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Remuneration

First strike 'expected' at Telstra AGM? According to media reports, Telstra is reportedly 'expecting a material vote' against its remuneration report after proxy advisers Glass Lewis, ISS and Ownership Matters issued recommendations against it, ahead of the 16 October AGM.

Context: In 2017 Telstra introduced a new incentive plan for executives, called the Executive Variable Remuneration Plan (EVP). The plan combined (and replaced) the previous Short Term Incentive (STI) and Long Term Incentive (LTI) plans into a single variable plan over a five year period, and was designed to support 'long-term shareholder value creation'. The plan also, The AFR reports, gave the board increased discretion to reduce bonuses.

According to media reports, ahead of the AGM on 16 October, there is disagreement among investors over whether the board has done enough to reduce executive bonuses in light of Telstra's recent performance.

- **Bonuses should have been reduced to zero? Proxy advisers are reportedly recommending against the remuneration report:** According to media reports, proxy advisers CGI Glass Lewis, ISS and Ownership Matters have recommended voting against Telstra's remuneration report. According to The AFR and Business Insider, though the Telstra board exercised its discretion to reduce executive bonuses (30-66% for group executives and the CEO), the view of proxy firms is that it did not do so sufficiently. The AFR quotes from an ISS report, 'given the significant extent of the poor experience, it is questioned whether the discretion [to reduce bonuses] was sufficient and what level of poor performance would justify a zero EVP award'.

- **Shareholder opposition given recent poor performance and job cuts?** The AFR also observes that a number of shareholders may vote against the report in light of the 8000 job cuts at the company and the fact that the targets set at the Telstra2022 strategy day (held in June) are incomplete. The article quotes one shareholder as commenting 'It's a sizeable amount of money [executive bonuses]. It's hard to explain that to someone in Telstra who has lost their job, the board should have been bolder.'

- **Australian Shareholder Association has reportedly signalled it will vote in favour of the report** on the basis that it considers that the bonus cuts applied by the board were appropriate in the circumstances. The Australian quotes the ASA as stating: 'We believe the board acted responsibly in applying a cut of 30 per cent to bonuses because of the poor share price performance over the period. While you could argue for a greater cut, this has to be balanced against the impact such an arbitrary move could have on senior executives' belief in the veracity of the bonus system.' The AFR quotes the ASA as commenting more generally that 'The remuneration report complies very well with ASA disclosure requirements with a table of actual take home remuneration and the use of market value rather than fair value in calculating LTI (long term incentive) grants'.

- **Telstra letter to shareholders:** In response to shareholder concerns, Telstra issued a letter to shareholders on 11 October which acknowledges that 'Some shareholders still feel that our remuneration outcomes were either not sufficiently transparent or resulted in higher payouts than shareholders felt were reasonable'. The letter also states that 'we recognise we perhaps did not provide enough transparency around some of the metrics that we adopted to measure management performance and the reasons as to why these were chosen. For this we apologise'. The letter then goes on to provide additional information around the metrics used and to justify the approach taken stating, 'we believe that shareholder interests are reflected in the [remuneration] plan'.

- **Telstra has reportedly said it anticipates a 'material' vote against the report?** According to media reports (written before the release of Telstra's letter to shareholders), Telstra has said 'We are aware a number of proxy advisor firms have recommended against Telstra's Remuneration report and a number of investors have also indicated a vote against…While we will not know the result until the AGM we are therefore expecting a material vote against the report at the AGM which is naturally of great concern'. Telstra reportedly went on to say that 'The board will be doing everything it can to address the concerns raised by investors both in respect of the previous 2018 financial year as well as the current year going forward…We consulted widely on the new incentive plan put to shareholders as part of the Remuneration Report that was strongly endorsed at the last AGM, and these discussions will continue as we respond in detail to shareholders once the final results of the vote are known'.

- **Are 'balanced scorecard' remuneration plans 'heading in the wrong direction'?** Noting the Rio Tinto board's decision not to implement a 'simplified' remuneration plan for lack of shareholder support earlier in the year, and the 'major protest votes' at QBE and AMP, The AFR comments that a number of entities who have introduced (broadly) similar models to the one considered by the Rio board (eg Telstra, NAB, JB Hi-Fi and iSentia) now appear to be facing the prospect of 'investor backlashes'. Under these plans, variable pay is determined by a 'balanced scorecard' of both financial and non-financial metrics which determines how much of the bonus pool executives will receive. The source of investor concern, The AFR writes, appears to be the removal of long term targets eg total shareholder returns from long-term incentives. The AFR quotes ISS as commenting: 'By basing executive remuneration on performance over only a one-year period, these new structures appear to head in the wrong direction.' The Australian Shareholders' Association is also quoted as commenting that the ASA is of the opinion that plans that the removal of long term targets means that these plans are 'not a true LTI'. Having said this, the report goes on to note that a number of plans (eg Telstra and Wesfarmers) do not propose to remove the total shareholder return target (before long term incentives would vest). However, shareholder advisers reportedly consider that removal of some existing financial hurdles, rather than adding a mix of both financial and non-financial hurdles to be problematic and have said that they have informed company boards that a move to the new models will not be supported.

[Sources: Telstra ASX media release: Letter to shareholders 11/10/2018; [registration required] The AFR 09/10/2018; AFR 09/10/2018; Business Insider 09/10/2018; [registration required] The Australian 10/10/2018; [registration required] The SMH 12/10/2018]

Proxy advisers reportedly raised concerns about 'excessive' CEO pay at Transurban ahead of the AGM, but nevertheless advised investors to support the remuneration report (which was subsequently approved).

The AFR reports that ISS, CGI Glass Lewis and the Australian Shareholders Association (ASA) recommended investors vote in favour of Transurban's remuneration report ahead of the 11 October AGM, though reportedly, ISS and Glass Lewis expressed concerns over the increasing gap between Transurban CEO Scott Charlton's pay and the pay of other Transurban executives.

Reportedly, Mr Charlton's total pay is more than triple the pay of other executives in his team, and his short-term bonus package is almost five times larger than other executives. ISS is quoted as stating that while Transurban's financial performance has been strong with net profits more than doubling over 2017-2018 to $468m, the pay gaps are of concern because they reflect 'the excessive and significantly increasing remuneration levels of the CEO'. In addition, ISS reportedly said that Transurban's lack of disclosure on individual performance targets, particularly for Mr Charlton, and how performance was measured is 'a material shareholder concern for transparency'. Glass Lewis has reportedly said the difference between the CEO's pay and that of other executives was an issue of corporate governance, (reportedly) writing 'Since oversized CEO pay is usually the size of an all-powerful CEO, internal pay equity can also serve as a check on a CEO's authority, increasing the involvement of other executives in the management of the company and preparing them for future transition into the role of the CEO…Accordingly, a high level of executive pay inequity, as in this case, may indicate long-term problems with the company's remuneration practices and, more broadly, its board-level management and oversight'.

Despite these concerns, resolutions on the adoption of the remuneration report and performance awards to Mr Charlton were approved in both cases (with 13% and 6% voting against the resolutions respectively).

[Sources: [registration required] The AFR 10/10/2018; ASX media release: Results of AGM 11/10/2018]

Overseas developments

United Kingdom | Compulsory ethnicity pay reporting for UK employers? The UK government has issued a consultation paper seeking views on how ethnicity pay reporting could be implemented as a means of helping to address the disparities between the career prospects and salaries of minorities.

The UK government is consulting on the possible introduction of mandatory ethnicity pay reporting for large UK employers. 'Reporting ethnicity pay information enables employers to identify – and then tackle – barriers to creating a truly diverse workforce. If there is a consistent approach to reporting, they can also benchmark and measure their progress by comparing themselves to other employers and learn from them' the consultation paper states.

The consultation paper sets out various options and seeks feedback on the following issues (among others):

- **What ethnicity pay information should be reported by employers to allow for meaningful action (but 'not place undue burdens on business').** Among other things, the paper questions whether ethnicity reporting should mirror gender pay gap reporting (or should be undertaken differently), whether standardised classifications of ethnicity should be used to ensure consistency, and whether employers who identify disparities in their ethnicity pay in their workforce should be required to publish an action plan for addressing the disparities.
- **Who should be expected to report (what size of employer should be within scope for mandatory ethnicity pay reporting)**.
- **Next steps/implementation** eg what support measures would be useful for employers

The consultation responses will be used to inform future government policy in this area.

Timeline: Consultation closes 11 January 2019.

[Sources: Ethnicity Pay Reporting Consultation media release 11/10/2018; Ethnicity Pay Reporting: Government Consultation; BBC news 11/10/2018]

Shareholder Activism

In Brief | Change in approach? Governance issues are now a key concerns for Elliott Management according to The WSJ, which reports that Elliott has shifted away from its traditionally 'aggressive' engagement style, to focus instead on building long-term relationships in line with shifting shareholder expectations.

[Source: [registration required] The WSJ 08/10/2018]

In Brief | Unilever has reportedly abandoned plans to collapse its dual listed structure into a single Dutch entity under pressure from UK shareholders. The primary reason for their opposition was reportedly the fact that unification would require Unilever to surrender its FTSE100 listing. The AFR suggests that given the same shareholders who opposed the Unilever unification plan are also 'major owners' in BHP, it may signal the end of Elliott's push to end BHP's dual listing.

[Source: [registration required] The AFR 07/10/2018]

Institutional Shareholders and Stewardship

In Brief | 'Fearful' of confronting boards on ESG issues or merely preferring to engage privately? An ACCR survey has found that some of Australia's largest funds are less than active when it comes to supporting ESG governance reforms (considered by ACCR) to be in the best long-term interests of shareholders. Overall, the report found that though some funds 'assert' themselves at AGMs, many superannuation funds appear 'fearful of confronting company boards and management on policy issues significant to the long-term interests of beneficiaries'.

[Sources: [registration required] The SMH 10/10/2018; Australasian Centre for Corporate Responsibility: Survey of the responsible investment policies and related voting transparency of selected Australian asset owners and fund managers September 2018]

Other Shareholder News

China | Revised Chinese Corporate Governance Code released: Glass Lewis comments that new requirements for listed companies to establish party organisations mean that overseas investors 'should be mindful' of Chinese government involvement, and the potential for conflicts between the interests of the Party and other stakeholders.

Glass Lewis reports that the China Securities Regulatory Commission (the CSRC) issued a revised *Code of Corporate Governance for Listed Companies* on 30 September.

[Note: The new Code is available here. An English translation of the revised Code is not available at time of writing. The post below is based on Glass Lewis' report.]

According to Glass Lewis, the final version of the Code is similar to the draft circulated for consultation earlier in the year (with some exceptions). Among the changes to the Code are the following.

- A new requirement for companies to establish 'party organisations' (which Glass Lewis describes as 'representative units of the Communist Party intended to play a political role in the company and ensure implementation of state objectives and policies') and incorporating Party building work into the articles of association of state-controlled firms.
- Restricting powers of controlling shareholders.
- Encouraging cash dividend distribution.
- New environmental, social and governance (ESG) requirements eg green development and 'targeted poverty alleviation'.
- Promoting board diversity.
- Strengthening audit committee functions.

Commenting on the implications for overseas investors, Glass Lewis writes that 'Overseas investors should be mindful of state involvement, and the potential for conflicts between the interests of the Party and other stakeholders'. Glass Lewis goes on to state that though the new Party Building requirements 'highlight a fundamental difference between how companies operate in China and other markets, most other provisions of the New Code appear focused on improving Chinese regulation to provide flexibility and encourage innovation'.

[Source: Glass Lewis blog 04/10/2018]

Meetings and Proxy Advisers

ISS 2018 Governance Principles Survey results released: Shareholders were asked to comment on the issues of auditor independence, director accountability and track records, board gender diversity and the 'one share, one vote principle' to inform the ISS policy process, ahead of the release of ISS policies in November.

On 18 September, Institutional Shareholder Services (ISS) released its latest annual Governance Principles Survey, the results of which will inform its annual policy development process. The survey topics this year sought respondent's views on a limited number of 'high profile' issues including: auditors and audit committees, director accountability, board gender diversity and the 'one-share, one-vote' principle.

ISS writes that it will release final policies in mid-November which will be applicable to global shareholder meetings occurring on or after 1 February 2019.

About the survey: ISS received 669 responses to the survey, from 638 different organisations. This is an 11% increase on the total number of responses received last year. Geographically, the bulk of respondents (over 400 of the 669 respondents) were based in the US. The survey also included: 94 responses from entities based in Europe, 53 responses from Canadian entities, 20 responses from entities based in Asia, 7 entities based in Latin America and 5 based in Africa. A small number of responses were also received from entities based in Australia, New Zealand and Russia.

Some Key Findings

- **Assessing auditor and auditor committee independence:** ISS comments that the role of auditors and audit committees has 'captured increased focus recently' in the wake of recent events in the UK and the US eg the collapse of Carillion plc after a clean bill of health from its auditor (see: Governance News 21/05/2018) and the high level of shareholder opposition to ratifying General Electric's long-tenured auditor after unexpected accounting charges and a SEC investigation. Given this, ISS observes, regulators and investors are both increasingly focused on additional indicators of audit quality and auditor independence.

[Note: The UK Competition and Markets Authority (CMA) has recently announced a review into the UK audit sector, and separately the Financial Reporting Council (FRC) (itself currently under independent review) has announced that it will conduct a series of reviews of the audit sector (including reviewing whether firms should be allowed to conduct consulting work). These developments are discussed in a separate post in this issue of Governance News below.]

  - **Auditor independence?** ISS asked respondents to identify the audit-related factors (other than fees paid to the auditor for non-audit services) that they consider important in evaluating the independence and performance of external auditors. According to the survey, investor respondents most often cited regulatory fines or other penalties imposed on the auditor for weaknesses or errors in audit practices as a significant matter of interest, followed by audit controversies. Non-investors most frequently cited consideration of the identity of the audit partner and any links they have to the company or its management, followed by regulatory fines or other penalties imposed on the company related to financial disclosure practices or weaknesses not identified in the audit report as significant.
  - **Factors relevant to the assessment of audit committee independence?** ISS also asked survey respondents to identify information that shareholders should consider when evaluating a company's audit committee. Both investors and non-investors most often cited the skills and experience of audit committee members (including number of financial experts, if applicable) as the top consideration. A joint response on behalf of both an investor and non-investor respondents indicated that the audit committee's charter should be an additional factor for consideration.

- **Director accountability and track records:** The survey found that investors are interested in 'tracking' individual directors who have been involved in controversies with respect to one or more of their past or present directorships and that they would consider it 'appropriate' and 'useful' for this information to be noted in proxy research. In particular, the survey found that both investor and non-investor respondents would like to see any risk oversight failures relating to fraud or other forms of corporate malfeasance and oversight failures regarding protection of shareholder rights or shareholder value included. In terms of the 'look back' period for oversight 'shortfalls', ISS found that investors and non-investors had divergent views: 39% of investors indicated that they did not consider there should be a time limit (as compared with 9% of non-investors) and 44% of non-investors indicated that the time limit should be 3 years (as compared with 16% of investors).

- **Board gender diversity appears to be an area of increasing concern for investors and non-investors**. Glass Lewis found that 80% of investors consider lack of gender diversity at board level to be problematic (an increase on 69% in the previous survey) and 45% consider the absence of at least one female director at board level could indicate problems in the board recruitment process. The survey also found that disclosure of a policy/approach describing the considerations taken into account by the board or nominating committee to increase gender diversity was considered by some investor respondents (37%) to be sufficient to mitigate these concerns. There was also an increase in the number of non-investors who consider lack of gender diversity to be problematic with 60% agreeing that this was the case (up from 54% last year).

- **Shareholder attitudes to the 'one-share, one-vote' principle:** Noting that the number of entities with unequal voting structures is increasing, ISS asked respondents whether it should provide vote results, where possible, to show what the vote results would have been if all votes were counted equally. Both investors and non-investors 'overwhelmingly' (92% investors and 59% non-investors) indicated they want such information.

[Sources: ISS media release 18/09/2018; ISS 2018 Governance Principles Survey: Summary of Results 18/09/2018; JD Supra 04/10/2018]

Disclosure and Reporting

Climate Disclosure

CalPERs is among the supporters of a petition for the US SEC to 'promptly initiate rulemaking to develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful environmental, social, and governance information'.

Writing on Harvard Law School Forum for Corporate Governance and Financial Regulation, Professors Jill Fisch (University of Pennsylvania) and Cynthia Williams (York University) write that their petition to the Securities and Exchange Commission (SEC) calling for the regulator to 'promptly initiate rulemaking to develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful environmental, social, and governance information' has attracted the support of a group of investors and associated organisations, representing more than $5 trillion in assets under management including California Public Employees' Retirement System (CalPERS), American Federation of State, County and Municipal Employees (AFSCME) and Arjuna Capital among others.

Why mandatory rules are needed

According to the writers mandatory rules are needed, and would be of benefit for a number of reasons including the following.

- **Increased demand for ESG information:** Investors including retail investors, are demanding and using a wide range of information designed to understand the long-term performance and risk management strategies of public-reporting companies.
- **Poor quality of information available:** Increasingly public companies are making voluntary disclosures, but 'ESG disclosure is episodic, incomplete, incomparable, and inconsistent, and ESG disclosure in required SEC filings is similarly inadequate' the writers argue. The petition argues that a comprehensive framework is needed in order to provide 'clearer, more consistent, more complete, and more easily comparable information relevant to companies' long-term risks and performance'.
- **Enhance capital formation and promote market efficiency?** The writers also note that the SEC has 'clear statutory authority to require disclosure of ESG information', and that doing so would 'promote market efficiency, protect the competitive position of American public companies and the US capital markets, and enhance capital formation'.
- **Benefits for both investors and reporting entities:** A mandatory framework would, in the writers' view, benefit both investors and reporting entities in that it would both better inform investors; and provide clarity to companies on the 'providing relevant, auditable, and decision-useful information to investors'. The writers argue that the measure would also 'reduce the current burden on public companies and provide a level playing field for those engaging in voluntary disclosure' who currently, in the absence of guidance, may be reporting against multiple frameworks.
- **TCFD recommendations?** Commenting more specifically on The Task Force on Climate-Related Financial Disclosure (TCFD) Recommendations, the writers suggest that the TCFD recommendations 'would be an industry-developed (operating companies, investors, insurance companies, and accounting) platform for the SEC to use as a starting point in promulgating its own Framework for comprehensive ESG disclosure'.

[Note: In Australia, the Australian Securities and Investments Commission (ASIC) has encouraged companies to 'consider' adoption of the TCFD guidelines and has flagged that a review of relevant regulatory guidance is planned for release by the end of the year (see: Governance News 03/09/2018, 21/09/2018).]

Guide to climate disclosure: MinterEllison has prepared a guide on climate risk disclosure to assist boards and their committees: The climate risk reporting journey: a corporate governance primer. See: ASIC's new focus on climate change risk disclosure - what does it mean for corporate boards?

[Sources: Harvard Law School Forum on Corporate Governance and Financial Regulation 09/10/2018; SEC Petition 01/10/2018]

Progress update one year on from the release of the TCFD recommendations: The TCFD recommendations have been adopted by 457 companies globally, but there is room for improvement on reporting practices the Taskforce states.

As part of its effort to promote the adoption of the Task Force on Climate Related Financial Disclosure (TCFD) Recommendations, the TCFD has released a status report on the extent to which the recommendations have been adopted in 2017 reports. In addition, the report identifies a number of areas for improvement.

Some Key Points

- **Support for the recommendations has rapidly increased since the final recommendations were released:** According to the TCFD, more than 457 companies globally with an aggregate market capitalisation of over $7.9 trillion have expressed their support since the recommendations were released in June 2017. This includes 287 financial firms, responsible for assets of nearly $100 trillion. The Taskforce observes that this represents a substantial increase from the 100 firms who initially supported the recommendations.
- **The majority of firms surveyed disclose some climate-related information.** According to the report, the majority of companies reviewed disclosed information aligned with at least one recommended disclosure, usually in sustainability reports.
- **Wide variation in disclosure practices across industries and across regions:** In terms of regional variations, the report found that a higher percentage of companies in Europe disclosed information aligned with the recommendations as compared with other regions. In terms of variation in reporting practices across different sectors, a higher percentage of non-financial companies reported information on their climate-related metrics and targets compared to financial companies; but a higher percentage of financial companies indicated their enterprise risk management processes included climate-related risks.
- **Room for improvement:** The report found that very few companies describe the 'resilience of their strategies' under different climate related scenarios (including a 2°C or lower scenario). The report identifies this (ie the need to improve data analytics and modelling of climate-related issues) as a key area for improvement as the Taskforce regards 'qualitative or quantitative disclosure on how a company's strategies might address potential climate-related risks and opportunities' to be a 'key step to better understanding the potential implications of climate change on the company'. Though the report acknowledges that the use of scenarios in assessing the potential financial implications of climate related issues is relatively recent, it emphasises that 'such analysis is important for improving the disclosure of decision-useful, climate-related financial information'.
- **Other areas for improvement include:**
  - **Information is often spread across multiple reports/included in very lengthy reports:** The report found that disclosures are often spread across multiple reports (financial filings, annual reports, and sustainability reports). The TCFD suggests that where climate disclosures are spread across reports/included in lengthy reports, 'companies may wish to consider providing cross-references or mappings to assist users of disclosure in locating relevant information'.
  - **Financial impact is often undisclosed:** While many companies disclose climate-related information (eg the costs of individual projects, investments with climate-related implications, or measures of the company's impact on the environment), few firms disclose the financial impact of climate change on the company. The TCFD observed that disclosures would be improved if companies with material climate-related issues described the actual or potential financial implications of climate change.

- **Lack of context:** The report observes that in some cases it was difficult to understand the significance of climate-related projects described in companies' reports and their relevance to the companies' overall strategies. The report observes that 'if companies do not describe the reasons for their climate-related projects, it may be difficult for investors and others to determine the importance of such projects'.

Reporting on climate risk and opportunities should become a 'natural part of companies' risk management and strategic planning processes' over time?

The Report argues that wide adoption of the recommendations, and incorporation into risk management and strategic planning processes, is key to improving the quality of reporting. **'**As this occurs, companies' and investors' understanding of the financial implications associated with climate change will grow, information will become more useful for decision making, and risks and opportunities will be more accurately priced, allowing for the more efficient allocation of capital' according to the TCFD.

The TCFD concludes that 'As the financial implications of climate change become more apparent to investors, their consideration of this issue is increasingly relevant to companies. As such, the impetus is on companies to ensure that they are providing decision-useful disclosure concerning the bottom line impacts of climate change'.

Next steps: Over the next nine months, the Task Force writes that it will continue to promote and monitor adoption of its recommendations and will prepare a second status report for the Financial Stability Board in mid-2019.

[Sources: TCFD media release 26/09/2018; Task Force on Climate related Financial Disclosures: 2018 Status Report 26/09/2018; Glass Lewis blog 02/10/2018]

Regulators

Top Story | APRA to reconsider its approach to enforcement? In the wake of the release of the Financial Services Royal Commission's Interim Report, APRA Chair Wayne Byres has called on industry to raise standards of professionalism and has also signalled that APRA will also reconsider its regulatory approach.

In a speech entitled 'Good banking, by good bankers' Australian Prudential Regulation Authority (APRA) Chair Wayne Byres has called for greater professionalism in Australia's financial services sector to address issues raised in the Financial Services Royal Commission Interim Report, and to restore trust in the sector. Mr Byres also flagged that the regulator will reconsider its current approach to enforcement following the release of the Financial Services Royal Commission's Interim Report, noting that 'based on what has been revealed' during the Commission hearings, the suggestion that 'regulators can and should do more to actively enforce standards of behaviour within the financial sector and punish those who breach them' appears to be a 'quite reasonable conclusion'.

Some Key Points

- **The financial system remains financially sound:** Mr Byres commented that 'It's important that we continue to recognise and acknowledge that the Australian financial system remains financially sound. APRA certainly continues to work to keep it that way' Mr Byres said.
- **Change in the sector is necessary and will 'ultimately be positive for the industry'**: Commenting on the Financial Services Royal Commission Interim Report, Mr Byres described it as 'confronting' and 'uncomfortable to read'. He said that the report 'raises serious questions and issues for the financial industry, regulators and policymakers to contemplate, and the Commission will inevitably change many elements of the way institutions currently operate, as well as the way they are regulated. As much as the industry, and those of us associated with it, are feeling the intense glare of the Commission's scrutiny, I have no doubt it will be for the best. The Royal Commission will ultimately be positive for the industry, as well as consumers'.
- **Addressing the issues identified in the Commission's interim report will require cultural change:** Mr Byres emphasised that addressing the issues identified by the Financial Services Royal Commission 'will require enormous effort from everyone who understands the importance of a well-

functioning financial system that serves the community. Entire companies, sometimes comprising tens of thousands of employees, must change their policies and cultures. But ultimately it comes down to people – collectively and individually. Everyone in the industry has a role to play'.

- **The business of banking is 'not a profession':** Commenting on the need to raise standards of professionalism in the sector, Mr Byres said that 'the business of banking at least thus far, is not a profession'. He went on to comment that 'the combination of compulsion, opacity and materiality inherent in many financial products generates, as a quid pro quo, a heightened expectation that financial institutions will exhibit high standards of behaviour in the way they operate. Yet…there is no defined body of knowledge or high entry standards for those who perform key roles. Where codes of conduct exist, they are often totally voluntary. And on the evidence before the Royal Commission, the balance between self-interest, company interest and serving the community's interest has not always been appropriately struck'. He went on to say that, though the standards currently under development by industry are a 'very welcome development', 'increased professional standards are not a panacea'.
- **Technology may assist, but cannot wholly address poor decision making – 'people are still paramount':** Though technology won't solve the entirety of issues identified over the course of the Financial Services Royal Commission, Mr Byres noted, the Commission 'process has shone a light on the all-too human flaws that have badly tarnished trust in the financial sector'. Mr Byres went on to suggest that the 'the increasing dependence on technology may help address some of these issues, by removing those flaws from some decision-making'. Having said this, Mr Byres added that 'correcting flaws in corporate governance and culture will require traits that only humans can provide: leadership, judgement, a deep understanding of the fundamentals of their businesses, a strong ethical and moral compass, and the ability to successfully balance the interests of the company, shareholders, consumers and society in general. The future may be on built on technology, but to get this all right, people are still paramount'.
- **APRA's role in the process: the regulator will consider a change in approach?** Mr Byres commented that the Financial Services Royal Commission 'has suggested, amongst other things, that regulators can and should do more to actively enforce standards of behaviour within the financial sector, and punish those who breach them. Based on what has been revealed, that is a quite reasonable conclusion. Consistent with prudential supervisors around the world, APRA has traditionally examined cases of poor conduct as an indicator of risk, but not a direct prudential risk in and of itself, unless it was likely to jeopardise the stability of the system or an individual institution. We will clearly need to reflect on that approach'.

[Sources: APRA Chair Wayne Byres' speech to the FINSIA Summit 2018 Sydney: Good Banking, by Good Bankers 11/10/2018; The ABC 11/10/2018;

Australian Banking Association (ABA) supportive 'in principle' of 'the professionalization' of banking

In a speech entitled 'Earning back trust and the role of self-regulation' ABA CEO Anna Bligh said (among other things) that the ABA Council 'support in principle the professionalization of banking as important to raising training and conduct standards' and that industry is working with FINSIA and stakeholders to develop a model for the Australian context.

[Sources: 'Earning back trust and the role of self-regulation', Anna Bligh CEO Australian Banking Association FINSIA Summit 2018 11/10/2018]

Update on professional standards for financial advisers: ASIC has released an instrument delaying reporting dates and making minor amendments

The Australian Securities and Investments Commission (ASIC) has registered the *ASIC Corporations (Professional Standards - Transitional) Instrument 2018/894* which gives effect to revised reporting dates for the financial adviser professional standards regime, as previously announced on 1 August 2018. It also makes minor technical amendments.

ASIC said the reporting changes simplify licensees' notification obligations and enable ASIC to implement the required systems changes more effectively but that the changes do not affect the substantive obligations under the professional standards reforms. Advisers and licensees must still comply with the new professionalism and education requirements and licensees must keep appropriate records for compliance purposes, ASIC said.

[Sources: ASIC media release 10/10/2018; ASIC Corporations (Professional Standards—Transitional) Instrument 2018/894]

Short selling changes: Following consultation, ASIC has released a new legislative instrument and updated guidance on short selling.

Following consultation earlier this year, (see: *CP 299 Short selling: Naked short selling relief* as reported in Governance News 21/05/2018) ASIC has issued a new legislative instrument providing various relief and modifications to the laws in relation to short selling (the Short Selling Instrument).

In addition to providing new relief and modifications, the Short Selling Instrument (*ASIC Corporations (Short Selling) Instrument 2018/745*) continues the effect of other ASIC instruments that were due to expire. ASIC has also updated its existing guidance in *Regulatory Guide 196 Short selling* to reflect the legislative instrument.

The Short Selling Instrument took effect from 28 September 2018. ASIC will publish a Feedback report on the submissions to CP 299 in November 2018.

[Source: ASIC media release 08/10/2018]

In Brief | The Reserve Bank of Australia has identified bank culture among the 'vulnerabilities for Australian financial stability' in its latest half-yearly Financial Stability Review, noting that to date the impact of these failings has been small but that 'the consequences of reputational damage could impair banks' profitability and resilience'. The report also states that 'bank culture needs strengthening'.

[Sources: RBA October Operational Stability Review 12/10/2018; [registration required] The AFR 12/10/2018]

In Brief | SEC has released its Strategic Plan for FY 2018 through FY 2022: Chair Jay Clayton writes that 'The SEC's long-standing tripartite mission—to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation—remains our touchstone' and unchanged. Among the goals/priorities identified in plan are a focus on pursuit of misconduct impacting retail investors modernising design, delivery and content of disclosure; involving investors in rule-making; and a focus on cyber risk and preparedness.

[Source: SEC media release 11/10/2018; Strategic Plan Fiscal Years 2018-2022]

Financial Services

Fee for no service (FFNS) developments

Australian Banking Association to amend the Banking Code to end FFNS and support changes to FoFA legislation to end grandfathered payments/trail commissions to financial advisers.

On 10 October, the Australian Banking Association (ABA) announced reforms in response to the Financial Services Royal Commission.

- **Ending 'fees for no service'**: 'Banks will change the way they manage ongoing financial advice, proactively contacting customers to confirm what advice is required and only charging for what is provided'.
- **Amending the Banking Code of Practice (Banking Code) to 'improve the way banks manage' deceased estates**. 'Once notified of a customer's death, banks will proactively identify fees that are for products and services that can no longer be provided in the circumstances, stop charging those fees and refund any paid'.

- **Seek legislative change to end grandfathered commissions/trail commissions:** Seek changes to the Future of Financial Advice (FOFA) reforms to 'remove all legislative provisions that allow grandfathered payments and trail commissions in financial advice'.

According to the ABA the reforms are 'the first of several key changes' in response to the Commission.

CEO of the Australian Banking Association Anna Bligh said these initiatives addressed concerns raised by the Royal Commission's Interim Report:

- In relation to fee for no service conduct/fees charged to dead customers she commented: 'It has always been unacceptable for any organisations to charge fees without providing a service. This announcement will put beyond the shadow of a doubt that this practice has no place in Australia's banking industry.' She went on to say that banks are 'working with customers' to refund those charged a fee where no service was provided, noting that according to ASIC data, customers stand to receive more than $1bn in refunds.
- In relation to grandfathered commissions, Ms Bligh said that supporting the removal of grandfathered commissions in relation to financial advice would is 'another important piece in the puzzle of ensuring there are no conflicts for advisers'.

CBA announcement: The day before the ABA announcement, the CBA issued its own statement outlining further improvements to its wealth management business 'including the rebating of grandfathered commissions for Commonwealth Financial Planning (CFP) customers, and a review and remediation program for any instances where unauthorised advice fees have been charged to deceased estates'.

[Sources: Australian Banking Association media release 10/10/2018; CBA media release 09/10/2018; [registration required] The AFR 09/10/2018]

FFNS update | ASIC has announced a review of possible 'systemic non-compliance' with requirements for Fee Disclosure Statements and Renewal Notices in the financial advice sector and flagged that it is currently investigating 'substantial breaches' of these obligations with a view to taking enforcement action.

On 11 October, ASIC announced a review of compliance with the requirements for Fee Disclosure Statements (FDS) and Renewal Notices in the financial advice sector. ASIC states that it will test compliance with these obligations across a range of small and large licensees and will provide findings 'in 2019'. In addition, ASIC states that it 'is currently investigating substantial breaches of these obligations with a view to taking enforcement action'.

Role of FDSs and Renewal Notices in mitigating against FFNS issues

ASIC writes that its ongoing work on fee for no service (FFNS) 'failings' in the advice industry has highlighted the importance of FDSs and Renewal Notices in mitigating against future FFNS issues. More particularly, ASIC states that the measures (which were implemented as part of the Future of Financial Advice (FOFA) reforms in 2013), were intended to a) enable customers to gain a better understanding of the advice services for which they are charged/services they are entitled to receive (FDS); and b) reduce the likelihood of passive or disengaged customers from being charged ongoing fees by requiring that they actively 'opt-in' before they are charged (renewal notices).

Systemic non-compliance?

ASIC states that the review is being undertaken in response to the volume of breach reports received from licensees which indicate that they may not have complied with the FDS and Renewal Notice requirements. The 'volume and range of breach reports could suggest systemic non-compliance' ASIC writes.

ASIC states that it is 'investigating breach reports received and will take enforcement action where breaches are substantiated' and in addition will undertake a broader review to test compliance with FDS and renewal notice requirements across the industry.

Focus of the industry review

ASIC will examine to what extent advice licensees comply with their FDS and renewal notice obligations. More particularly, the review will assess whether:

- licencees issue FDSs and Renewal Notices to customers;
- whether they do so within the required timeframes;
- the extent to which required content is included in FDSs;
- whether licensees ensure the content of FDSs is accurate in describing what customers are charged for and what services customers have received; and
- whether licensees have appropriate procedures in place to ensure fees for ongoing services are discontinued when the arrangements are terminated as a result of licensees failing to comply with the FDS or Renewal Notice requirements.

Enforcement action for substantial breaches? ASIC states that it 'is currently investigating substantial breaches of these obligations with a view to taking enforcement action' and is also ''supervising remediation programs which require licensees who reported failures to issue compliant FDSs to customers and/or refund and compensate customers for the ongoing service fees charged'.

[Note: ASIC previously provided an update on FFNS refund programs in August. See Governance News 13/08/2018].

[Source: ASIC Media release (accessed via Capital Monitor): 18-305MR ASIC Action on compliance breaches with fees disclosure and renewal notices 11/10/2018]

Other Developments

Progress update implementation of APRA culture review recommendations | CBA has released independent monitor, Promontory Australasia's, first quarterly report into the progress of CBA's Remedial Action Plan to address all 35 of the recommendations of APRA's Prudential Inquiry.

The Commonwealth Bank of Australia (CBA) has released the independent report, conducted by independent monitor Promontory Australasia (Promontory), into the CBA's progress towards implementing the recommendations of APRA's prudential inquiry into the culture of the bank. Promontory's report describes the design and management of CBA's Remedial Action Plan (RAP) program of work and provides an update on progress towards implementing the 153 actions or 'milestones' identified to address APRA's recommendations for the period to 31 August 2018.

CBA Remedial Action Plan (RAP)

- CBA's remedial action plan includes 153 milestones or actions to be undertaken to address the 35 recommendations in APRA's final report.
- A central team in the bank — the BROP (better risk outcomes program) team, which comprises experienced executives drawn from across the organisation — is responsible for the design and coordinating the execution of the RAP.
- Work to address each recommendation is being performed under the oversight of an accountable executive under the new BEAR (Banking Executive Accountability Regime) framework.
- The board and the executive leadership team were both participants in the formation of the remedial action plan, and are involved in overseeing its execution.

Progress update

- Promontory assessed one action (of 153) as complete and effective (as at the end of the reporting period: 31 August). This action was completion of the chief risk officer (CRO) assessment.
- Promontory notes that an additional 8 actions had been completed by CBA, but were reported to Promontory at the end of the reporting period. Consequently, Promontory had not commenced assessment of those actions at the end of the period.
- CBA had commenced work on 50 other actions.

Promontory observations

- **Evidence of commitment to the plan:** Promontory states that 'to date, CBA's design and management of the Program evidences a commitment to meeting the challenges described in the Inquiry Report in a timely and comprehensive way. Furthermore, the foundation of a successful risk remediation program is being laid'. Promontory adds that due to the size and complexity of the organisation, implementation of the plan will be a long process.

- **Commitment to cultural change:** Commenting specifically on culture, the report states that a 'strong sense of commitment to sustainable cultural change has been evident' in interactions with the Better Risk Outcomes Program team (who have responsibility for developing and coordinating the execution of the plan). The report adds that 'We see this as important, given the leadership role that team is playing in driving the outcomes the Program is seeking'.

- **Vigilance needed:** 'Although there is evidence…to date, of clear commitment to moving on from the project execution practices criticised in the Inquiry Report, CBA should remain vigilant in ensuring those practices do not re-emerge' the report states. Promontory adds that CBA should 'continue challenging itself around whether the processes it is applying to project execution are necessarily the most effective way of achieving program outcomes. In particular, as the program evolves and focus turns from the design of milestones to implementation, CBA should recognise that project execution risks are likely to increase. This will require ongoing close monitoring and the effective escalation of project risks to appropriate governance forums for discussion and resolution'.

- **Momentum needs to be maintained:** Promontory comments that: 'Moving forward, the sheer size of CBA, the extent to which existing processes and sub-culture are embedded, and the complexity of the Program are likely to pose ongoing execution challenges…The Board and management should, therefore, work to ensure Program momentum is maintained through engagement, communication of its commitment to the Program and monitoring of the Program as it is executed'. The report adds that ensuring appropriate systems and technology are in place will also be important to the execution of the plan 'on a sustainable basis'.

- **Evidence that program delivery risk are being managed:** Promontory comments that 'There is evidence that program delivery risks and issues are being reported on and closely monitored and that CBA appears to be responding to delivery risks in a timely way and goes on to note 'the issues' described 'are not unusual for early-stage, complex programs.

Next report: Promontory's next report will be released in December.

CBA comment: In a statement announcing the release of the report, CEO Matt Comyn said: 'We have embarked on a significant program of change and we are making progress. We understand there is still a lot to do and remain committed to implementing our plan in full and on time. We recognise that ultimately, we will be judged by the improvements we make in customer and risk outcomes'.

The statement adds that 'to ensure that CBA remains focused on making these changes, all senior leader have 20-30% of their performance metrics tied to the successful delivery of the Remedial Action Plan milestones for the current financial year'.

[Sources: CBA media release 10/10/2018; Promontory Australasia's Independent Review of the Commonwealth Bank of Australasia's Remedial Action Plan: Progress in addressing Prudential Inquiry Recommendations 28/09/2018; [registration required] The AFR 10/11/2018; [registration required] The Australian 11/10/2018]

House economics standing committee public hearings: CEOs of the big four banks have been/will be required to answer questions on remuneration and their response to issues raised by the Financial Services Royal Commission.

The House of Representatives Standing Committee on Economics held public hearings on the 11 and 12 October (CBA, Westpac, ANZ), and will hold a final hearing on 19 October (NAB), as part of its ongoing scrutiny of Australia's big four banks.

Focus of the hearings

Committee Chair Tim Wilson MP, indicated ahead of the hearings that remuneration structures within the banks would be an area of focus. 'Commissioner Hayne's Interim Report identified incentives in banks against the interest of customers that has led to appalling conduct contrary to law. Yet, this misconduct has either gone unpunished, or the consequences have not met the seriousness of what has occurred and must be addressed' he said.

In addition, Mr Wilson indicated that the hearings would also provide an opportunity to follow up on unresolved issues from earlier hearings; 'and to consider how best to ensure appalling behaviour is not repeated without inhibiting the banks' essential contribution to grease our economy'.

ANZ CEO Shayne Elliot's opening remarks to the committee

ANZ released CEO Shayne Elliott's opening remarks to the Committee.

- **Impact of the issues identified by the Financial Services Royal Commission:** The statement acknowledges that the conduct identified in the Financial Services Royal Commission's Interim Report has 'rightly dismayed and disappointed Australians' and notes that ANZ has acknowledged to the Commission, that it 'has engaged in misconduct and conduct falling below community standards and expectations' and that the Commissioner has 'also observed that ANZ may have other cases to answer'.
- **Personal accountability:** Mr Elliott takes personal responsibility for the issues identified, stating 'It is completely unacceptable that we have caused financial harm and emotional stress to our customers. As CEO since 2016, I'm ultimately accountable for this'.
- **Broader accountability at ANZ:** Mr Elliot writes that 'In truth, accountability for the misconduct examined by the Commission has been limited' noting that there has been insufficient focus in the past on holding executives to account. 'Where there have been consequences, they have often involved pay cuts and people leaving the bank' he added, and 'direct and documented links between specific failures and consequences have been limited and insufficient'. He went on to say that 'this needs to change, and it is' noting that the 'failings acknowledged to the Commission and the lack of satisfactory progress on remediation will have a material impact on executive remuneration this year'. According to media reports among other things, Mr Elliott said in response to questions from the Committee around changes to accountability mechanisms that he was 'frankly appalled' by the misconduct uncovered at by the Financial Services Royal Commission and that 200 people at the bank (including 10 executives) had been terminated without pay as a result of misconduct. In addition, he reportedly said that the Banking Executive Accountability Regime (BEAR) had provided a framework for the bank to hold executives more accountable.
- **Changes in response to the Commission:** Mr Elliott said that his focus since becoming CEO had been on 'working to make our bank simpler and better able to serve our customers' but that 'complexity makes it harder to identify and fix problems' and outlined a number of changes on foot at ANZ including improvements to the remediation process. 'There is more to do but our changes so far are already making ANZ easier to manage and better for customers. The Commission's Interim Report strengthens our resolve to fast track these, and other, reforms'.
- **Invitation for customers to contact him directly**: Mr Elliott said that meeting with a customers is a priority and inviting customers to email him personally.

CBA CEO Matt Comyn's opening remarks to the standing committee

The Commonwealth Bank of Australia (CBA) has released CBA CEO Matt Comyn's opening remarks. The statement outlines the actions underway already to 'make Commonwealth Bank a better and simpler bank by improving our culture, putting our customers first and making changes to the way we work' including: 'embracing' the APRA Report into culture at the bank and implementing the recommendations; making changes to the structure of remuneration 'to reduce the reliance on financial measures', demerging the wealth and mortgage broking businesses; and rebating grandfathered commissions to customers (among others).

Mr Comyn also acknowledged the 'many instances of unacceptable customer outcomes' at the organisation and the causes of those issues. Mr Comyn concluded by stating that 'We recognise these changes are only the beginning and we are committed to doing the work necessary to earn the community's trust'.

According to media reports, questions put to Mr Comyn largely focussed on the banks' response to the issues identified by the Commission and the adequacy of that response, including questions around changes to remuneration structures, the extent to which employees are being held accountable for misconduct, progress on implementing the recommendations of the APRA prudential inquiry; and the steps the bank is taking to ensure customers are heard.

Westpac's comments to the Committee

Westpac CEO Brian Hartzer and CFO Peter King Westpac also appeared before the Committee. Westpac has not released CEO Mr Hartzer's opening statement.

Reportedly, the Committee's questions focussed on the same issues as were put to ANZ and CBA, that is, on Westpac's response to the issues identified by the Financial Services Royal Commission, and in particular on remuneration, and on the adequacy of that response.

The AFR reports that Mr Hartzer told the committee that the Royal Commission process had been a valuable one for the organisation and acknowledged that 'from an overall reputation point of view' the impact would take years to 'restore'.

Asked to comment on the issue of remuneration, Mr Hartzer confirmed that Westpac has fully implemented the Sedgewick report recommendations and it is the first entity to remove grandfathered commissions attributable to BT products. In addition, Mr Hartzer reportedly said that Westpac had improved its complaints handling by appointing a new group executive for that function.

On the topic of incentives, Mr Hartzer reportedly defended the new 'balanced scorecard' approach Westpac has implemented stating that it is appropriate in a 'commercial organisation' and that the key was to ensure there were no 'perverse' outcomes. Asked why the government shouldn't regulate to restrict the variable component of banking executives' remuneration, Mr Hartzer reportedly said that the ability to offer competitive pay is an important component of hiring high quality executives.

Banking is no longer the 'main job' of an Australian bank CEO? In an opinion piece, the AFR suggests that the Committee hearings demonstrate that given the scope of misconduct identified, Australian bank CEOs will 'find their next few years occupied by a mix of public relations, customer remediation, corporate restructuring and internal cultural change' in addition to running their businesses.

[Sources: House of Representatives standing committee on economics media release 08/10/2018; CBA media release 11/10/2018] [registration required] The AFR 11/10/2018; 11/10/2018; ANZ media release 12/10/2018; Investor Daily 12/10/2018]

In Brief | Estimated financial impact of remediation: The AFR reports that Morgan Stanley has predicted that ANZ, CBA, NAB and Westpac will repay customers an estimated $2bn in 2018/2019.

[Sources: [registration required] The AFR 10/10/2018]

In Brief | CCIV update: The government has released Tranche 3 of the *Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2018* CCIV for consultation. This exposure draft includes draft provisions relating to depositary independence, external administration, takeovers, compulsory buy-outs and acquisitions, disclosure and fundraising, the Asia Region Funds Passport (ARFP), and other miscellaneous amendments (such as amendments to the Australian Securities and Investments Commission Act 2001 (ASIC Act)). Consultation closes 26 October.

[Sources: Treasury media release 12/10/2018; Exposure draft: Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2018; Draft Explanatory Materials; Consultation 'cover note']

Accounting and Audit

Recent UK developments

Top Story | More reviews of UK audit sector: CMA to review the UK audit sector; FRC to continue with planned program of reviews

The UK Competition and Markets Authority (CMA) has announced the launch of a detailed market study into the audit sector to examine 'concerns that it is not working well for the economy or investors'. The review is being undertaken, the CMA writes, 'amid growing concerns about statutory audits, in particular following the collapse of construction firm Carillion and the criticism of those charged with reviewing the organisation's books, as well as recent poor results from reviews of audit quality'. As part of its review, the CMA will investigate whether the sector is competitive and resilient enough to maintain high quality standards.

The announcement followed a separate announcement by the Financial Reporting Council (FRC) of completion of its 'state of the nation' review of audit in the UK, and a series of planned further reviews/actions into various issues in the sector.

A brief overview of the CMA review, and separately the FRC's planned reviews/actions is below.

Focus of the CMA Review

The review will examine three main areas.

1. **'Choice and switching': Is there a real choice available?** The CMA writes that changes put in place by the Competition Commission appear to have strengthened competition between the big four firms — Deloitte, KPMG, E&Y and PwC — but that despite this, the largest UK companies 'still turn almost exclusively to one of them when selecting an auditor to review their books'.
2. **Does the perception that the big 4 are 'too big to fail' and their market dominance threaten long-term competition?** The CMA will examine what the role of the big four firms means for 'resilience — the risk being that each of the big four auditors is 'too big to fail', potentially threatening long-term competition'.
3. **Is there a lack of incentive to produce challenging audits?** As companies, not their investors, pick their auditor, there are 'concerns' the CMA writes that there is a lack of incentive for auditors to product challenging audits.

[Note: The CMA review is being undertaken following the delivery of a report by the Work and Pensions and BEIS Committees into the collapse of Carillion plc. Among other things the report recommended that KPMG, EY, PwC and Deloitte should be referred to the Competition Authority for possible break up. See: Governance News 21/05/2018]

Possible regulatory response to implement recommendations? The CMA writes that if the review finds that the market is not working well, it 'will scrutinise all proposals' including the possible need for legislation to implement the its findings and those of the independent review of the FRC being led by Sir John Kingman.

[Note: On 17 April, the UK government announced the launch of an independent 'root and branch' review of the FRC to be led by Sir John Kingman (Kingman Review). The purpose of the review according to the government's statement is to 'make the FRC the best in class for corporate governance and transparency, while helping it fulfil its role of safeguarding the UK's leading business environment'. See: Governance News 20/04/2018]

Commenting on the need for the review CMA Chairman Andrew Tyrie said 'If the many critics of the audit process are right, it is not just the companies which buy audits that lose out; it is the millions of people dependent on savings, pension funds and other investments in those companies whose audits may be defective. Sir John Kingman's independent review of the regulator is a big step in the right direction. And the CMA will now examine the market carefully to establish what contribution more effective competition could make to improving audit quality.'

Timeline: The CMA intends to consult on provisional views by the end of 2018 and to 'complete its work as soon as possible thereafter'. The CMA states that as part of this process it will take into account the views of a range of stakeholders including the Financial Reporting Council (FRC) as the sector regulator.

Response to the CMA's announcement

- **The FRC** said: 'We have expressed concern about concentration at the top of the audit market so we welcome this announcement. We will work closely with the Competition and Markets Authority as they carry out this study. It is essential that there is widespread confidence in the quality of company audit in the United Kingdom'.
- **CEO of the Institute of Chartered Accountants in England and Wales (ICAEW)** Michael Izza said that the announcement of the review is a 'very positive development' and the 'accountancy profession as a whole will welcome it'. He added that the ICAEW will 'need to coordinate closely with other processes already under way, such as the review of the operation of the FRC by Sir John Kingman' as well as with FRC initiatives and that 'it is vital that we rebuild public trust in audit – the success of UK business depends on it.'
- **Mazars UK** senior partner Phil Verity welcomed the announcement and the 'tight timescales' to which CMA is working. He added that there is 'a widely accepted need for reform of the listed market and we support changes which help to create a genuinely competitive market which addresses stakeholders' needs'. He went on to say that 'Previous attempts at reform have not brought about the necessary change. We now look forward to discussing with the CMA solutions that can be successfully implemented and are guaranteed to make a real difference.'

[Sources: CMA media release 09/10/2018; FRC media release 09/10/2018; AccountancyAge 09/10/2018; [registration required] The FT 11/10/2018]

FRC 'state of the nation audit review' and series of planned actions announced

Prior to, and separately from, the CMA review The Financial Reporting Council (FRC) released its own a 'state of the nation' audit review covering audit quality, confidence in the sector and the future of audit. Based on the issues identified, the FRC also announced a further program of planned reviews, intended to address falling trust levels in the UK audit sector. The planned review actions include, among other things, consideration of whether auditors should be banned from consulting work.

Report findings

Among other things, the FRC found that trust in the quality of audit is falling and that the 'Big Four' (PwC, KPMG, Deloitte and EY) still dominate both audit and non-audit consultancy work for listed companies which raises questions over conflicts of interest and independence.

Further planned reviews/actions in response

1. **Banning consulting work?** The FRC writes that as part of a comprehensive review of the 2016 auditing and ethical standards, it will 'test the effectiveness of the rules on [auditor] independence'. More particularly, the FRC writes that that the review will include determining whether 'further actions are needed to prevent auditor independence being compromised, including whether all consulting work for bodies they audit should be banned'. The FRC states that it will work closely with the Competition and Markets Authority (CMA) in this area.
2. **Tighten auditor requirements for assessing whether an organisation is a 'going concern': '**Taking lessons from recent company failures' the FRC states that it will develop proposals to strengthen requirements on auditors when considering whether an organisation is a going concern. This includes whether the responsibilities of auditors in assessing companies' statements on their longer-term viability should be enhanced and whether auditors should report publicly on their views of the realism of assessments made by companies.
3. **Consider whether auditors are undertaking enough work to determine whether information is misstated in annual reports**: The FRC states that it is undertaking a review of the work auditors do 'on the front half of the annual report' to assess whether auditors are undertaking enough work to conclude it is not materially misstated. The FRC adds that it will shortly launch a major review of stakeholders' needs for information in corporate reports and will consider to what extent such information needs to be assured.
4. **Additional monitoring:** The FRC states that it has adopted an enhanced program of audit firm monitoring and has strengthened its enforcement capacity to enable it to conclude cases more

quickly. In addition the FRC notes that its revised sanctions framework includes penalties that 'reflect the gravity' of the conduct.

Actions are intended to address the trust gap: Commenting on the release of the report, and the FRC's planned reviews/actions, FRC CEO Stephen Haddrill said the planned 'comprehensive reform programme addresses fundamental issues underlying falling trust in business and the effectiveness of audit, whilst also looking to ensure that the requirements on what companies say about themselves are fit for the future needs of stakeholders. If stakeholders are to have confidence in audit, they also need to have confidence in audit rules and regulation. The FRC has reviewed how we can improve audit quality and our supervision of audit firms. In addition to the programme set out today we look forward to proposals from Sir John Kingman and the CMA.'

Who will be reformed first? In an opinion piece, the FT suggested the FRC's release of the report, and suggested further actions, is as an indication that it is 'seemingly oblivious' to recent events and the criticisms that have been levelled against it and against the audit sector. The article adds that 'The watchdog [The FRC] has serially been criticised for its poor performance, its muddled structure and for being in thrall to the firms it oversees. The race is on to see which will be reformed first — the bean counters or their watchdog'.

[Sources: FRC media release 08/10/2018; Developments in Audit 08/10/2018; Reuters 08/10/2018; The Guardian 08/10/2018; [registration required] The FT 09/10/2018; CityAM 08/10/2018]

BlackRock supportive of FRC's current approach? The FT reports that BlackRock has called for more power and resourcing to be given to the UK FRC.

The FT reports that in response to the Kingman Review (see: Governance News 20/04/2018) BlackRock has called for the Financial Reporting Council (FRC) to be given increased powers and increased resourcing, including:

- greater powers to investigate all company directors (including those who are not registered accountants or actuaries); and
- greater resources to enable it more easily monitor 'grey areas' that arise when managers 'adopt a series of individually legitimate accounting practices, which, taken together, give rise to a misleading picture of a company's health'.

The FT quotes BlackRock as adding that it 'strongly believe[s] that oversight of governance and stewardship should remain with the FRC. 'We commend the good work done by the FRC to date on the UK corporate governance code, and would not recommend fundamental changes to its approach, nor a transfer of oversight responsibility to another body' the FT quotes BlackRock as stating.

The FT comments that this approach is at odds with 'other investors, auditors and academics' who have called on Sir John Kingman to consider 'radical action to reform the FRC following scandals in the audit sector that have brought into question the watchdog's independence from the firms it supervises and its willingness to mete out serious sanctions'.

[Source: [registration required] The FT 09/10/2018]

Risk Management

Cybersecurity

Google's failure to immediately report a cyber issue has 'raised eyebrows'? Google knew of a security flaw that exposed the private data of Google Plus users to third parties in March, but elected not to disclose the issue until October. Media reports have queried the delay and suggested that it has heightened the negative impact of the issue on the company.

On 8 October, Google published a blog post entitled: *Project Strobe: Protecting your data, improving our third-party APIs, and sunsetting consumer Google+.* The statement announces the findings of 'project strobe' which Google describes as a 'root and branch review of third party developer access to Google account and Android device data and of our philosophy around apps' data access' which was initiated by Google earlier in the year. The post announces among other things, that as a result of project strobe, Google Plus will be shut down, and that Google will limit the access it gives outside developers to user data on Android smartphones and Gmail.

Security flaw in google plus discovered in March

The post also notes that a 'bug' was discovered in March which exposed private user data (email address, occupation gender, age of users) to third party applications via online programming interfaces. Google writes that the issue was addressed in March and adds that 'We found no evidence that any developer was aware of this bug or abusing the API and we found no evidence that any Profile data was misused.' Following review by Google's 'Privacy and Data Protection Office' of the issue, Google writes, no notice was given at the time: 'Our Privacy & Data Protection Office reviewed this issue, looking at the type of data involved, whether we could accurately identify the users to inform, whether there was any evidence of misuse, and whether there were any actions a developer or user could take in response. None of these thresholds were met in this instance' Google writes.

The announcement has received wide media coverage.

- **Delay in reporting the issue is questionable?** The New York Times reports that given the scale of the issue (the exposure the private data of up to 500,000 users to 438 third-party applications via online programming interfaces), the decision to stay quiet has 'raised eyebrows in the cybersecurity community' especially in the context of 'relatively new rules in California and Europe that govern when a company must disclose a security episode'.
- **Reputational risk/increased regulatory scrutiny the cause of the delay?** The WSJ reports that an internal memo prepared by Google's legal and policy staff and shared with senior executives warned that disclosing the incident would likely trigger 'immediate regulatory interest' and invite comparisons to Facebook's leak of user information to data firm Cambridge Analytica.
- **Wrong decision?** Bloomberg reports that shares in Alphabet Inc (Google's parent company) fell following the WSJ report of the decision by Google not to report the security flaw. Bloomberg argues that despite the fact that the breach was relatively small (when considered against the scale of the Cambridge Analytica breach) Google 'made the wrong decision' in failing to report the issue immediately. 'The company did this in full knowledge of the blowback it would face if the Google+ privacy glitch was known, and that makes what Google did completely indefensible. If the company had disclosed the Google+ problem in March, it would have been a big deal but not a crisis. This cover-up, however, makes the Google+ digital-security problem so much worse'.

[Sources: Google blog post 08/10/2018; Bloomberg 09/10/2018; [registration required] The WSJ 08/10/2018; The New York Times 08/10/2018]

Is SEC toughening its stance on cybersecurity issues? SEC has announced the first enforcement action charging violations of the Identity Theft Red Flags Rule.

The US Securities and Exchange Commission (SEC) recently announced a settlement with broker-dealer and investment adviser, Voya Financial Advisors (Voya) to settle SEC charges in relation to Voya's allegedly flawed cybersecurity processes. SEC alleges that these flaws enabled intruders to gain access to the personal information of 5600 Voya customers. The SEC comments that the action against Voya is the first enforcement action charging violations of the Identity Theft Red Flags Rule.

SEC alleges that failures in Voya's security procedures enabled identity theft: According to SEC, 'cyber intruders' impersonated Voya contractors over a six-day period in 2016 by calling Voya's helpline and requesting that the contractors' passwords be reset. The intruders then used the new passwords to gain access to the personal information of 5,600 Voya customers. This information was then used to create new online customer profiles and to obtain unauthorised access to account documents for three customers.

According to SEC, Voya's failure terminate the intruders' access 'stemmed from weaknesses in its cybersecurity procedures, some of which had been exposed during prior similar fraudulent activity'. In addition, SEC alleges that Voya also failed to apply its procedures to the systems used by its independent contractors (who make up the largest part of Voya's workforce).

SEC settlement details: Without admitting or denying the SEC's findings, Voya agreed to be censured and pay a $1 million penalty. Voya will also retain an independent consultant to evaluate its policies and procedures for compliance with the Safeguards Rule and Identity Theft Red Flags Rule and related regulations.

Reminder to update policies/procedures and ensure they are designed to fit specific business models

Chief of the SEC Enforcement Division's Cyber Unit Robert A Cohen commented: 'This case is a reminder to brokers and investment advisers that cybersecurity procedures must be reasonably designed to fit their specific business models…They also must review and update the procedures regularly to respond to changes in the risks they face.'

SEC taking a tougher stance on cybersecurity?

The SEC charged Voya with violating the Safeguards Rule and the Identity Theft Red Flags Rule, which SEC said is 'designed to protect confidential customer information and protect customers from the risk of identity theft. The Red Flags Rule was adopted in 2013 and firms have been required to comply since November 2013 but it has never been used until now.

Given this, media reports have suggested that the action is a possible further indication of the SEC's increasing focus on cybersecurity and on enforcement of cybersecurity issues. The New York Times comments that 'The SEC's action should set off alarm bells for every financial firm and board of directors under the agency's watch. Most companies are probably not in compliance with the rule and, given the agency's increased focus on cybersecurity, they should move quickly to address any issues'.

[Sources: SEC media release 26/09/2018; Identity Theft Red Flags Rule; The New York Times 08/10/2018; Reuters 27/09/2018]

In Brief | Human error identified as the cause of the majority of cyber breaches: The Canberra Times reports that OAIC Acting Deputy Commissioner Andrew Solomon has said that eight months into the mandatory notifiable data breach scheme, it is clear businesses should focus on addressing the 'human element' of data breaches given that in excess of one third of breaches over the last quarter were the result of 'simple' human mistakes.

[Source: [registration required] The Canberra Times 11/10/2018]

Climate Risk

2C isn't enough? UN commissioned IPCC Climate report has found limiting temperature increase to 1.5C is significantly better in terms of outcomes than the 2C scenario. However, the report finds 'drastic' change is needed to meet the target and to limit the detrimental impact of rising temperatures.

Following the Paris climate agreement, and at the request of the United Nations, The Intergovernmental Panel on Climate Change (IPCC) has released a report: *Global Warming of 1.5C.* According to the report, limiting warming to 1.5C brings significant benefits as compared with limiting it to 2C, as the impacts of climate change would be significantly reduced in the 1.5C scenario. For example, the report highlights a number of climate change impacts that could be avoided by limiting global warming to 1.5ºC compared to 2ºC, or more including (among others): by 2100, global sea level rise would be 10 cm lower with global warming of 1.5°C compared with 2°C; and coral reefs would decline by 70-90% with global warming of 1.5°C, whereas virtually all (> 99 percent) would be lost with 2ºC.

However, according to the report, 'rapid, far reaching and unprecedented changes in all aspects of society' are required in order to meet this 1.5C target as currently, it could be exceeded by 2030.

The report proposes a number of steps to prevent further warming including (among other things) an objective of providing 85% of global electricity from renewable sources by 2050 (including phasing out coal power).

The report states that the cost of inaction is considerable: 'The challenges from delayed actions to reduce greenhouse gas emissions include the risk of cost escalation, lock-in in carbon-emitting infrastructure, stranded assets, and reduced flexibility in future response options in the medium to long-term'. In addition, the report found that these 'may increase uneven distributional impacts between countries at different stages of development (medium confidence'.

Australian government response? The ABC reports that Federal Environment Minister Melissa Price has questioned whether ending coal power is required in order for Australia to meet its Paris commitments, maintaining that Australia remains on track to do so. Ms Price said: 'I just don't know how you could say by 2050 that you're not going to have technology that's going to enable good, clean technology when it comes to coal…That would be irresponsible of us to be able to commit to that'. Ms Price added that 'Back in 2017, we had a review of our climate change policies, and they were found adequate in terms of us meeting our 2020 target from Kyoto — we know we are going to meet that target and we're very comfortable we're going to meet the 2030 target'.

The Guardian reports that a number of 'climate researchers have overwhelmingly rejected the federal government's claim it is on track to cut greenhouse gas emissions as promised under the 2015 Paris agreement' (under current policy settings). Reportedly, author of the Finkel Review, Alan Finkel, has said the transition to a low-emissions economy will take decades, require action in many sectors and would require policy change. 'I am confident that we will comfortably meet the existing targets in the electricity sector and, with an evolving suite of policy measures, it is possible to meet the whole-of-economy targets as well' he said.

[Sources: The Intergovernmental Panel on Climate Change media release 08/10/2018; IPCC Report: Global Warming of 1.5ºC; Summary for policymakers; [registration required] The Australian 08/09/2018; The ABC 09/10/2018; The Guardian 10/10/2018; [registration required] The FT 08/10/2018; The Conversation 08/10/2018]

Other Developments

In Brief | How should boards prepare for future crises? Is crisis preparation necessary? EY board matters argues that advance crisis preparation 'is now imperative' for companies, and for boards, given the virtual impossibility of total avoidance and have outlined a number of suggested steps for boards to take.

[Source: Harvard Law School Forum on Corporate Governance and Financial Regulation 07/10/2018]

In Brief | Compulsory reading for every board: Co-author of the Final Report into culture at CBA, Professor Graeme Samuel has called on all companies to 'distribute it to the board, all senior executives and maybe even middle management' to assess operations against the 35 recommendations in the report. Professor Samuel has also called on companies to undertake any assessment internally with minimal involvement by consultants in order to 'own' the change.

[Note: The Australian Prudential Regulation Authority (APRA) released the Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia (CBA), which examined the frameworks and practices in relation to the governance, culture and accountability within the organisation, on 1 May. APRA wrote at the time that the 35 report recommendations 'provide a roadmap for the CBA Board and executive team to deliver organisational and cultural change across the CBA group' as well as 'important insight for all institutions particularly about the need to maintain a broad focus on all aspects of risk and stakeholder interest'. See: Governance News 04/05/2018]

[Source: [registration required] The AFR 09/10/2018]

In Brief | UNSW has appointed Professor Dimity Kingsford Smith as the inaugural MinterEllison chair in risk and regulation. MinterEllison partner Ross Freeman said that connecting academic inquiry to leading professional practice is critically important to the financial services industry in Australia. MinterEllison partner Rahoul Chowdry said: 'The industry is going through the most profound changes we are likely to see in our lifetime. As advisers to the industry we have a particular interest in supporting sound risk management, regulation and legislation that benefits society and the economy more widely'.

[Source: LaywersWeekly 09/10/2018]

Other News

MinterEllison update: Terms of Reference released — Royal Commission into Aged Care Quality and Safety

MinterEllison Partner, Penelope Eden writes that the federal government has announced the terms of reference for the Royal Commission into Aged Care Quality and Safety. The update is available on the MinterEllison website here.

[Source: Royal Commission into Aged Care Quality and Safety: Letters Patent]