2018; Guidance on Board Effectiveness July 2018; Feedback Statement: Consulting on a revised UK Corporate Governance Code July 2018; FRC blog 16/07/2018; Feedback statement annex: UK Corporate Governance Code; Key Highlights of the Code; FRC blog 16/07/2018]

Does the revised UK Corporate Governance Code go far enough? Industry response to the new Code is mixed according to media reports.

Following consultation, the Financial Reporting Council (FRC) released a revised 'shorter, sharper' Corporate Governance Code (Code) on 16 July 2018. The revised Code appears to be largely consistent with the draft changes released for consultation at the end of 2017 and outlined previously in Governance News (see: Governance News 15/12/2017) though some changes were made post-consultation (these are outlined in separate posts above).

Media reports suggest there are a diverse range of views on the revised Code. The issues of worker representation on boards, engagement with the workforce and the treatment of climate risk are some of the areas on which there has been particular comment.

- **No mandatory worker representation on boards:** Trades Union Congress (TUC) General Secretary Frances O'Grady said that while the reforms are a step in the right direction they are 'not the shakeup of corporate Britain Theresa may promised and the country needs'. Ms O'Grady went on to express disappointment that the government did not stick 'to its commitment to make workers on boards mandatory'.
- **Degree of flexibility in determining how best to engage with the workforce is a positive (though the idea of appointing workforce representatives to boards shouldn't be dismissed too quickly):**
  - KPMG's Board Leadership Centre Timothy Conell said that retaining a degree of flexibility around how boards gather the views of the workforce is to be commended as one size doesn't fit all but that 'it would be unfortunate if boards were too quick to dismiss the idea of appointing directors from the workforce simply because it sits uncomfortably with the traditional UK corporate governance framework'.
  - Hermes Investment Management's CEO Saker Nusseibeh said that 'Whilst our inclination is for there to be an employee-elected representative as a director on the board, the Code is right to put the onus on company boards to determine what the optimal approach is in their specific context'.
- **Focus on engagement with the workforce is a positive:** CBI UK chief policy director Matthew Fell welcomed the focus on company engagement with employees in the revised Code: 'Companies should define their most important stakeholders – which will often be employees – and then set out how they choose to engage with them to take their views into account. It is helpful to see this new emphasis by the FRC' he said.
- **Less focus on professional development:** Institute of Directors, Head of Corporate Governance Roger Barker has welcomed the Code, particularly its 'engagement with a wider range of stakeholders including the workforce, as well as encouragement of more long-term oriented business behaviour and recognition of the board's role in overseeing a company's purpose and

culture'. However, he expressed disappointment that a recommendation for directors to undertake continued professional development 'has been demoted to the guidance'. Mr Barker said: 'The role of the modern director is increasingly complex and specialised, and there is an ongoing need for these individuals to take stock of their competencies. By removing reference to the professional development of directors from the Code and only mentioning it peripherally in the guidance, the FRC risks indicating to directors that it is not important'.

- **Failure to 'sufficiently address' climate risk?** BoardAgenda quotes 'environmental activist' lawyers ClientEarth as expressing disappointment that the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations were not integrated more fully into the Code (as opposed to being referenced in the Guidance as one of the number of frameworks that might be used to 'help identify social and environmental considerations that are relevant for the business). More particularly, ClientEarth is critical of the fact that the 'minimal reference' to the TCFD recommendations appears in the section of the FRC guidance on relations with stakeholders, which fails, in their view, to recognise the 'central importance of climate risk information to stakeholders' from a financial perspective.

[Sources: Board Agenda 16/07/2018; 17/07/2018; [registration required] The FT 16/07/2018; The BBC 16/07/2018; The Guardian 16/07/2018; National Law Review 16/07/2018; Economia 16/07/2018; The Times 16/07/2018; [registration required] The WSJ 16/07/2018]

Disclosure and Reporting

In Brief | The Airlie Australian Share fund has reportedly criticised the quality of financial reporting by Australian companies saying that profit and loss statements are becoming increasingly irrelevant for investors trying to value a business because of the tendency by companies to take too many expenses 'below the line'.

[Source: The AFR 18/07/2018]

Regulators

Australian Competition and Consumer Commission (ACCC)

Top Story | Are incentives to maximise returns to shareholders driving poor corporate behaviour? Stronger penalties for breach of the ACL are needed to drive improve consumer outcomes and to drive companies to raise behavioural standards says ACCC Chair Rod Sims.

In a recent speech entitled: *Companies behaving badly?* Australian Competition and Consumer Commission (ACCC) Chair Rod Sims said that currently the incentives to behave badly — including bonus structures and business models that reward delivery of short term profit — 'often outweigh the incentive to put the customer first' and that 'increasing the private cost of bad behaviour is the key to reducing its incidence'. Mr Sims went on to comment that new legislation (which he said is expected to pass when parliament resumes sitting in August), mandating higher penalties for breach of the Australian Consumer Law may cause companies amend their behaviour, 'Our market economy needs some intervention and it needs the higher penalties just mentioned. And it certainly needs a strong ACCC' Mr Sims said.

[Note: The legislation referred to appears to be: *Treasury Laws Amendment (2018 Measures No. 3) Bill 2018* which passed the House without amendment and is currently at second reading before the Senate. Mr Sims said that he expected that the Bill will pass in when parliament resumes sitting in August.]

- **Numerous examples of observed poor company behaviour:** Though not all companies behave poorly, Mr Sims said, in the ACCC's experience many businesses do. He added that 'poor behaviour usually occurs on a spectrum, with few companies behaving badly often, but rather many engaging in occasional significant instances of bad behaviour, which remains unacceptable'.
- **Overly focused on delivery of short term profits at the expense of customers:** Mr Sims said that despite statements to the contrary, many businesses 'appear to put immediate profit ahead of their customers either by engaging in misleading or unfair conduct, or even unconscionable conduct towards their customers, or they engage in cartel or other anti-competitive activity that raises prices

for their customers'. Mr Sims outlined a number of recent examples of this behaviour noting that the 'list' of examples included a number of 'major Australian companies'.

- **Reasons for the misconduct?** Poor behaviour is attributable to a number of causes, Mr Sims said, including (among others): market pressure, and incentives (bonuses) for executives to deliver short term profits; lack of safeguards in the design of financial incentives; lack of punishment for poor behaviour (due to lack of visibility to consumers, lack of alternatives and difficulties/costs of switching); and a 'race to the bottom' mentality (eg banks and electricity retailers). In addition, Mr said that executives could be too loyal to the company ie company executives appeared to 'behave differently when they are at work, than the way they would privately' feeling their obligations to the company compel them to 'pursue profit to the maximum, even if their behaviour pushes too close to the boundaries of the law'. Mr Sims said 'It also sometimes appears as if there is no other ethical standard being applied than adherence to some technical interpretation of the law' and that in many of the examples outlined, the cases were heavily contested, 'clearly the companies had legal advice that they had prospects of success in court given their particular behaviour and the letter of the law'.

- **Profits can be achieved without 'pushing hard against the boundaries of the law':** Mr Sims said that how directors and senior managers 'maximise shareholder value, and how they treat their customers, is their call, not mine or the ACCCs', but observed that despite hard decisions needing to be made, it was nevertheless possible to do so/achieve profits without 'pushing hard against the boundaries of the law'. He added that stronger penalties likely to be enacted in August, may also be effective in changing behaviour.

- **Suggested actions to address these issues — directors and senior management: '**I believe that the first step is for directors and senior management to give more consideration to balancing short and longer term profit considerations, to the interests of their customers and suppliers, and to the reputation of their company. I will leave them to reflect on this. They may well resent being lectured on this by the regulator' Mr Sims said.

- **Suggested actions to address these issues — governments and regulators:**

  - **'Identify and shine a light on bad behaviour'**: 'The greater the likelihood that bad behaviour will be exposed and made public, the more companies will do to guard against such behaviours' Mr Sims said. He added that 'Regulators need to be proactive in identifying bad behaviour and be transparent about what they see; it is not enough to simply take enforcement action after breaches occur'.

  - **Increase penalties to deter bad behaviour**: 'When the incentives for misconduct are strong, and the penalties for misconduct, given the likelihood of detection, are comparatively weak, it is easy to understand that company boards and senior management do not act strongly enough to ensure such behaviour does not occur'. Mr Sims went on to say that the ACCC views 'stronger penalties [as] a key part of the answer' and 'strongly encourages' parliament to approve the necessary changes to the Australian Consumer Law to strengthen penalties.

  - **Case for intervention in the market?** Mr Sims noted that the ACCC has limited resources (60 people) to investigate potential breaches of the ACL in all sectors and in all states and territories and that consequently it was not possible to investigate or deal with 'all breaches of the law'. He added that there are some areas where existing laws are 'weak' eg in relation to product safety and unfair contract terms. 'Under current laws there is little incentive to change such contracts because if the ACCC finds out about them you need only then change them as this is not a breach of the law, and no penalties apply' he said. Later in his speech, Mr Sims questioned whether 'more regulation' is the answer stating that 'more regulation can often be harmful to consumers, especially in sectors of the economy that are already heavily regulated' because it can lead to 'perverse' policy outcomes.

  - **Ensure markets are competitive as possible**: 'Bad behaviour by firms is more likely to be 'punished' in competitive markets. The more alternatives consumers have, the greater their ability to avoid bad behaviour' Mr Sims said. 'The more firms in the market and the lower the barriers to entry, the greater the imperative for companies to look after their customers. A key objective of competition law is to prohibit conduct that substantially lessens competition, whether it be mergers or acquisitions, unilateral conduct by firms with substantial market power or agreements among competitors or other parties. Strong competition laws and rigorous enforcement of those laws is a key part of preserving and promoting competition'.

- **Improved price transparency***:* 'More price transparency will usually help markets, as the ACCC has or will argue in dairy, beef, electricity, and banking. We have proposed, or will propose, measures to achieve this' Mr Sims said. Mr Sims added that he views the Consumer Data Right (CDR) as 'a game changer here'.

[Note: The implementation of the CDR was the topic of another recent separate speech: *Consumers' right to their own data is on its way* given by Mr Sims at the National Consumer Data Policy Research Centre. The speech reiterates the benefits of the CDR to consumers and outlines the progress the ACCC has made towards implementation. See: *Consumer data and regulatory reform: Speech by APRA Chair Mr Rod Sims, at the National Consumer Data Policy Research Centre 16/07/2018*]

[Sources: ACCC media release 13/07/2018; Speech by ACCC Chair Rod Sims at the 2018 Giblin Lecturer: Companies Behaving Badly 13/07/2018; [registration required] The Australian 14/07/2018]

Australian Securities and Investments Commission (ASIC)

Further consultation on draft legislation relating to the design and distribution of financial products and product intervention powers for ASIC: *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill* 2018.

Following initial consultation on exposure draft legislation relating to the design and distribution of financial products and ASIC product intervention powers (See: Governance News 15/01/2018), the government has released a second exposure draft of the legislation for consultation. Accompanying the exposure draft is an information sheet outlining the post-consultation changes made to the revised draft legislation.

Among the post-consultation amendments are the following.

- **Apply to financial products not current regulated under the *Corporations Act (2001)* Cth in certain circumstances:** Addition of new provisions (Schedule 2, subsections 764A(3), subsections 765A(3) and (4)) that will allow the regimes to cover additional products or to exclude products. The new provision allowing coverage of additional products will enable the government to 'act if a financial product is not currently regulated under the *Corporations Act* 2001 but is causing, will cause, or is likely to cause significant consumer detriment'. The government writes that at this stage, it is considering using the regulation-making power to allow ASIC to use the product intervention power with respect to:
  - funeral expenses insurance;
  - certain extended warranties that are functionally equivalent to add-on insurance; and
  - short-term credit that is not regulated under the National Consumer Credit Protection Act 2009 ('Credit Act').

- **Penalties increased:** In addition, the criminal penalties for failing to cease distribution, notify an issuer of a significant dealing outside the target market, and failing to notify ASIC of a significant dealing/failing to provide ASIC with information on request have been increased to be consistent with analogous provisions under the *Corporations Act 2001* (Cth).

- **Extended timeline:** In the original exposure draft, the application and transitional provisions applied to all financial products one year after the legislation receives Royal Assent. In the revised draft version, this timeline has been extended such that the obligations will apply to all financial products two years after the legislation receives Royal Assent. In the previous exposure draft, the obligations applied to new financial products one year after the legislation receives Royal Assent.

[Sources: Treasury media release 20/07/2018; Information note; Exposure draft: Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018; Exposure Draft Explanatory Memorandum]

Uptick in reporting 'bag eggs' to the regulator? Reportedly, Deputy ASIC Chair Peter Kell has said the level of reporting is such that it is creating new challenges for ASIC.

The AFR reports that Australian Securities and Investments Commission (ASIC) Deputy Chair Mr Kell has said that financial firms are beginning to report advisers with poor records to the regulator in increasing numbers, preventing poor advisers from shifting to another firm and continuing to provide advice. 'We are getting more financial advice firms coming to us and reporting bad apples…That was always a source of enormous frustration. They [financial firms] would let go an adviser who they knew was a very poor performer, who may have engaged on borderline misconduct, they would just let them wander down the road to the new firm. They would provide no information to that new firm, and they would provide no information to the regulator. That is really beginning to change. We're beginning to see far more reports coming in letting us know where problematic advisers are going' Mr Kell reportedly said. Reportedly Mr Kell went on to say that the volume of information being reported is creating new challenges for the regulator in 'figuring out how to deal with that level of reporting'.

Mr Kell reportedly attributes the upswing in reporting to the increased scrutiny the industry is under (eg the Financial Services Royal Commission) which he said had led to a 'lot of soul searching' within the sector.

[Source: [registration required] The AFR 17/07/2018]

In Brief | ASIC Deputy Chair has called on financial services firms to move away from 'minimal or technical compliance with the law' and act to raise standards to address the 'trust deficit' in the sector and before new before regulatory reforms are enacted. 'ASIC, and other regulators, do not have the capacity to examine every transaction in every sector, and this is not the expectation nor is it desirable for an efficient system. What our regulatory regime does expect is that firms will be the first line of accountability for ensuring that your systems, your culture, your practices, the design of your products demonstrate that you have as a paramount concern the best interests of your customers' he said.

[Sources: Speech by ASIC Deputy Chair, Peter Kell at the ASIC Regulatory Update 17/07/2018; [registration required] The Australian 18/07/2018; nestegg.com.au 18/07/2018]

Australian Prudential Regulation Authority (APRA)

APRA has called for further consultation on timeframes to implement, 'protecting your super' reforms: APRA has released Deputy Chair Helen Rowell's opening statement to the Senate committee hearing on *Treasury Laws Amendment (Protecting Your Superannuation Package) Bill* 2018

The Australian Prudential Regulation Authority (APRA) has released Deputy Chair Helen Rowell's opening statement to the Senate Economics Legislation Committee on the *Treasury Laws Amendment (Protecting Your Superannuation Package) Bill* 2018.

[Note: Among the measures announced in the Federal Budget 2018-2019 was the 'Protecting your super package' which the government describes as a 'comprehensive package of regulatory reforms designed to protect Australians' superannuation savings from undue erosion by fees and insurance premiums'. Exposure draft legislation and explanatory material to implement the reforms was released by the government for consultation at the same time. For a high level overview of the draft legislation see: Governance News 11/05/2018.]

Key Points

- **Supportive of the policy intent of the reforms:** Ms Rowell said that APRA supports the 'policy intent of the proposals, which seek to improve member outcomes by reducing the potential for the retirement savings of members with low account balances to be inappropriately eroded through excessive fees or unnecessary insurance'.
- **Delay of the proposed implementation date?** Ms Rowell said 'unintended consequences may arise for members and there will be significant pressure on, and heightened operational risk for, superannuation funds and their insurers and administrators, if sufficient time is not allowed to implement the proposals in an appropriate and orderly manner' and suggested that further

consultation and discussion of the 'appropriately targeted transition options' (eg phased implementation of the reforms' should be considered.

- **Reasons: '**Further consultation' on the implementation date is justified, Ms Rowell said for a number of reasons including the following.
  - **Implementation will require a review of fee structures by superannuation funds:** Ms Rowell said that the proposals to require the transfer of accounts of less than $6,000 that have not received a contribution for 13 months to the Australian Taxation Office (ATO); and the proposal to limit the fees that can be charged to members with balances under $6000 will 'require funds to review their fee structures and may lead to higher fees for members with balances over $6000'. In addition, the proposals in relation to the provision of insurance to members in the default market (ie members with balances below $6000 and new members under 25 years of age only being offered insurance on an opt-in basis) will likely result in 'the removal of these members from the "default" insurance pool' which she said '(together with the removal of members with inactive accounts) will create upward pressure on premiums for the remaining insured members'.
  - **Implementation will require time for funds to communicate the changes to members:** 'In implementing these proposals, funds will be required to make members aware of the changes through both changes to product disclosure statements and the use of broader member communication processes. It will be particularly important to ensure that inactive account members are aware that their accounts may be moved to the ATO, and their insurance cover consequently ceased, if they fail to make an active contribution or an active decision regarding their insurance' Ms Rowell said. Ms Rowell added that effective communication of the changes in relation to insurance in superannuation would be of 'paramount' importance given the 'significant shift' in approach and the need to ensure members are made fully aware of the changes.
  - **Implementation will require systems/administrative change:** Ms Rowell said that it would be 'challenging' to implement the necessary administrative changes/changes to systems by proposed implementation date of 1 July 2019 'given both the complexity and extent of the changes that will be required to be made across the entire superannuation sector'. She added that this was particularly so in the case of proposed reforms to insurance arrangements.
  - **Certainty of final legislative requirements needed:** Ms Rowell said that effective communication would require 'certainty in the final legislative requirements so that the nature and extent of the changes to insurance and fees can be determined by each superannuation fund, in collaboration with their service providers and to ensure funds' current disclosure obligations are able to be met.'

[Source: APRA Opening Statement - Senate Economics Legislation Committee 20/07/2018]

APRA submission to the Financial Services Royal Commission Round 4 hearings: An ADI is in the 'business of accepting financial risk to earn a return' and 'subject to not acting unethically, unfairly or unlawfully, the ADI will quite reasonably put its interest in achieving repayment first', writes APRA.

The Financial Services Royal Commission Round 4 hearings considered two topics: issues affecting Australians who live in regional and remote communities which relate to finance provided to agricultural businesses, and interactions between Aboriginal and Torres Strait Islander people and financial services entities. The Australian Prudential Regulation Authority's (APRA's) written submission to the Commission in response to general submissions has now been released.

Key Points

Balancing competing interests

- **ADIs are profit making entities:** APRA writes that ADIs are profit making entities 'in the business of accepting financial risk to earn a return' and ADIs have a duty to act in the best interests of the company, within the parameters of the applicable legal and regulatory framework, and conscious at all times of the obligation to return depositor funds. They should not take risk without the prospect of an adequate return'.

- **The interests of borrowers and lenders may not align:** APRA also noted that the interests of borrowers and lenders may not align, 'the ability of the ADI to recoup money owed is likely to be influenced by factors (climate, pests, disease and market volatility) that are beyond the control of the borrower or itself. The ADI's assessment of these factors will be relevant both at origination and when a borrower may be in financial difficulty. That assessment may well—indeed is likely to—differ between ADI and borrower. Prudent banking generally requires assessing a borrower's ability to repay as the primary means of recouping a loan, with collateral used as a backstop. However, in circumstances when conditions deteriorate and the borrower's ability to service the loan is threatened, the parties' interests—and assessment of how to protect those interests—may diverge. The borrower is not simply interested in repaying its debt but may also want to minimise the loss of, for example, the family home or business. For a farmer, there is also likely to be an interest that is not strictly financial: retaining what may be a longstanding connection to a particular farm or community. The ADI on the other hand will remain primarily concerned to ensure repayment of the loan within a reasonable time and to minimise the risk that this may not occur' APRA writes.
- **Acting fairly and reasonably:** APRA writes that an ADI acting fairly and reasonably in balancing its interests with those of its agribusiness borrower would be expected to: 'make a proper credit risk assessment of the borrower before making the loan; adhere to the terms of the loan contract, taking account of regulatory hardship and other consumer protection obligations; not impose unreasonable requirements on the borrower that are unsuitable to the circumstances (for example, acknowledging that cash flows for agribusinesses may be seasonal, considering providing longer timeframes for realising collateral than may be applied for a residential mortgage loan) and subject to securing the ADI's interests, pursue repayment of debts in a manner that avoids unnecessary diminution in the value attributable to the borrower'. APRA goes on to state that an 'ADI should not be expected to provide forbearance to a borrower in financial difficulties where it is clearly apparent that doing so will generate a larger economic loss for the ADI relative to the likely outcome of enforcement action….there is a balance to be struck between the benefit of affording business borrowers additional protection and the costs of doing so. This balancing involves a determination as to the level of risk borne by each party, which, if unduly placed on the ADI, may ultimately limit borrowers' access to funding, either at all or at an acceptable price'.

Internal valuations

APRA states that it does not consider it necessary to prohibit valuations from being conducted by suitably qualified internal appraisers, subject to the ADI meeting the requirements for acting 'fairly and reasonably' (outlined above). APRA adds that it's position is that 'it is better practice for valuations to be undertaken independently of staff involved in origination, to remove the potential for real or perceived conflicts of interest, which may affect the valuation'. APRA states that it intends to 'incorporate this position' into proposed revisions to the credit risk capital framework by adopting the Basel Committee on Banking Commission's requirement that real property valuations are appraised independently from an ADI's mortgage acquisition, loan processing and loan decision process'.

Funeral expense products

- **Regulatory framework for funeral products**: APRA states that change of the current 'complex' framework is merited: 'APRA is of the view that there is merit in consistent treatment under the Corporations Act for funeral products to facilitate a consistent level of consumer protection such as licencing of the provider, disclosure and dispute resolution is achieved regardless of the specific product or structure involved'.
- **Financial Services Council Code of Practice:** APRA supports making the Code applicable to all life insurers and for the Financial Services Council to seek ASIC's formal approval under its statutory powers.
- **Restricting the use of the term 'insurer' and associated terms could be considered?** APRA notes that the entities involved in the case studies, while not undertaking insurance business, appear to have represented themselves, or been represented, as insurers. APRA suggests that to address

this, consideration could be given to whether restrictions should be placed on use of the term 'insurer', 'with the intent to firm up the perimeter between what is prudentially regulated insurance business and what is not'. In addition, APRA supports requiring that discretionary funds clearly and prominently disclosure that they are not insurers and not subject to regulation.

[Sources: Written Submission of the Australian Prudential Regulation Authority: Round 4: Experiences with financial services entities in regional and remote communities; [registration required] The AFR 18/047/2018;19/07/2019]

Other Developments

In Brief | SEC action on alleged 'secret backroom deals' at Energy XXI Ltd: SEC has settled allegations of misconduct by the former CEO (alleged non-disclosure of $10m in personal loans obtained from XXI vendors and board candidates in exchange for business contracts/appointment to board), activist nominee director (alleged non-disclosure of a $3m loan made to former CEO) and largest activist investor (alleged non-disclosure of plan to place a director on the XXI board).

[Source: SEC media release 17/07/2018]

Corporate Social Responsibility and Sustainability

United States | A means to demonstrate commitment to corporate social responsibility and sustainability? New legislation — H.B. 310, the *Certification of Adoption of Transparency and Sustainability Standards Act of 2018* — establishes a state based voluntary certification and disclosure regime in Delaware.

The Certification of Adoption of Sustainability and Transparency Standards Act establishes a voluntary disclosure regime to foster dialogue around sustainability and responsibility among participating Delaware business entities and their various stakeholders.

Key Points

- **The Act is 'entirely voluntary'**. The decision whether to seek certification is in the sole discretion of each entity.
- **Adoption of principles, guidelines and standards:** The Act requires the governing body of each entity seeking certification under the Act to adopt principles, guidelines and standards to guide its business activities in a sustainable and responsible manner, as well as metrics for assessing whether it has met its objectives. The Act does not prescribe specific standards, measures of performance of criteria.
- **Certification is 'focused on information acknowledged by an authorized representative of the entity regarding its adoption of procedures to operate sustainably and responsibly and its commitment to disclose, at least annually, such procedures'.** The Act does 'not contemplate that State officers will make qualitative judgments regarding the standards or metrics that an entity adopts'.
- **No penalties for failure to seek certification or failure to meet performance standards:** The Bill synopsis states that the 'Act does not impose fines or penalties on entities that elect not to seek certification, nor does it impose penalties or fines on entities that, having become certified, fail to satisfy their own performance standards. Moreover, the Act specifies that fiduciary liability shall not be imposed as a result of, among other things, the decision whether or not to seek certification or the failure to meet specific sustainability and responsibility standards'.
- **Penalties/fines for misrepresentation:** Any person or entity that misrepresents an entity's certified status may be 'subject to civil or criminal fines or penalties'.

Timing: The Act was signed into law on 27 June and will become effective on 1 October 2018.

Significance? A recent post on Harvard Law School Forum comments that the Act is a response increasing calls from investors, customers and clients for greater transparency in sustainability practices and provides

Delaware entities a 'verifiable means of demonstrating to their constituents that they are committed to sustainability'.

[Sources: Harvard Law School Forum on Corporate Governance and Financial Regulation 15/07/2018; H.B. 310, the Certification of Adoption of Transparency and Sustainability Standards Act of 2018]

Financial Services

In Brief | CCIV update: The government has released for public consultation the second tranche of the *Treasury Laws Amendment (Corporate Collective Investment Vehicle)* Bill 2018 and explanatory materials. The second tranche of the CCIV Bill covers external administration of a CCIV in a winding up situation, the application of the Chapter 7 financial services regime to CCIVs and the liability of the corporate director of a CCIV for contraventions of the law by the CCIV. Consultation closes on 10 August.

[Sources: Minister for Revenue and Financial Services Kelly O'Dwyer media release 19/07/2018; Exposure draft; Explanatory materials; consultation cover note]

In Brief | Time to raise standards of professionalism in banking says FINSIA: Citing the results of a survey of 2000 people which found that 57% believe that banking does not have high ethical standards (though 66% trust their banks to process their payments efficiently and to hold their money securely), Financial Services Institute of Australia (FINSIA) has called for the sector to improve standards of professionalism.

[Note: This appears to mirror recent calls by the Australian Securities and Investments Commission (ASIC) on the same theme. For example: Chair James Shipton used his inaugural keynote address to the ASIC Annual Forum to call on industry to raise standards of professionalism in the sector to address the trust deficit (see: Governance News 23/03/2018). Professionalism has also been a theme in subsequent speeches.]

[Source: [registration required] FINSIA media release (accessed through LexisNexis Capital Monitor) 19/07/2018]

In Brief | SG Regulations to be remade: The existing *Superannuation Guarantee (Administration) Regulations* 1993 are scheduled to sunset on 1 October 2018. To ensure the ongoing operation of the Superannuation Guarantee, draft *Superannuation Guarantee (Administration) Regulations* 2018 have released for consultation. Treasury states that the draft makes 'no alteration to the substantive meaning or operation of the existing Regulations'. Consultation closes on 15 August 2018.

[Sources: Treasury media release 18/07/2018; Exposure draft: Superannuation Guarantee (Administration) Regulations 2018; Explanatory Statement]

Risk Management

Cybersecurity

In Brief | Google has been fined €4.3 billion ($6.8 billion) by the European Union and ordered to change the way it puts search and web browser apps on Android mobile devices, setting a new global record for antitrust penalties according to The AFR.

[Source: [registration required] The AFR 18/07/2018]

Climate Risk

In Brief | Ireland to become the first country in the world to divest from fossil fuels? A Bill (*Fossil Fuel Divestment Bill* 2016) requiring Ireland's national investment fund (Ireland Strategic Investment Fund) to divest $10bn in investments within the coal, oil, gas and peat industry as 'soon as practicable' is reportedly expected to pass in September.

[Sources: Fossil Fuel Divestment Bill 2016 (Bill 103 of 2016); As passed by Dáil Éireann 12/07/2018; Explanatory Memorandum; NPR 12/07/2018]

Whistleblowing

United States | The CFTC has awarded the largest ever whistleblower award of $30m to a whistleblower who voluntarily provided key original information that led to a successful enforcement action; separately the CFTC awarded the first whistleblower payment to a foreign whistleblower.

Largest ever award: The Commodity Futures Trading Commission (CFTC) announced an award of approximately $30 million to a whistleblower who voluntarily provided original information that led to a successful enforcement action. The award is the largest award made by the CFTC's Whistleblower Program to date and is the fifth award made by the program.

James McDonald, Director of the Division of Enforcement, said: 'Whistleblower submissions have become a significant part of our enforcement program, allowing us to pursue violations we might otherwise have been unable to detect. That's one reason why we've worked hard to expand our Whistleblower Program, including by increasing the protections afforded to whistleblowers that come forward. I expect the Whistleblower Program to contribute even more substantially to our enforcement efforts going forward.'

Previously, the highest award amount paid to a CFTC whistleblower was in March 2016 of more than $10 million.

Conflicts of interest at JP Morgan Chase & Co? The WSJ reports that the payment was made in connection with alleged conflicts of interest at JP Morgan Chase & Co. The article quotes Edward Siedle, a former Securities and Exchange Commission lawyer who does forensic investigations in the investment-management industry, as stating that he alerted regulators to the JPMorgan Chase matter and handled whistleblower claims at both the CFTC and SEC on his own behalf.

[Sources: CFTC media release 12/07/2018; FCPA blog 12/07/2018; [registration required] The WSJ 12/07/2018]

First whistleblower award to a foreign whistleblower: The CFTC announced that it has awarded the first payment to a whistleblower living in a foreign country. The CFTC writes that the award demonstrates the 'international reach' of the program, 'underscoring that any person worldwide who has information about potential violations of the Commodity Exchange Act (CEA) can become a whistleblower by simply submitting a tip online at https://www.whistleblower.gov/, a website created and administered by the CFTC's Whistleblower Office'. Director of the CFTC's Division of Enforcement added that 'The award also serves as another example of the increasing significance of whistleblowers in our enforcement program, a trend I expect to continue going forward.'

[Source: CFTC media release 16/07/2018]

More flexible approach to whistleblower awards? Commenting on the fact that within one week, the CTFC has issued two awards to whisltleblowers, one in the amount of $30m and the other in the amount of $70,000, National Law Review suggests that the CFTC is increasingly adopting a flexible approach to award determination.

[Note: Separately the Securities and Exchange Commission (SEC) is consulting on proposals to amend the rules governing its whistleblower program (including a proposal to enable the SEC to limit the largest whistleblower payouts to $30m and to increase the smallest payouts to $2m. See: Governance News 09/07/2018]

[Source: National Law Review 17/07/2018]

Other Developments

In Brief | Uber is reportedly being investigated by the US Equal Employment Opportunity Commission over alleged gender discrimination. This news follows the recent departure of Liane Hornsey (HR Head) who reportedly resigned after claims that she ignored allegations of racial discrimination and reports that Uber COO Barney Harford had made allegedly insensitive comments about women and minorities.

[Sources: Fortune 16/07/2018; 11/07/2018; CNN 17/11/2018;The New York Times 13/07/2018; [registration required] The WSJ 16/07/2018; The Verge 16/07/2018]

Restructuring and Insolvency

Report into the economic impact of potential illegal phoenix activity released by the ATO; new phoenix hotline to protect Australian workers and small businesses.

To continue to address illegal phoenix activity, three Phoenix Taskforce member agencies (the ATO, Australian Securities and Investments Commission (ASIC) and the Fair Work Ombudsman) commissioned PricewaterhouseCoopers (PwC) to measure the current impacts of illegal phoenix activity. The report: *The Economic Impacts of Potential Illegal Phoenix Activity* estimates the annual direct impact of illegal phoenix activity is between $2.85 billion and $5.13 billion.

More particularly the report presents two separate groups of impacts resulting from the activity of potential phoenix organisations: direct costs; and economy-wide impacts.

- **Direct Costs:** According to the report the direct costs (ie the immediate costs to the lawful affected parties as a result of potential illegal phoenix activity) of potential illegal phoenix activity in 2015-2016 was $2.85bn to 5.13bn. The costs to business (unpaid trade creditors) were estimated at between $1,162-$3,171m; the costs to employees (unpaid entitlements) was estimated at between $31-298m; and the cost to government in unpaid taxes and compliance costs was estimated at $1,660m.
- **Broader impact:**
  - The estimated total impact to GDP as a result of potential illegal phoenix activity is between $1.76 billion and $3.46 billion. This represents between 0.11 per cent and 0.21 per cent of real GDP for 2015-16.
  - The estimated total impact to household consumption as a result of potential illegal phoenix activity is between $1.20 billion and $2.36 billion.
  - The estimated total impact to government revenue as a result of potential illegal phoenix activity is between $760 million and $1,500 million.

PwC comments that the results highlight not only the costs to individuals, government and business but also flow-on losses through the supply chain and concludes that 'successfully combating potential illegal phoenix activity in a cost-effective manner could provide a significant boost to the Australian economy.'

[Sources: The Australian Taxation office media release 16/07/2018; The economic impacts of potential illegal phoenix activity report]

New phoenix hotline created

Minister for Revenue and Financial Services Kelly O'Dwyer has announced that the government has established a new phoenix hotline to combat phoenixing activity.

The new hotline is intended to:

- Make it easier for employees, creditors and/or the general public to report suspected phoenix behaviour directly to Australian Taxation Office (ATO) either via the ATO website, or via the hotline. This is intended to enable 'timely action to be taken against companies and their directors'.
- Online disclosures, or disclosures made via the new hotline will be protected by privacy laws and the 'government's legislative action in protecting whistleblowers'. The Phoenix Hotline is available on 1800-807-875 or online at ato.gov.au/reportphoenixactivity.

[Note: The legislative action referred to appears to be the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill* 2017 which is currently before the Senate. See: MinterEllison: *Whistleblower Bill update – what you need to know and do next* 24/04/2018]

Ms O'Dwyer said that the establishment of the hotline builds on the government work to deter phoenixing including 'the announced introduction of a director identification number, new phoenix offences, new clawback powers for ASIC, the extension of the director penalty regime, addressing corporate misuse of the

Fair Entitlements Guarantee Scheme, the establishment of the Phoenix Taskforce in 2014, strong new laws to target the non-payment of superannuation entitlements, reforms that will prevent GST fraud through phoenixing in the precious metals industry and the construction sector, as well as reforms to target black economy activities'.

The Australian Institute of Company Directors (AICD) has issued a statement welcoming the government's aim of 'deterring and disrupting phoenixing activity', and more particularly welcoming both the introduction of the Phoenix Hotline and website, and the introduction of DINs. 'The effective implementation of DINs would make it easier for regulators and other stakeholders to track the corporate history of individual directors and further support targeted anti-phoenixing measures, while also addressing cybersecurity and privacy concerns. We note that as with any electronic identification system, information confidentiality and security issues will be of paramount importance in implementing the DIN regime' The AICD writes.

[Note: The Government is currently consulting on proposed changes to the way in which business registry services will be provided. One aspect of this consultation is the implementation of Director Identification Numbers (DINs). Consultation closes on 17 August. See: Governance News 16/07/2018.]

[Sources: Minister for Revenue and Financial Services Kelly O'Dwyer media release 16/07/2018; [registration required] The SMH 16/07/2018; [registration required] The AFR 16/07/2018; AICD media release 16/07/2018]

Consultation on possible reform of the ABN system in response to the Black Economy Taskforce report findings: the government is seeking views on how best to 'strengthen and modernise' the ABN system.

In line with the Black Economy Taskforce findings (in particular the finding that the ABN system is being used by participants in the black economy to provide a false sense of legitimacy to their business), the government announced in the 2018-19 Budget, that it would consult stakeholders on the best way to strengthen and modernise the Australian Business Number (ABN) system.

On 20 July, the government released a consultation paper seeking views on possible changes to the ABN system including: adjusting ABN entitlement rules, imposing conditions on ABN holders, and introducing a renewal process including a renewal fee.

Following this consultation period, the government will consider stakeholder views and develop a coordinated package of ABN reforms. Further consultation is planned to occur on the details of these reforms and how they should be implemented.

Timeline: Consultation closes on 31 August.

Related consultations: Treasury notes the consultation on proposed reforms to modernise business registers, implementation a digital identity framework, proposed introduction of director identification numbers (DINs) (see: Governance News 16/07/2018) as well as the introduction of the phoenix hotline (see post above) will contribute to the reduction of phoenixing activity.

[Source: Treasury media release 20/07/2018; Consultation Paper: Tackling the Black Economy: Designing a modern Australian Business Number system Consultation Paper 20 July 2018]

In Brief | ASIC has released its latest quarterly insolvency update: The update includes ASIC's initial findings on why creditors are exercising their (new) power to replace appointees in voluntary administrators and creditors' voluntary liquidations and quarterly insolvency statistics for the third quarter of the 2017/18 financial year.

[Source: ASIC Corporate Insolvency Update - Issue 8]