Governance News

29 May 2019

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 2 9921 8785 |

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

Contents

Remuneration

United States | US companies who pay men more than women to face fines? Presidential hopeful, Senator Kamala Harris has reportedly said she will take executive action to create an 'equal pay certification' scheme if elected

The Washington Post reports that presidential candidate, Senator Kamala Harris, has said that if elected to the presidency, she plans to take executive action to create an 'Equal Pay Certification' scheme.

Details

According to the Washington Post the scheme would work as follows.

- The certification scheme would be administered by the Equal Employment Opportunity Commission
- To receive certification, companies would have to prove they are paying employees comparable pay for comparable work, irrespective of gender
- Companies would also be required to provide data about hiring processes, including information about the race and gender of their workforce
- Companies unsuccessful in obtaining certification would be fined 1% of profit for every 1% of wage gap that exists after accounting for differences in job title, experience and performance
- Money collected through fines would be used by the government to assist in financing universal paid family and medical leave

The Washington Post comments that a number of other democrats have proposed pay equality measures. What is notable about Senator Harris' plan is that though it would not require the support of Congress to be implemented.

[Source: The Washington Post 20/05/2019]

Shareholder Activism

Scope 3 emissions a bridge too far? BP shareholders have voted overwhelmingly in favour of a shareholder resolution calling on the company to align its business operations with the aims of the Paris Agreement, but a second resolution calling on BP to set emissions reduction targets for all emissions failed to secure sufficient support to pass

BP shareholders have voted overwhelmingly (99.14%) in favour of passing a shareholder proposal, organised by Climate Action 100+, seeking that the company align its business operations with the aims of the Paris Agreement. A second stronger resolution (organised by Follow This) calling for firm emissions reduction targets (including scope 3 emissions) failed to secure sufficient support to pass.

Key Takeouts

1. **Climate Action 100+ resolution passed:** 99.14% of BP's shareholders voted in favour of a Climate Action 100+ resolution at the BP AGM. The resolution called on BP to align its business strategy with the goals of the 2015 Paris Agreement. The resolution was supported by the BP board which recommended shareholders vote in favour of the resolution.
2. **Scope 3 resolution failed to secure support:** A second resolution, organised by Follow This, seeking that BP set specific climate targets for emission reductions, including emissions from use of its products (scope 3 emissions) failed to secure significant support (receiving only 8.4% votes in favour). This resolution was not supported by the BP board. Among other things, the board advised shareholders to vote against the resolution on the basis that it 'calls for targets for Scope 3 (end user) emissions that BP does not control'. A similar resolution at Equinor (which also did not have board support) also failed to secure sufficient support to pass at the 15 May AGM.

3. **A similar Scope 3 emissions resolution was withdrawn ahead of the Shell AGM after Shell committed to reduce scope 3 emissions.** The Shell AGM was also held on 21 May. Follow This withdrew a similar 'scope 3' resolution ahead of the meeting, after Shell agreed that it would aim to reduce direct and indirect carbon emissions, associated with producing its energy products by around 20% in 2035 and by around 50% in 2050, and also aim to 'help and influence such suppliers and consumers to likewise lower their emissions' (scope 3 emissions). Reportedly, Shell remains the only oil major to commit to reducing scope 3 emissions.

Details: Two Shareholder Climate Resolutions were put to Shareholders

Climate Action 100+ Resolution on climate change disclosures

- The resolution called for BP to describe how company strategy is consistent with the achievement of the goals of the Paris agreement. More specifically, the resolution calls for BP to include in its strategic report and/or other corporate reports (as appropriate) for the year ending 2019 onwards:
  - a description of its strategy which the board considers to be consistent with the goals of the Paris Agreement;
  - how the company evaluates the consistency of each new capex investments with the Paris goals;
  - the company's principal metrics and relevant targets or goals over the short, medium and/or long term (consistent with the Paris Goals);
  - disclosure of various other related information including the following: a) the anticipated levels of investment in oil and gas resources and reserves (and other energy sources and technologies); b) BP's targets to promote reductions in its operational greenhouse gas (GHG) emissions; c) the estimated carbon intensity of BP's energy products and progress on carbon intensity over time; and d) any links between the above targets and executive remuneration.
- BP announced, ahead of the meeting, that following 'constructive engagement' with investors, the BP board would support the Climate Action 100+ resolution and advised shareholders to support it on the basis that the board considered it to be in the 'best interest of the company and its shareholders as a whole'.
- Separately, BP also said (ahead of the AGM) that greenhouse gas (GHG) emissions reductions have been included as a factor in the reward of 36,000 employees across the group and around the world, including executive directors.
- The resolution passed with 99.14% support.
- In a press release welcoming the result, Climate Action 100+ said that the scale of support the resolution received reflects the 'growing importance investors place on climate change as a matter of corporate strategy and corporate governance'.

Follow This Resolution on Climate Change Targets

- A second resolution, organised by Follow This, was also considered at the BP AGM.
- The resolution called on the company to set and publish targets that aligned with the goal of the Paris Agreement, covering GHG emissions of the company's operations and the use of its energy products (Scope 1, 2 and 3) in the immediate and long term. In addition, the resolution called for BP to report annually on plans and progress towards achieving the targets.
- Follow This argued that shareholders should support the resolution on the basis that the actions outlined, particularly the inclusion of scope 3 emissions, are necessary in order to achieve the goals of the Paris Agreement. 'Failure of an oil company to set a target for reduction of Scope 3 emissions is incompatible with the goals of the Paris Climate Agreement and will allow them to continue to increase Scope 3 emissions' Follow This argues. Follow This called on BP to follow Royal Dutch Shell's example by 'including Scope 3 in their ambition to halve their carbon intensity by 2050.'

- In recommending shareholders vote against the resolution, The BP board gave the following three reasons: 1) setting specific long-term reduction targets is inconsistent with the flexibility that is central to BP's strategy; 2) it calls for targets for Scope 3 (end user) emissions that BP does not control; and 3) it would risk significant erosion of long-term shareholder value. In addition, BP states that the board is of the view that the group's contribution to a low carbon future is better addressed through the Climate 100+ resolution

- The resolution failed to pass, receiving 8.4% support.

Are Scope 3 resolutions a bridge too far?

Similar 'scope 3' resolutions asking oil companies to set targets to reduce all emissions were also filed at Equinor and Chevron.

- The Equinor AGM was held on 15 May. The board recommended shareholders vote against it, on the basis that its activities 'do not include direct engagement with end users of products'. The resolution was not adopted, receiving 2% overall support. However, Follow This points out that the majority of shares in Equinor are owned by the Norwegian government, which, though a signatory to the Paris Agreement, did not support the resolution. Support from private shareholders, Follow This argues, was significantly higher — the resolution reportedly secured 12% support from private shareholders (with a further 7% abstaining).

- The Chevron AGM will be held on 29 May.

Australia?

According to Follow This, both Santos and Woodside Petroleum faced questions from the Australasian Centre for Corporate Responsibility (ACCR) with respect to responsibility for Scope 3 emissions, at their respective AGMs. According to Follow This, Santos acknowledged that it may need to undertake Scope 3 'tracking' in future. Woodside is reportedly of the view that it is 'too early' to set emissions targets.

[Sources: BP AGM 2019 Poll Results: 21/05/2019; Shell AGM Speeches by Chair and CEO 21/05/2019; Follow This climate resolution; BP Notice of Meeting; Follow This blog 07/05/2019; DW.com 20/05/2019; Climate Action 100+ media release 21/05/2019; As You Sow media release 21/05/2019; Equinor Minutes from AGM 15/05/2019; Equinor Shareholder proposals and board response to Equinor's AGM 2019; This is Money 21/05/2019; The Guardian 14/08/2019; BusinessGreen 14/05/2019Reuters 25/04/2019; Bloomberg 21/05/2019; Climate Liability News 21/05/2019; CNN Business 21/05/2019; Greenbiz 20/05/2019; Bloomberg 21/05/2019; 22/05/2019; EnergyPost 31/01/2019; FastCompany 21/05/2019]

The Climate Action 100+ proposal will not be considered at the Exxon Mobil Corporation AGM, triggering supporters of the resolution to threaten to vote against the Exxon board

A shareholder resolution organised by Climate Action 100+ seeking that Exxon set emissions reductions targets in line with the Paris agreement and report on them, will not be considered at the up-coming shareholder meeting after Exxon requested that the Securities and Exchange Commission (SEC) allow the proposal's exclusion, and the SEC agreed to Exxon's no action request.

SEC's reasoning: SEC agreed that it was reasonable for Exxon to exclude the proposal under the ordinary business exception (under rule 14a-8(i)(7)). SEC states 'In our view, the Proposal would require the Company [Exxon] to adopt targets aligned with the goals established by the Paris Climate Agreement. By imposing this requirement, the Proposal would micromanage the Company by seeking to impose specific methods for implementing complex policies in place of the ongoing judgments of management as overseen by its board of directors. Accordingly, we will not recommend enforcement action to the Commission if the Company omits the Proposal from its proxy materials in reliance on rule 14a-8(i)(7)'.

Exclusion of the Climate Action 100+ proposal is a failure of governance? In response, supporters of the resolution — the New York State Comptroller Tom DiNapoli and the Church of England — have said that they intend to vote against the Exxon board and that they will vote to separate the positions of board chair and CEO in protest against what they see as governance failings at the firm. Thomas P DiNapoli said, 'Exxon's board's refusal to adequately address significant shareholder concerns and properly account for climate risk in its operations, even as its competitors do so, presents a governance crisis. Exxon's failure to demonstrate it is prepared to take steps toward the transition to a lower carbon future puts its business at risk. We encourage other investors to join us in voting to separate the roles of chair and CEO.'

Other climate related shareholder proposals are still likely to be considered: Though the Climate Action 100+ proposal was excluded, other climate-related and environmental shareholder proposals including: a proposal calling for the creation of a new board committee to address climate change and another calling on the company to more fully disclose political contributions to tax-exempt organisations, including trade associations and other 'dark money' organizations are still likely to be considered.

Exxon's annual meeting will be held on 29 May.

[Source: Glass Lewis Blog 22/05/2019; SEC no action letter 02/04/2019; As You Sow 08/05/2019; Climate Liability News 09/05/2019; Church Commissioners and the New York State Pension Fund joint media release 07/05/2019; Forbes 23/05/2019]

The AFR reports that in a speech to industry, Shell's most senior Australian representative has called (among other things) for the oil and gas industry to develop a united industry position on climate change

The AFR reports that Shell's most senior representative in Australia and Chair of the Australian Petroleum Production & Exploration Association (APPEA) Zoe Yujnovich has given a speech to industry in which she:

- **called on industry to speak with a united voice to take on the activists 'waging a virtual war' on the oil and gas industry** including by developing a united industry position before going public and avoiding being drawn into 'either/or debates' eg debates concerning domestic vs export gas should be avoided. 'If we want our politicians and the public to listen to us, we can't be telling them different things' Ms Yujnovich reportedly said.
- **called on industry to 'welcome transparency and scrutiny' to build trust** (and credibility). Industry would only be listened to, if it is trusted she reportedly said.

Ms Yujnovich also reportedly named three key policy settings as priorities for the industry: 1) climate change; 2) domestic gas supply; and 3) tax reform. On the issue of climate change, Ms Yujnovich reportedly highlighted the need for a 'a joined-up national energy policy' that is consistent with national climate-change goals, helps to remove barriers to supply and reduces sovereign risk. Reportedly, she said that this is important because 'poor or disjointed policy reduces investment attraction.'

[Source: [registration required] The AFR 28/05/2019]

Germany | Hermes EOS has given a 'final warning' to companies to act to increase gender diversity in leadership roles

The FT reports that German companies, which reportedly lag behind other countries in terms of gender diversity, are under pressure from London fund manager Hermes EOS, to take steps to increase female management board representation to 30% over the next five years.

The FT quotes Hermes EOS executive director Hans-Christoph Hirt, as commenting that, with regard to diversity on the management board and below, 'Germany is still lagging very much behind internationally' and adding that a number of German companies have no stated plan to address the issue. Mr Hirt reportedly said that Hermes EOS wants to see 'decisive action' and otherwise would use 'the ultimate sanction' of voting against the re-election of individual supervisory board members.

Scale of the challenge? According to The FT, to meet the target, German companies (on average) would have to more than triple the current share of female management board members. Reportedly:

- Two-thirds of the companies have all male boards and only 8% of companies have more than one woman on the executive board.
- The appointment rate for male directors outstrips the female director appointment rate: the number of female directors increased by 11 to 61 in 2018, but the number of male directors increased by 12 to 650.
- EY data indicates that 8.6% of senior executives in Germany's 160 largest companies are women (up from 7.3 per cent last year).

Other pressures to increase diversity

The FT observes that since 2015, listed German companies have been required by law to lift the share of female supervisory board members to at least 30%. In addition, the new German corporate governance code reportedly encourages companies to reach the 30% 'within a reasonable timeframe'.

Growing pressure from investors to increase diversity? The FT suggests that the move by Hermes EOS reflects a growing push by European fund managers to improve gender diversity at board, and increasingly, at senior management level. The article quotes Alexandra Niessen-Ruenzi, professor for corporate governance at Mannheim, as stating that Hermes EOS' policy will send a 'signal' across the money management industries and may mean other asset managers follow suit.

[Source: [registration required] The FT 22/05/2019]

Related News: Revised German Governance Code

On 22 May, the German Corporate Governance Commission approved a revised governance Code. At present, the full code is not available in English. However, a press release highlights (among other changes) that the new Code will include tougher rules on board independence and pay. No mention is made of diversity requirements in the press release.

[Source: Deutscher Corporate Governance Kodex press release 22/05/2019]

Eight shareholder proposals on a range of governance and product issues at Facebook

Glass Lewis reports that Facebook is facing eight shareholder resolutions on a range of governance and social issues at its upcoming meeting. These include proposals concerning the political ideology of the board and employees; how the content on the platform is governed; how Facebook is ensuring male and female employees are being paid equally for the same work; and proposals calling for the elimination of the dual class share structure and the appointment of an independent Chair.

In addition, Glass Lewis reports that Facebook founder Mark Zuckerberg is the target of a 'vote no' campaign aimed at convincing shareholders to vote against his reelection.

Glass Lewis observes that despite the apparently high level of shareholder concerns regarding the company's products and governance, the proposals are unlikely to be successful due to Facebook's dual class structure (ie Mr Zuckerberg controls 58% of voting power).

Facebook's AGM is due to be held on 30 May.

[Source: Glass Lewis blog 22/05/2019]

Woolworths' shareholder (Perpetual Investments) is reportedly exerting pressure for it to exit its pubs and pokies business

The SMH reports that Woolworths' third largest shareholder, Perpetual Investments, is exerting pressure on the Woolworths' board to exit its pubs/slot machine business — Woolworths reportedly owns a majority stake in ALH Group, which has more than 12,000 pokie machines across its 323 pubs and clubs — on the basis that gambling is incompatible with the supermarket's stated values and is therefore a threat to its reputation in the community. However, Perpetual has also reportedly said that it should only exit the gambling business if doing so does snot damage shareholder returns. Reportedly, ALH contributed $259m to Woolworth's profits last year (or about 10% of its pretax profit).

Tim Costello, of the Alliance for Gambling Reform, is quoted as welcoming Perpetual's stance, 'The Woolworths board can never claim to be responsible or sustainable whilst it aggressively promotes gambling' Mr Costello reportedly said.

The SMH reports that Woolworths Chair Gordon Cairns had told major investors that his board has considered various ways of exiting ALH, but that doing so is complicated due to QLD's liquor laws which require it to own pubs in order to hold licences for its Dan Murphy's and BWS bottle shops.

The SMH comments that Perpetual Investments is also the largest investor in Tabcop and the Star Entertainment casino group, and reportedly has no ethical issues over investing in those companies, because gambling is not antithetical to their stated values.

[Source: [registration required] The SMH 24/05/2019]

Institutional Shareholders and Stewardship

The majority of Australia's largest 50 superannuation funds are failing to support a majority of shareholder proposals on ESG issues according to a new report from ACCR

Report Overview | ACCR report, Vote like you mean it

The Australasian Centre for Corporate Responsibility (ACCR) has released the results of its analysis of the proxy voting records of Australia's largest superannuation funds in 2018.

Key Takeouts

- The majority of funds are failing to support a majority of shareholder proposals on ESG issues, (although there is a small cohort of funds that consistently support such proposals)
- The ACCR found that the majority of funds are failing to disclose (complete or partially complete) proxy voting records and that disclosure of international proxy voting records is particularly poor
- Overall, the ACCR found that there is a 'vast difference' between the 'leading funds and the laggards in both disclosure and voting behaviour'
- Among other things, the ACCR recommends that superannuation funds should be required to both align their ESG/responsible investment policies with their voting behaviours and that they should be required to disclose their entire proxy voting record for every proposal at every company meeting

Context

According to The ACCR, the number of shareholder proposals filed with Australian companies has steadily increased in recent years. In 2018, 17 shareholder proposals were filed (including seven special proposals seeking changes to company constitutions). Given the increasing focus of both investors and the broader community on climate change, shareholder proposals related to the disclosure of climate risk and requests of companies to set emissions targets have become far more frequent and have received increasing support from shareholders in both Australia and in the US.

In this context, ACCR undertook an analysis of the results the proxy voting records of Australia's largest superannuation funds in 2018. A high level overview of some of the key findings of the research and the ACCRs recommended reforms is below.

Failure to support a majority of shareholder ESG proposals?

- 3 funds (Local Government Super (91%), Vision Super (88%) and Cbus (77%)) supported more than 75% of the shareholder proposals on ESG issues that they voted on globally in 2018
- 6 funds (AustralianSuper (63%), VicSuper (60%), UniSuper (59%), HESTA (56%), Mercer (52%) and Tasplan Super (50%)) supported more than 50% of the shareholder proposals on ESG issues that they voted on globally in 2018
- 5 funds (Cbus (11% to 84%), VicSuper (10% to 81%), AustralianSuper (41% to 73%), Macquarie (0% to 55%), HOSTPlus (0% to 27%)) significantly increased their support for climate-related shareholder proposals that they voted on between 2017 and 2018
- Thirteen funds supported 50% or more of the lobbying-related shareholder proposals that they voted on in 2018.
- **Support not linked to fund size:**The ACCR found no correlation between support for shareholder proposals on ESG issues and fund size. The most supportive funds manage between $10 billion and $50 billion in assets.
- **Public sector funds/member of industry associations more likely to support ESG resolutions**:

- Public sector funds including Local Government Super, VicSuper and Vision Super were more likely than other types of funds to support shareholder proposals on ESG issues in 2018.
- Members of investor industry associations the Australian Council of Superannuation Investors (ACSI), Investor Group on Climate Change (IGCC), Principles for Responsible Investment (PRI) and Responsible Investment Association Australasia (RIAA) were more likely to support shareholder proposals on ESG issues in 2018 than non-members.

[Note: As part of its broader policy response to the Financial Services Royal Commission, ACSI has called on the incoming government, regulators and investors to commit to strengthen investment stewardship and to mandate the integration of environmental, social and governance considerations into investment decision making. See: Governance News 08/05/2019]

Commenting on the findings the Director of Climate and Environment at ACCR, Dan Gocher, said that it is 'concerning' that only nine of the largest Australian superannuation funds supported ESG proposals in 2018, despite the fact that most proposals made 'reasonable asks' of companies and often 'broadly align with most funds' stated ESG principles'. He added that 'despite claims from many funds that they are 'ESG aware', there is still widespread reluctance to support sensible shareholder proposals on these issues…Funds are running out of valid excuses for not supporting proposals of this nature, particularly when groups like the Investor Group on Climate Change (IGCC) are making similar demands of companies'.

Disclosure: Majority of funds do not disclose complete/incomplete proxy voting records

- Only one fund – Local Government Super – discloses its votes before company meetings are held; another five funds disclose their voting record less than a week after the company meeting.
- 11 of the 50 largest funds disclose a complete proxy voting record, including all Australian and international shareholdings.
- 12 funds disclose their proxy voting record on Australian shares only.
- 6 funds disclose only a summary of their proxy voting record.
- 11 funds either do not vote, or do not disclose a proxy voting record.
- 10 funds disclose an incomplete proxy voting record, including both Australian and international shareholdings; six of these funds disclose what appear to be complete international voting records, but numerous companies were excluded from these records despite being listed in the funds' disclosed shareholdings.
- The ACCR found that there was no clear correlation between the disclosure of a complete proxy voting record and superannuation fund size. Funds managing between $20 billion and $50 billion were more likely to disclose a complete proxy voting record than both smaller and larger superannuation funds.
- Public sector funds were more likely than other types of funds to disclose a complete proxy voting record.
- Members of some investment industry associations – ACSI, IGCC, PRI and RIAA – were more likely than non-members to disclose a complete proxy voting record; while FSC members were less likely than non-FSC members to disclose a complete proxy voting record.

On the issue of disclosure, Mr Gocher urged 'both regulators and investor bodies like the Australian Council of Superannuation Investors (ACSI) and the Financial Services Council (FSC) to ensure that funds improve their disclosures to members. Funds can no longer get away with only providing information to members on a 'need-to-know' basis. As the superannuation sector continues to grow, so do the demands for greater transparency and accountability' he said.

Recommendations

The report makes seven recommendations related to the transparency of proxy voting and urges funds to support all reasonable shareholder proposals which seek to remedy clear ESG deficiencies within companies.

- **All funds should disclose their entire proxy voting record**, for every proposal at every company meeting.

- **Funds that delegate proxy voting to fund managers should disclose the proxy voting record of those fund managers**.
- **Disclosures should be made accessible** and easy to locate on a fund's website.
- **Funds describing themselves as 'active owners' must demonstrate such** claims through disclosure and justification of their proxy voting record.
- **Funds should align their ESG/responsible investment policies with their voting behaviours.**
- **Funds should employ similar approaches to thematic voting across jurisdictions**: if the fund supports a type of proposal in one country (eg climate risk disclosure), it should support similar proposals in all countries unless a clear justification is given.
- **Australian funds should consider filing or co-filing shareholder proposals in Australia**, given the limitations of the tools available to investors to escalate issues within companies.

About the study: The study examined the publicly available voting records of 50 superannuation funds on 260 shareholder proposals relating to environmental, social and governance (ESG) issues, across six jurisdictions (Australia, Canada, Japan, Norway, the United Kingdom and the United States (US) during March and April 2019.

The ACCR writes that the 50 largest superannuation funds were included in the study because they account for 95.8% of assets under management (AUM) at APRA-regulated funds, and represent the vast majority of the sector.

[Sources: ACCR media release 22/05/2019; Report summary 22/05/2019; ACCR Report: Vote like you mean it May 2019; [registration required] The AFR 22/05/2019]

Short and Long-Termism

United States | SEC will hold a Staff Roundtable on Short/Long Term Management of Public Companies, the periodic reporting system and regulatory requirements

Securities and Exchange Commission (SEC) Chair Jay Clayton has announced that SEC staff will host a roundtable to hear from investors, issuers, and other market participants about the impact of short-termism on US capital markets and whether the current reporting system, or other aspects of regulations, should be modified. Mr Clayton said that the needs of 'Main Street investors' (many of whom are retirees) are more than ever focused on long term results, and questioned whether current disclosure and other rules are sufficiently focused on the long rather than the short term.

Mr Clayton said that an 'undue focus on short-term results among companies may lead to inefficient allocation of capital, reduce long-term returns for Main Street investors, and encumber economic growth' and there is also a need for further dialogue on the causes of, and potential solutions to the issue.

Mr Clayton said that the staff roundtable would explore the causes of short termism and facilitate conversations on what market-based initiatives and regulatory changes could encourage longer-term performance perspective in US companies.

Possible Topics for Discussion

Mr Clayton said that the agenda items will be announced soon but that he has directed staff to consider the following topics.

1. The role, if any, that short-termism plays in the declining number of public companies.
2. Whether there is potential to reduce the reporting burden for companies while also facilitating improved disclosure for long-term investors eg whether the information typically included by companies in earnings releases could be allowed to satisfy certain quarterly reporting obligations and whether there are ways that quarterly disclosures could be streamlined.
3. The potential for certain categories of reporting companies, such as smaller reporting companies, to be given flexibility to determine the frequency of their periodic reporting.

4. The extent to which certain market practices (eg the activist practice of acquiring voting rights over shares but having little or no economic interest in the shares) are driving short term focus.

Timing: The roundtable will be held over the 'summer' but no date has as yet been confirmed.

[Source: SEC public statement 20/05/2019;

Financial Services

Superannuation reform agenda? The AFR reports that Treasurer Josh Frydenberg has outlined plans to progress a number of superannuation reforms

The AFR reports that Treasurer Josh Frydenberg has given an interview in which he outlined the government's priorities with respect to progressing planned superannuation reform.

Priorities

- Implement the Financial Services Royal Commission's Final Report recommendation to 'staple' a single default superannuation account to new employees entering the workforce (to minimise fees incurred from unintended multiple accounts).

[Note: Recommendation 3.5 of the Financial Services Royal Commission's Final Report recommended that 'A person should have only one default account. To that end, machinery should be developed for 'stapling' a person to a single default account' on the basis that the 'proliferation of unnecessary default accounts is not in the interests of members'. See: Financial Services Royal Commission Final Report. The government's response to the Final Report indicated agreement with the recommendation. See: Government response to the Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry.]

- Make life insurance inside superannuation opt-in, rather than default. The AFR comments that this proposal is largely opposed by industry.

[Note: Following the passage of the *Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018* (see: Governance News 20/02/2019), the government introduced *Treasury Laws Amendment (Putting Members' Interests First) Bill 2019* into the House of Representatives on 20 February. The Bill (which lapsed when the election was called) proposed to require insurance in superannuation for under 25 year olds and members with low balance accounts to only be offered insurance on an opt-in basis from 1 October 2019. See: Governance News 27/02/2019.]

- Commission a review of the retirement income system including the interaction of superannuation, government pensions (and possibly taxation) as recommended by the Productivity Commission.

[Note: Recommendation 30 of the Productivity Commission's final report recommended an independent public inquiry into the role of compulsory superannuation in the broader retirement incomes system. For an overview of the report recommendations see: Governance News 16/01/2019.]

- In addition, Mr Frydenberg said that the government is likely to pursue its plans to reform the composition of superannuation fund boards (and more particularly industry superannuation fund boards) to dilute the influence of employee and union groups.

[Note: This appears to be a reference to proposed reforms in *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2017*. This Bill proposed to require registrable superannuation licensees to have at least one-third independent directors and for the Chair of the Board of directors to be one of these independent directors. The Bill was introduced into the Senate in September, but was not progressed. See: Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017]

PC 'Best in Show' recommendation? The AFR comments that the government has not indicated whether it will implement the Productivity Commissions' recommendation that the current default system be replaced with a 'best in show' list or how the recommendation will be implemented.

[Note: Among other things, the Productivity Commission recommended (recommendation 2) that a single 'best in show' shortlist of up to 10 superannuation products should be developed by an independent panel (recommendation 3) and presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. The Productivity Commission recommended that the first 'best in show' shortlist should be in place by no later than the end of June 2021. See: Governance News 16/01/2019]

[Source: [registration required] The AFR 24/05/2019]

The AIST is calling on the government and industry regulators to develop a superannuation fund comparison tool to assist consumers to make more informed decisions

The Australian Institution of Superannuation Trustees (AIST) commissioned Essential Media to conduct research into the decision-making process of Australians who are in retail for-profit superannuation funds. The purpose of the research was to investigate: a) how people choose their superannuation fund; b) the extent to which they are aware of their fund's financial performance.

The AIST writes that with a growing body of evidence pointing to the persistent underperformance of many retail funds, particularly those in the non-default 'choice' sector, it was keen to explore how people end up in these funds and whether these members are aware of their fund's performance.

Conclusions: The report found that a large group superannuation fund members are misinformed about how their fund is performing and what type of fund (retail fund vs industry fund) they are in. Most, are also in default funds (as a result of a referral through a financial adviser or employer).

In addition, almost a third of those surveyed said that they had considered shifting funds, and indicated that a comparison tool to enable them to compare fund performance would assist in this.

On the basis of these findings, the AIST is calling on the government and industry regulators to develop an easy-to-use online super comparator tool to help consumers make more informed decisions about their superannuation.

[Sources: AIST media release 21/05/2019; AIST commissioned report: Understanding the decision making process of retail fund members; InvestorDaily 23/05/2019]

AFCA has announced plans to expand its leadership team to support its rapid growth and the expansion of its jurisdiction

The Australian Financial Complaints Authority (AFCA) has issued a statement announcing that it will expand its leadership team to support its rapid growth and the expansion of its jurisdiction from 1 July 2019 (when AFCA will start accepting complaints dating back to 2008).

Chief Ombudsman and CEO David Locke will appoint a Deputy Chief Ombudsman and a General Counsel.

AFCA will also be recruiting a Lead Ombudsman — Banking and Finance, following the resignation of Philip Field, who will finish up at AFCA at the end of July.

Mr Locke said that 'Appointing the key senior roles of Deputy Chief Ombudsman and General Counsel will ensure AFCA is able to deliver a fair, proactive and customer-focused dispute resolution service in a rapidly changing, complex operating environment'. He added that AFCA had received 35,000 complaints from consumers and small businesses over the first six months of operation, which he described as 'extraordinary' and a reflection of the 'increased awareness by consumers of their rights, and an increased willingness to complain'. In addition, Mr Locke said that it was important to have 'the right people' to guide AFCA's approach to working with financial firms to improve the internal dispute resolution (IDR) practices.

[Sources: AFCA media release 22/05/2019; Independent Financial Adviser 23/05/2019]

APRA uses new directions powers for the first time: APRA has issued directions to IOOF group for failing to comply with licence conditions

Using for the first time the broader directions powers under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) that were granted by parliament in April 2019, the Australian Prudential Regulation Authority (APRA) has announced that it has issued directions to companies within the IOOF group, requiring them to set up a dedicated business function to ensure IOOF acts in the best interest of superannuation members.

APRA states that failure to comply by the stated deadline is an offence under the SIS Act and may attract a financial penalty.

[Note: This reference to new powers is a reference to the powers under the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2019*, enacted in April 2019. Schedule 5 amends the SIS Act to strengthen APRA's supervision and enforcement powers to include the power to issue a direction to an RSE licensee where APRA has prudential concerns.]

Details

- APRA imposed additional conditions on the licences or registration of IOOF-owned subsidiaries, IOOF Investment Management Limited (IIML), Australian Executor Trustees Limited (AET) and IOOF Ltd (IL) in December 2018, after launching disqualification proceedings against five IOOF directors and executives.
- One of the additional licence conditions required each of IOOF's APRA Regulated Entities (AREs) to implement and maintain a dedicated business function to support the AREs to meet their fiduciary obligations. The deadline for implementing this dedicated business function was 31 March 2019.
- An independent review, conducted by Ernst and Young, found that though IOOF had taken positive steps towards implementing an Office of the Superannuation Trustee (OST), the dedicated business function was not implemented and maintained by the deadline.
- Following completion of a show cause process, APRA issued directions to IIML and AET to comply with the dedicated business function condition and set a new 30 June 2019 deadline for this to occur.
- APRA's statement says that the regulator 'recognises the recent progress IOOF has made towards meeting the conditions, yet holds the IOOF entities accountable for the timely implementation of the conditions to ensure improvement to IOOF's organisational structure, governance and conflicts management frameworks'.

IOOF response: In a statement to the ASX, IOOF says it 'remains confident of meeting APRA's deadline of the end of June 2019 for the implementation and maintenance' of the dedicated business function.

[Sources: APRA media release 22/05/2019; IOOF Holding Ltd ASX Statement 22/05/2019; [registration required] The AFR 22/05/2019; [registration required] The Australian 23/05/2019]

United States | The FSB has launched a review of the of 2008 'too big to fail' reforms

The US Financial Stability Board (FSB) is conducting a review of the 'too big to fail' (TBTF) reforms for banks passed after the 2008 financial crisis. The review will assess whether the implemented reforms are reducing the 'systemic and moral hazard risks associated' with systemically important banks (SIBs) as well as the broader effects of the reforms on the overall functioning of the financial system.

The FSB has called for feedback on six issues (in particular).

1. To what extent are TBTF reforms achieving their objectives (as described in the terms of reference)
2. Which types of TBTF policies (eg higher loss absorbency, more intensive supervision, resolution and resolvability) have impacted SIBs and how
3. Whether the effect of the reforms differs according to the type of SIB (eg global vs domestic)
4. What effect TBTF reforms have had on financial system resilience and structure more broadly, the functioning of financial markets, global financial integration, and/ or the cost and availability of financing
5. Whether there have been any material unintended consequences from the implementation of the reforms
6. Any other issues relating to the effects of TBTF reforms (on which stakeholders would like to provide views)

Timeline: Submissions are due by 21 June.

[Source: FSB media release 23/05/2019; FSB Summary of Terms of Reference: Evaluation of too big to fail reforms 23/05/2019]

Professional investors are unconcerned about audit quality? 93% of professional investors in Australia rate audit quality as either 'average' or 'above average' according to an AASB/FRC report

Report Overview | Audit Quality in Australia: The perspectives of professional investors March 2019

The Financial Reporting Council (FRC) and the Auditing and Assurance Standards Board (AASB) have jointly released the results of a survey examining how professional investors view audit quality.

Why undertake the survey? The FRC and AASB note that regulators in Australia and internationally have continued to raise concerns in relation to the quality of external audits, including in the most recent Australian Securities and Investments Commission (ASIC) Audit Inspection report.

[Note: The report referred to is ASIC Report 607 Audit inspection program report for 2017-2018. The identified, that that though efforts had been made by audit firms to improve audit quality, further improvements are required. For example, the report identified 20% of reviewed audits (ie reviews of audit files of the six largest firms for the period 1 January 207 to 30 June 2018) lacked reasonable assurance that the financial reports were free from material misstatement. See: Governance News 30/01/2019; 10/04/2019]

The report argues that ASIC's findings are only 'one aspect' of gauging audit quality. As the 'objective of an external audit is to provide confidence to investors in the quality of financial reports, their views are vitally important' the report states, and as such, the views of key stakeholders are also an important aspect.

Report conclusion: The report concludes that professional investors are not concerned that audit is not achieving its objective of providing confidence in the quality of the financial report.

Further Detail

- 93% of professional investors indicated audit quality is average or above average. Only 7% indicated audit quality is below average or poor.
- This perception of audit quality was influenced by various factors, the three most important being: 1) the quality of financial reporting disclosures; 2) reported episodes of fraud within audited companies; and 3) quality of information contained within the auditor's report (for example key audit matters).
- The most important factor influencing their perception of the value of the audit is the quality of the information contained in the auditor's report.
- Professional investors said that regulators and standard setters should prioritise: 1) going concern judgements and disclosures; 2) developing and monitoring robust audit quality indicators; and 3) ascertaining appropriate level of assurance on Non-GAAP Financial Measures (NGFMs).

The report also compares the responses of Australian professional investors with the CFA Institute's international results.

About the survey: The survey was distributed by the following bodies to their members: The Association of Superannuation Funds of Australia, Corporate Reporting Users Forum, Australian Council of Superannuation Investors, Financial Services Council, and Australian Institute of Superannuation Trustees.

The survey was completed by 47 professional investors in the current roles of: Portfolio / investment managers (43.5%); Research analysts (26.1%); Shareholders (8.7%); Other (21.7%).

[Source: Audit Quality in Australia: The perspectives of professional investors March 2019 released 21/05/2019]

New Zealand | The Financial Markets Authority has issued a report highlighting the expectation gap between what investors expect and what auditors deliver

The New Zealand Financial Markets Authority (FMA) has circulated the results of research into public and industry perceptions of audit quality in New Zealand.

Some Key Points

Trust in the ethics and integrity of audit?

- The 'overall theme' to emerge from the research was that investors generally lacked 'faith and trust in the audit profession in NZ'.
- Having said this, views were found to differ according to the level of involvement or 'closeness' to the audit process of the different groups of respondents. Those least involved in the audit process (retail and institutional investors) were found to be the least trustful of the ethics and integrity of the audit profession. Just over half (56%) of investors agreed they trust the audit profession in NZ to act with ethics and integrity (56%) and 18% disagreed, 6% did not know and 20% were neutral. By contrast, auditors, managers and directors had a higher level of trust. 98% of auditors said they trusted the audit profession to act with ethics and integrity, 97% of managers and 68% of directors said the same.
- Investors had concerns about: the independence of auditors from the entities they audit; lack of professional scepticism; auditors not asking questions and challenging the judgement of the management and directors; and lack of competition in the sector. By contrast, directors rated auditor independence fairly highly (71% agreed).
- The 9% of directors who disagreed that the audit profession could be expected to act ethically and with integrity had concerns about conflicts of interest and scepticism about the independence of auditors from the entities they are auditing.

Quality of audit

- Just under half of investors agreed the quality of auditors in NZ is of a high standard (48%) and 38% agreed the quality of the audit firm is of a high standard.
- 69% of investors agree that audited information provides more reliable information than unaudited information.
- Directors and audit and risk committee members were found to have much stronger opinions than investors about the quality of auditors and the audit firms acting on their behalf. 57% agreed that the quality of the auditor (57%) or audit firm (59%) acting on behalf of their business is of a high standard. The majority of managers agree that the quality of the auditor (92%) or audit firm (97%) acting on behalf of their business is of a high standard.

Rob Everett, FMA CEO commented: 'While we can see that overall confidence is positive, serious expectation gaps exist among stakeholders with what they believe audit actually delivers. Our research shows that investors are not connected to the value that auditors can bring. To fill these gaps we need a concerted effort from the industry to explain their work and how they operate'.

[Source: FMA media release 21/05/2019; Perceptions of audit quality in New Zealand Executive Summary May 2019]

IFIAR has released its annual audit inspections survey: Audit quality globally appears to be improving but the findings indicate that a 'sustained focus' on continual improvement is needed IFIAR writes

The International Forum of Independent Audit Regulators (IFIAR) released its seventh annual survey of inspection findings. The survey collects data on key results from IFIAR members' inspections of audit firms' systems of quality control and audits of listed public interest entities (PIEs), including systemically important financial institutions (SIFIs).

Forty-five IFIAR members contributed to the 2018 survey drawn from its global membership base.

Key Finding

According to the report, IFIAR members reported in the 2018 survey that 37% of audit engagements inspected had at least one finding — a deficiency in audit procedures that indicates that the audit firm did not obtain sufficient appropriate audit evidence to support its opinion, but does not necessarily imply that the financial statements were also materially misstated — compared to 40% in the 2017 survey and to 47% in the first survey capturing this percentage (2014 survey).

IFIAR comments that though the downward trend is 'encouraging' the recurrence and level of findings reflected in the survey 'indicate a lack of consistency in the execution of high quality audits and the need for a sustained focus on continuing improvement'.

[Sources: IFIAR media release 16/05/2019; IFIAR 2018 Inspection Findings Survey 16/05/2019]

In Brief | The UK Financial Reporting Council (FRC) has published its Plan & Budget for 2019-20. It's first priority is supporting the transition to the new regulator the Audit, Reporting and Governance Authority (ARGA). FRC CEO Stephen Haddrill said that 'the FRC will do all in its power to promote transparency and integrity in business, and improve audit quality, corporate governance and investor stewardship

[Sources: FRC media release 23/05/2019; FRC plan and budget 2019/2020]

Risk Management

Top Story | APRA says weaknesses identified in the CBA report are not unique to the CBA

Report Overview | APRA Information Paper: Self-assessments of governance, accountability and culture

The Australian Prudential Regulation Authority (APRA) has released an information paper presenting the results of its own analysis of the self-assessments undertaken by 36 financial institutions (banks, insurers and superannuation funds) in response to the regulator's request that they assess whether the weaknesses uncovered by the CBA Prudential Inquiry also exist in their own organisations. A high level overview is below.

Key Takeouts

1. **Overall, APRA found that the weaknesses identified in the Final Report of the Prudential Inquiry are not unique to CBA, but are, 'by and large, also apparent in other institutions'.** APRA Deputy Chair John Lonsdale commented that 'although the self-assessments raised no concerns about financial soundness, they confirmed our observation that industry is grappling to manage non-financial risks, such as culture and accountability'.
2. **Four 'common themes':** APRA identified four common themes across all industries: 1) non-financial risk management requires improvement; 2) accountabilities are not always clear, cascaded and effectively enforced; 3) acknowledged weaknesses are well-known and some have been long-standing; 4) risk culture is not well understood, and therefore may not be reinforcing the desired behaviours.
3. **Culture and remuneration were weak points:** APRA observed that the self-assessments were generally 'weaker' (less comprehensive) on culture and remuneration. Institutions were observed to struggle to articulate their assessment of culture or provide much evidence to support their assessment. Likewise, with respect to remuneration, self-assessments were observed to be generally less detailed and tended to focus on remuneration design rather than on the effectiveness of the framework as a whole.
4. **Have boards/leadership teams been sufficiently self-critical?** Mr Lonsdale commented 'It was also interesting to observe the generally positive assessments boards and senior leadership teams had of their own performance, even when they had identified serious weaknesses in their institutions'. APRA has said that one area of focus in engaging with institutions on the self-assessments will be whether boards and senior leadership have been sufficiently self-critical given the wide range of weaknesses identified.
5. **Additional capital requirement?** APRA states that where the issues identified in self-assessments are material and the changes required to address them are significant, it is considering applying an additional operational risk capital requirement to reflect the higher risk profile of these institutions. To incentivise effective and timely rectification by institutions, this requirement would likely remain in place until issues are fully addressed.

6. **Further regulatory action?** 'Boards must be committed to uplifting governance and management of non-financial risks. Where this commitment is not forthcoming, APRA will consider the need for further regulatory action. We also continue to encourage those institutions that have not yet done a self-assessment to do so as a valuable means of identifying and addressing weaknesses in their business'

Introduction

Following the release of its prudential inquiry into the CBA in May 2018, the Australian Prudential Regulation Authority (APRA) requested 36 financial institutions (9 Authorised Deposit Taking Institutions (ADIs), 9 General insurers, 4 Life insurers, 3 Private Health insurers and 11 superannuation funds) to undertake self-assessments against the findings in the CBA report.

APRA released an information paper on 22 May outlining some of the key themes to emerge from the self-assessments, as well as brief comments on some of the 'solutions' being implemented by some institutions. The paper also sets out the next steps in APRA's plans to strengthen prudential expectations and intensify supervision of governance, accountability and culture. APRA states that its purpose in releasing the paper is to 'assist institutions in understanding and addressing the challenges of embedding effective risk governance frameworks and practices'. In addition, the findings will be used to 'better target' the regulator's efforts to 'lift standards of non-financial risk management'.

APRA's expectations: What does a strong governance and risk management framework look like?

APRA states that strong governance and risk management frameworks would typically exhibit:

1. **accountability and remuneration frameworks that incentivise delivery of sound outcomes**, in particular executive remuneration that is designed to better align rewards with a holistic view of performance;
2. **effective assurance and compliance mechanisms** that drive proactive monitoring, early detection and escalation, and timely rectification of issues; and
3. **direct and proportionate rewards and consequences** that are consistently applied to hold individuals to account for financial and non-financial outcomes.

APRA adds that to be effective, the elements identified above need to be supported by strong governance and risk oversight, and driven by a sound risk culture.

Lifting governance standards is the board's responsibility

APRA makes clear that it considers lifting governance standards to be a board responsibility, stating that it is 'boards and management are ultimately responsible for addressing weaknesses in their institution, and APRA will be holding them to account'.

APRA adds that boards must regularly challenge, and seek assurance and evidence of whether frameworks are operating as intended to deliver the targeted risk and customer outcomes. In addition, senior leadership should also, APRA says, pay attention to the institution's risk culture, and the extent to which it aligns with risk appetite and is reinforcing the desired behaviours.

Quality of the assessments: remuneration and culture were weak points

Overall, APRA observed that the self-assessments were generally 'weaker' (less comprehensive) on culture and remuneration. Institutions were observed to struggle to articulate their assessment of culture or provide much evidence to support their assessment. APRA writes that though it 'acknowledges the challenges of measuring and analysing risk culture, it appears that there remains significant scope for improvement in this area'.

In addition, APRA observes that self-assessments contained less detail on remuneration frameworks with most self-assessments focussing on remuneration design rather than on the effectiveness of the framework as a whole. APRA said that there was 'a lack of coverage of implementation, the use of board discretion in the remuneration process, the link between risk, conduct and customer outcomes and whether remuneration outcomes reflect policy intent'.

Four common themes

APRA identified four themes common to emerge from the self-assessments across all industries. Namely: 1) non-financial risk management requires improvement; 2) accountabilities are not always clear, cascaded and effectively enforced; 3) acknowledged weaknesses are well-known and some have been long-standing; 4) risk culture is not well understood, and therefore may not be reinforcing the desired behaviours.

A summary of APRA's comments in relation to each theme is below.

1. Non-financial risk management requires improvement

Generally, institutions consider that their oversight of financial risks is strong, but that their oversight of non-financial risk is less so (because it has not traditionally been afforded the same importance). Institutions cited a range of issues in illustration of this including: resource gaps (particularly in the compliance function), blurred roles and responsibilities for risk, and insufficient monitoring and oversight. In addition, historical underinvestment was also acknowledged to have contributed to ineffective controls/processes.

Having said this, APRA observes that institutions generally rejected the idea that the cultural traits of 'complacency, insularity and collegiality underpinning the [CBA] Prudential Inquiry findings' are prevalent in their organisations.

Areas for improvement

- **Blurred roles:** APRA writes that many self-assessments identified challenges in consistently applying the three lines of defence model, noting that roles continue to be blurred in practice (particularly between the first and second line functions). For example, APRA says that most self- assessments identified a lack of risk ownership by first line leading to second line stepping in and conducting first line risk activities. In addition, APRA observed that particularly in the banking and insurance industries, the assessments identified that there is room to 'elevate' the organisational status and influence of risk/compliance functions. APRA notes that this view was not shared as strongly by superannuation funds.
- **Control weaknesses (and an 'apparent acceptance' of untimely/reactive resolutions):** Institutions recognised that risk management frameworks have not been implemented effectively. For example, institutions flagged inconsistent and reactive risk identification processes and weaknesses in control frameworks, including in data quality and control classification and assessment processes. APRA comments that there was 'also an apparent acceptance of untimely and reactive resolution, with a propensity for short-term tactical fixes rather than long-term strategic solutions.' For example, APRA notes that one institution said that there was an 'emphasis on creating more activity rather than understanding the root-cause, specifically when things have gone wrong'.
- **Insufficient data leading to poor visibility of issues (and limited ability to challenge):** APRA observed that many institutions recognised the need to improve data, measurement and reporting for non-financial risks on the basis that insufficient data and limited systems/processes have impaired their ability to identify, escalate and manage emerging or systemic risks. This was also identified as a limitation on their ability to analyse why sub-optimal outcomes were allowed to occur. In addition, institutions also acknowledged that indicators and metrics for measuring and monitoring non-financial risks are fairly basic (eg there was a focus on use of the net promoter score' but often no analysis or reporting of complaints data) which APRA observes compromises the ability for 'robust internal challenge'.
- **Poor board visibility:** A number of self-assessments identified failure to identify key risks requiring closer board attention as an issue in 'voluminous' board and committee reports. In one case, APRA observes that an institution noted that reporting to executive committees and the board was primarily focussed on the technological aspects of the incident rather than the negative customer impact.

2. Accountabilities are not always clear, cascaded and effectively enforced

Institutions indicated that 'while senior executive accountabilities are fairly well defined within frameworks, there is less clarity or common understanding of responsibilities at lower levels, and points of handover where risks, controls and processes cut across divisions'. APRA observes that this is 'further undermined by weaknesses in remuneration frameworks and inconsistent application of consequence management'.

Areas for improvement

- **Lack of clarity around accountability for non-financial risk:** Self-assessments acknowledged that accountabilities for non-financial risks were not always clearly understood, particularly where risks, controls and processes span multiple business units/divisions. In larger institutions, self-assessments identified organisational and process complexity (eg multiple forums and committees, as contributing to confused accountabilities. In addition, the rate of internal and external change facing many institutions was cited as an added challenge in embedding clear accountabilities. Institutions also noted a reliance on informal networks for resolving incidents. For banks, implementation of the Banking Executive Accountability Regime (BEAR) was credited with clarifying accountabilities for the most senior executives. In addition, other industries referred to the regime as a means to sharpen executive accountability. A number of self assessments also said that the institution plans to cascade and embed the principles of the BEAR throughout the organisation.

- **Need to enhance consequence management:** 'Self-assessments generally acknowledged the need to enhance consequence management' APRA states. This requires, APRA writes 'the application of direct and proportionate consequences to hold individuals to account when issues emerge and are not promptly addressed'. Many self-assessments also recognised inconsistencies in the way consequences were applied across business units and at different levels of seniority as well as variations in the frequency of non-remuneration consequences between divisions, back and front office functions, and staff levels.

- **Remuneration and risk are misaligned:** APRA found that self-assessments generally contained less detail on the effectiveness of remuneration frameworks and that 'further work is required to ensure risk and customer objectives are reflected in remuneration outcomes, with gaps evident between current remuneration frameworks and better practices as set out by APRA and international bodies'. More particularly, APRA states that most institutions are yet to address the findings from APRA's 2018 information paper Remuneration Practices at Large Financial Institutions or incorporate the Financial Stability Board's Principles and Standards on Sound Compensation Practices (including the Supplementary Guidance addressing misconduct risk). Where institutions have started to address these findings, progress 'appears slow and some material gaps remain'.

  APRA made the following high level observations with respect to remuneration:

  - some institutions recognised a need for stronger board oversight and challenge of remuneration outcomes
  - risk information provided to the board remuneration committee for remuneration purposes appeared to be at a high level without a clear link to the institution's broader approach to risk management
  - while non-financial metrics were commonly included in scorecards, it appeared that a disproportionate focus was placed on the achievement of financial metrics
  - the level of input by the risk function and the board risk committee (or equivalent) into the risk assessment component in scorecards remained limited for most institutions
  - guidelines for the use of adjustment tools such as malus and clawback need development

APRA writes that this raises questions about the rigour applied in assessing the effectiveness of remuneration frameworks, including back-testing of outcomes, as required under Prudential Standard CPS 510 Governance (CPS 510) and Prudential Standard SPS 510 Governance (SPS 510). APRA suggests that these reviews will assist institutions in identifying weaknesses in their frameworks (including those above).

3. Acknowledged weaknesses are well-known and some have been long-standing

The majority of self-assessment findings were reported to be already known to boards and senior leadership and some issues had been allowed to persist over time. Competing priorities and resource and funding constraints were typically cited as the basis for acceptance of slower progress. Assessments also observed that these issues were often only prioritised when there was regulatory scrutiny or other adverse events.

4. Risk culture is not well understood, and therefore may not be reinforcing the desired behaviours

Institutions are putting considerable effort into assessing risk culture, but many institutions continue to face difficulties in measuring, analysing, and understanding culture (and sub-cultures across the institution). APRA observes that 'it is therefore unclear if these institutions can accurately determine whether their culture is effectively reinforcing desired behaviours'.

Areas for improvement

- **Inadequate 'root cause' analysis:** APRA comments that 'institutions may not have fully identified the root causes of findings resulting in the risk that actions to address weaknesses may not be effective or sustainable'. APRA observed that self-assessments generally focused on symptoms without adequate consideration of the underlying drivers. Consequently, while most institutions have developed and committed to a list of actions, or have initiatives in train, there is a risk APRA cautions, that these activities may not address the issues effectively or sustainably.

- **Weaknesses in program delivery**: Larger institutions, in particular, identified weaknesses in program delivery, including for risk related projects as an issue. More particularly, institutions recognised tendencies for delays and changes in the scope of projects, and a lack of accountability for outcomes. Some of the largest institutions also 'acknowledged a propensity to cultivate complexity in what they do – systems, processes and policies – which hinders effective execution'. This suggests, APRA observes, further risks to effective execution of plans to address weaknesses.

- **Insufficiently self-critical of boards/leadership?** Though most firms 'critically examined' their organisation, and committed to a 'considerable' list of actions, there were limited findings relating to the role of the board and senior leadership oversight and the assessments relating to the effectiveness of boards and senior leadership were 'notably less critical'. For example, APRA states that 'many self-assessments noted that the institution is generally well governed, with a respected and suitably challenging board, strong executive leadership teams and a good tone from the top, although at the same time acknowledging weaknesses spanning most or all chapters of the Final Report'. APRA questions whether this may indicate that the boards/senior management of these institutions 'have a potential blind spot when it comes to assessing their own effectiveness'.

Next Steps?

- **Case by case approach**: APRA writes that it is meeting with participating institutions and, will be writing to the boards of each to provide feedback on their self-assessments, and outline APRA's intended targeted supervisory engagement. APRA states that the nature of the engagement will depend on the quality of the self-assessment and the risk profile of the institution.

- **One area of focus for the regulator will be whether boards and senior leadership have been sufficiently self-critical** given the wide range of weaknesses identified.

- **Additional capital requirement?** Where the issues identified in self-assessments are material and the changes required to address them are significant, APRA is considering applying an additional operational risk capital requirement to reflect the higher risk profile of these institutions. To incentivise effective and timely rectification by institutions, this requirement would likely remain in place until issues are fully addressed.

- **APRA will also consider the extent to which further targeted thematic reviews** may be required to continue to drive improvements in governance, accountability and culture across the financial services sector.

- **APRA will also strengthen its prudential framework and increase supervisory intensity of governance, accountability and culture to drive improvement across the sector.** APRA states that it cannot 'regulate good culture into existence or design and implement strong frameworks for institutions' but does have a role in providing a 'sound foundation' and in 'reinforcing' effective practice. As such APRA writes that it is directing additional resources to a multi-year effort involving interrelated streams of work to intensify supervision of governance, accountability and culture (in line with implementing the findings of the Financial Services Royal Commission). This involves: a) adopting a risk based approach to conducting risk culture reviews across a wide range of institutions; scoping these reviews to include consideration of the influence of risk culture on non-financial risk management; and c) stronger and more direct engagement with boards and senior leadership to hold them to account for actions to address identified risks. APRA's immediate focus will be on those institutions that undertook a self-assessment.

- **Time to conduct a self-assessment?** 'APRA expects all regulated institutions to identify and address points of weakness and continues to encourage institutions that have not yet completed a thorough self-assessment to do so. Institutions should consider the observations in this paper when designing and implementing steps to enhance risk governance'.

APRA's policy agenda for the next 12 months

APRA states that the findings in the research paper will be used to assist the regulator in better targeting its efforts to lift standards of non-financial risk management, as outlined in its 2019 Policy Priorities document (see: Governance News 06/03/2019). APRA's policy agenda for the next 12 months includes strengthening prudential expectations for governance, accountability and culture. In particular:

- APRA will update its requirements for remuneration and plans to consult on a new prudential standard on remuneration in mid-2019.
- As recommended by the Royal Commission, with the Government APRA has commenced planning for an extension of the BEAR to all APRA-regulated sectors, as well as a broadening of the scope to address product management and customer remediation. APRA will also align and integrate the legislative requirements under BEAR with the broader prudential framework, and will consult on updates to the existing fit and proper requirements in Prudential Standard CPS 520 Fit and Proper.
- APRA will also review and clarify the governance and risk management provisions set out in CPS 510 and CPS 220 to ensure they remain fit for purpose. This includes more clearly articulating APRA's expectations of boards and senior management.

[Sources: APRA media release 22/05/2019; Information paper: Self-assessment of governance, accountability and culture; [registration required] The AFR 22/05/2019; 22/05/2019; [registration required] The Australian 23/05/2019; 23/05/2019; 23/05/2019; Investor Daily 24/05/2019]

Risk management needs a rethink? The AFR quotes a number of business leaders as suggesting that the way in which risk has historically been managed needs to shift in line with changed expectations/the changed business environment

The AFR reports that companies in all industries are struggling to meet the challenges posed by a changed business environment in which the way in which the risk function has historically been approached has come in for criticism. More particularly, The AFR suggests that the weaknesses in the standard 'three lines of defence' model have been exposed by increased regulatory scrutiny, higher regulatory scrutiny, increased public expectations and heightened social media exposure. In this context, companies are faced with the challenge of balancing cost pressures and creating shareholder value while also accepting greater involvement of a broader group of stakeholders, and higher visibility of their actions.

[Note: The Australian Prudential Regulation Authority (APRA) released an information paper on 22 May, presenting APRA's analysis of the self-assessments completed by 36 financial institutions in response to the findings in APRA's Prudential Inquiry into the CBA. Among other things, APRA flags the lack of clear accountabilities within organisations and the blurring of roles as areas of weakness within a number of organisations. The findings in APRA's information paper are covered in a separate post in this issue of Governance News.]

How do directors approach this challenge?

The AFR outlines the views of a number of directors (and KPMG representatives) on how they perceive the risk function has changed/needs to change. All appear to agree that the risk function should not be siloed within an internal department, but rather that risk management should be integrated into businesses at every level (including the front line).

- Non-executive director at Suncorp Group Limited, Breville Group Limited, Premier Investments Limited and Evans Dixon Limited Sally Herman is quoted as saying that the new environment dictates that the risk function is 'brought out of its silo' and incorporated into every level of the organisation. Ms Herman reportedly added that lines of accountability also need to be clear, 'Any organisation has to think about risk as a core part of doing its job, which means it can't be the responsibility of some faceless department in the centre'. In addition, Ms Herman reportedly said that in order to be effective, the risk function needs to be focussed not only on what could go wrong, but on where there could be an opportunity to do better for customers and that this requires both the right people (sufficiently senior/skilled) and the right data.

- Non-executive director at ALS Limited, Lynas Corporation Limited, Redbubble Limited and OzForex Grant Murdoch reportedly said, like Ms Herman, that risk management should not be siloed, but should be integrated throughout the organisation. 'We institutionalised risk and made it the responsibility of the chief risk officer, but now we're saying, "We've got to move some of this responsibility back to the front line.' That is effectively taking it back to Management 101, because the front line are the people that are managing both the opportunities and the threats" he reportedly said.
- Chief risk officer at Queensland Investment Corporation (QIC), David Clarke reportedly emphasised that risk needs to be managed 'in real time' and this requires building it into an organisation's training. 'I work very closely with our executive director of HR, we do joint training, joint inductions, teach people all the policy framework, risk appetite statements, work hand in glove on the board HR risk committee. In the last few years, the risk team and the human capital team have become very much in concert' he reportedly said.

KPMG consultant Stephen Allen is quoted as arguing that a sufficiently commercially minded internal risk function, independent of management, can be effective in challenging front-line decisions, helping to identify alternatives and guarding against potential reputational damage. Matt Tottenham, director, audit, assurance and risk consulting at KPMG reportedly added that in his view, the optimum risk function is where the risk people have the credibility to be seen as partners of the front-line business, 'Where the risk function becomes really valuable is where it has the credibility, experience and gravitas that can actually challenge the front-line business — and then the business wants its view…Where the business is saying, "I still make the final decision, but I really want your opinion," that's a partnership, and that's when it really works well.'

Separately, the AFR reports that KPMG has also highlighted the importance of a diverse range of skills within the risk management function, especially in light of the rising importance of non-financial risks the management of which requires different skills from those traditionally associated with risk professionals. Though analytical skills, and more particularly quantitative analysis remains important, it is no longer sufficient to meet new challenges.

[Source: [registration required] The AFR 28/05/2019; [registration required] The AFR 27/05/2019]

In Brief | The AFR reports that Australian companies appear to increasingly conservative in appointing CEOs, with a high proportion of the 15 CEOs from financial services companies who have left their roles since April replaced with internal candidates

[Source: [registration required] The AFR 27/05/2019]

Restructuring and Insolvency

ASIC has banned a former financial adviser from managing companies for five years following his involvement in 14 failed financial services companies

The Australian Securities and Investments Commission (ASIC) has exercised its powers under s206F of the *Corporations Act 2001 (Cth)* to disqualify Daniel McSweeny from managing companies for five years, following his involvement in 14 failed financial services companies.

The companies were placed into liquidation between 21 August 2014 and 8 September 2015, owing total debts of $9.8 million.

Based on reports lodged by the liquidators of the failed companies, ASIC found that Mr McSweeny:

- had fraudulently misappropriated company money
- used the company structure for his own dishonest means
- showed a complete disregard of his director duties
- failed to observe requirements to lodge documents with the Australian Taxation Office

- failed to ensure the companies complied with their obligation to keep written financial records
- failed to prevent the companies from trading while possibly insolvent

Following a separate ASIC investigation, Mr McSweeny has been charged with 20 dishonesty offences and one offence of falsifying books while a company director.

[Source: ASIC media release 22/05/2019; Independent Financial Adviser 22/05/2019]

Other News

Reportedly 21 CEOs and Chairs from financial firms (investment banks, super funds and accounting firms) have pledged their support for the Uluru Statement from the Heart and its call for the establishment of a First Nations voice in the constitution

The AFR reports that in an open letter, 21 CEOs and Chairs from financial firms (investment banks, super funds and accounting firms) have pledged their support for the Uluru Statement from the Heart (Statement) and its call for the establishment of a First Nations voice in the constitution.

The AFR comments that support appears to be growing in the community: 18 law firms pledged support for the Statement in March, BHP and other miners pledged support in January and the Business Council backed the statement in November.

Reportedly, Prime Minister Scott Morrison has said that he is 'committed to getting an outcome' on constitutional recognition, but has given no details on the form the process may take or the timeframe to achieve it. Mr Morrison is quoted as saying that constitutional recognition must be achieved alongside 'practical goals' to make Indigenous Australians 'safe in their communities' and enable them to enjoy the same access to services as other Australians.

Reportedly, the Federal Labor party have said they are willing to work with the government on the issue. The SMH quotes Anthony Albanese as saying 'if there is one area where we can put aside partisanship and work together in the national interest, it must be to advance the agenda of the Uluru Statement'.

[Sources: [registration required] The AFR 23/05/2019; The SMH 27/05/2019]