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Is the independent board model still workable? Senior Fellow at Harvard Law School Program on Corporate Governance Stephen Davis suggests that it may be time to provide independent directors with their own dedicated staff support to close the information gap

Key Takeouts

- **Directors' roles have expanded** to include active oversight of a range of issues (eg performance, risk management, ethical behaviour and alignment with investor interests), yet they are struggling to handle their responsibilities effectively
- **Why are they struggling?** It's suggested that both a lack of information, ie 'directors must handle their duties at the short end of a massive information imbalance' and a lack of dedicated support (ie directors are reliant on an executive (usually a company secretary or general counsel accountable to/working for management) are contributing factors
- **Dr Davis suggests that providing boards with more support** — eg dedicated staff or access to outside advisers to provide support — would help ensure they have the information they need to function effectively. 'Without that feature, at many companies, directors will continue to push uphill in shepherding long-term performance as well as ethical and responsible corporate behaviour'

Reflecting on the expanded roles boards are expected to play in overseeing the good governance, financial performance and future direction of companies, Senior Fellow at the Harvard Law School Program on Corporate Governance Dr Stephen Davis questions whether the current governance structure provides directors with sufficient support to enable them to discharge their roles effectively. 'The independent board model isn't truly workable, at least not without a crucial reboot' it's suggested. More particularly, the writer's view is that there 'isn't enough help for boards to handle their responsibilities effectively'.

Directors are largely dependent on management for information (the team that they are supposed to oversee): A key issue for directors, Dr Davis argues is lack of access to information. 'Directors must handle their duties at the short end of a massive information imbalance' in which management has a 'virtual continuous monopoly on data and insights' which 'generally' translates into a 'routine advantage' for management in influencing what independent directors discuss and decide. 'Cementing the information imbalance is the fact that the typical company board has no everyday dedicated staff. Instead, directors rely on an executive—usually a company secretary or general counsel—who is accountable to and works for management'. Dr Davis suggests that 'outside observers would find it hard to fathom how companies go to such lengths to recruit great independent directors—only to make them largely dependent for help on the team they are supposed to oversee'.

Some isolated exceptions? In some cases, firms have implemented different arrangements. For example, Nissan, recently declared that it would establish a dedicated office of the board. However, beyond some isolated examples, most companies have not equipped their directors with permanent, dedicated staff. In addition, most corporate governance codes around the world still only advocate that directors tap independent advice in special circumstances rather than as a permanent feature.

Activist nominees? Dr Davis notes that activist board nominees have access to information (independent of management) and are able to share what they know with other directors, but this is also potentially problematic as it leaves the remaining directors reliant on either information from management or information from activists. 'Without dedicated help, independent boards are outgunned by activists, some of whom are short term, and by executive teams that directors are elected by shareholders to oversee' he argues.

Why directors need dedicated staff: 'Directors are trapped in a vice of mounting expectations and scant resources'. As such, it's suggested that 'perhaps the time has come for directors, shareholders, and others to acknowledge that an empowered board means an information-equipped board. Without that feature, at many companies, directors will continue to push uphill in shepherding long-term performance as well as ethical and responsible corporate behaviour'.

This doesn't necessarily mean every company needs to establish an independent secretariat group: Dr Davis identifies a number of possible barriers to independent board staffing. These include: the cost (which could mean it's only an option for larger companies); the potential to 'stoke friction' with counterparts in the management team; and the potential for dedicated staff to remain reliant on management. In response, he argues that the solution could be 'right sized' for each company. For example, a board could establish an independent secretariat group or, could instead have outside advisors (eg financial experts, lawyers, or compensation analysts)on retainer at the call of the board chair or lead director to provide support.

Other measures to consider: Dr Davis also suggests that shareholders can play a role in probing how boards ensure they have the information they need, and investors could push for more effective 'board empowerment options'. In addition, it's suggested that policymakers could amend corporate governance codes to include a requirement for boards to regularly disclose how they satisfy the need for ongoing, independent information and guidance on the different models by which independent board staffing might be achieved, depending on the company's size, ownership and risk profile.

[Source: Harvard Law School Forum on Corporate Governance and Financial Regulation 30/08/2019]

In Brief | What are the key challenges for future focused boards? A recent discussion paper jointly released by IOD and MinterEllisonRuddWatts identifies that technology is likely to play a key role in support a shift in the way director's meet, monitor organisations and make decisions. In addition, the report suggests that directors will spend more time outside board and committee meetings developing a deeper understanding of the business and closing the information gap with management. 'Tomorrow's directors will be constantly learning – always on duty' it's suggested

The full text of the discussion paper — Always on duty the future board — can be accessed on the Institute of Directors website here: https://www.iod.org.nz/Portals/0/Publications/IoD%20Always%20on%20duty-%20the%20future%20board.pdf?ver=2019-09-05-162739-047

Diversity

Going backwards? Though there has been some progress towards gender balance in senior executive roles in ASX200 companies, the CEW's latest senior executive census has found that the number of female CEOs in ASX200 companies has fallen from 14 (7%) in 2018 to 12 (6%) in 2019

Report Overview | Chief Executive Women, ASX200 Senior Executive Census 2019

Chief Executive Women have released the 2019 Chief Executive Women (CEW) ASX200 Senior Executive Census (Census), which measures year on year progress towards gender balance — defined as 40% women, 40% men and 20% of either gender (40:40:20)) — in Australia's largest listed companies.

Some Key Points

- **Going backwards?** The number of female CEOs in ASX200 companies has fallen from 14 (7%) in 2018 to 12 (6%) in 2019. 92% of ASX200 CEO appointments in 2019 have gone to men. CEW President, Sue Morphet commented that 'with few exceptions, progress towards gender balance at the executive level is slow, and at the very top it has gone backwards'.
- **Progression to CEO roles is still limited for women?** Overall, the report found that women remain underrepresented that drive key commercial outcomes, with profit and loss responsibility (line roles) and CFO roles. According to the Census, 16% of ASX200 CFO roles are held by women (up from 12% in 2018 and 9% in 2017) and 13% of line roles are held by women (up from 12% in 2018 and 2017).

  The Census argues that this is significant given that CFO and line roles are the most likely path to the CEO role. To illustrate: 88% of new ASX200 CEO appointees in 2019 held line roles, and 8% held CFO roles immediately prior to taking on the CEO role in 2019. By contrast, only 4% of ASX200 CEO appointments held functional roles (ie roles with no product and loss responsibility) immediately prior to their appointment. Commenting on this, Chio Verastegui, a Partner at Bain & Company, who led the data collection and analysis for the Census said that 'improving the gender balance at all levels of leadership will require companies to consider giving women in functional roles - like human resources or legal — the opportunities to gain line management experience. Without this experience, opportunities for women to progress to the CEO position will remain limited.'

[Note: Earlier in the year, EY and the 30% Club released a report, The Next Generation: Pathways to ASX 200 Board Roles of the 2018 Appointees, analysing the experience and pathways to appointment to an ASX 200 board. Among other things, the report found that the most important and desirable experience for ASX200 boards is senior executive experience, and more particularly experience in roles with significant profit and loss responsibility. For a summary see: Governance News 22/05/2019]

- **The emergence of new executive leadership team (ELT) roles may support women's career progression?** The Census suggests that the emergence of new roles in executive leadership teams such as risk and compliance and customer experience roles, (where women are more likely to be represented) has the potential to support women's career progression going forward.
- **Eight ASX 200 companies (4%) have gender balance in line roles in 2019:** 4% of ASX200 companies have gender balance in line roles in 2019. Telecommunications (32%), real estate (15%), consumer staples (15%) and energy (14%) have more women in line roles as compared to the ASX 200 average (13%). The Census comments that this represents little change in the proportion of women in line roles across industries as compared with 2018
- **Women CEOs 'promote gender balance'**: In ASX200 companies led by a female CEO, women make up 23% of line roles. Where the CEO is male, the proportion is 14%.
- **More than half of ASX200 companies (114) have zero women in executive leadership team** (ELT) line roles (down from 119 in 2018).
- **Women comprise 25% of executive leadership teams in ASX200 companies (up from 23% in 2018).** The Census comments that most of this improvement is due to more women in functional roles.
- **The proportion of women in ELTs (including in line roles) is marginally higher in ASX20 than ASX200 companies on average.**

[Note: A report earlier in the year, which also flagged a lack of diversity among ASX200 CEOs suggested that Australian companies may not (necessarily) be sourcing the best talent available. See: Easy to classify — the education and experiences of Australian CEOs. For a summary see: Governance News 15/05/2019. Another recent report by Apollo Communications, Australian Top 50 CEO Report 2019, also flagged lack of gender diversity as an issue. According to the report only 3 of Australia's top 50 CEOs are women. For a summary see: Governance News 04/09/2019.]

[Note: Among the policy reforms recently put forward by the Australian Council of Superannuation Investors (ACSI) in response to the Financial Services Royal Commission, is a call for all listed entities to be required to set a time frame within which they will achieve board gender balance (40:40:20). ACSI suggests that if this is not achieved by 2025, then regulatory intervention should occur. See: Governance News 08/05/2019]

[Sources: Chief Executive Women media release 10/09/2019; CEW Report: ASX200 Senior Executive Census 2019; The SMH 10/09/2019; [registration required] The AFR 10/09/2019; The ABC 10/09/2019; [registration required] The Australian 10/09/2019]

In Brief | Why so few CEOs? Only 5% of S&P 500 CEOs are women. Based on analysis of the findings of nearly 160 studies published during the past 25 years into the effects of gender on different aspects of CEOs' careers, researchers have found that stereotypes and favouritism pose significant barriers to the career progression of aspiring female leaders

[Source: The Conversation 05/09/2019]

Remuneration

The WSJ reports that Nissan CEO Hiroto Saikawa will return a portion of his performance-based pay, after Nissan auditors found that the amount was too high. Reportedly Mr Saikawa has also flagged his intention to step down as CEO

The WSJ reports that Nisson CEO Hirota Saikawa will return a portion of his pay, following an audit. According to The WSJ, Mr Saikawa received a higher payment (more than $400,000 in additional payments) than he was entitled to, because the execution date of his 2013 appreciation rights was changed to a date when the share price was higher.

Reportedly Mr Saikawa was unaware of the issue, though the WSJ reports that has been disputed.

Nissan auditors plan to present their findings to the company's board when it next meets . According to The WSJ, the report does not find that Mr Saikawa committed any wrongdoing, but does find that other Nissan executives also received payments that were higher than they should have been.

Reportedly, Mr Saikawa has flagged his intention to step down, but the exact date of his resignation and his replacement are yet to be decided.

[Sources: [registration required] The WSJ 05/09/2019; The New York Times 05/09/2019; Nikkei Asian Review 08/09/2019]

In Brief | The Australian Reports that Bendigo and Adelaide Bank executives will receive zero short term incentives after the bank failed to clear the required cash-earnings hurdle to establish a bonus pool

[Sources: [registration required] The Australian 07/09/2019]

Regulators

Operators of loyalty schemes 'on notice': The ACCC has released a draft report flagging 'significant concerns' about customer loyalty schemes and recommending law reform

Report Overview | ACCC report, Customer Loyalty Schemes [Draft Report]

On 5 September, The Australian Competition and Consumer Commission (ACCC) released for consultation a draft report into customer loyalty schemes. The ACCC says that the purpose of draft report is to highlight the consumer and competition issues associated with customer loyalty schemes, to educate consumers and to inform the industry of the ACCC's concerns with respect to certain practices which it considers have potential to cause 'widespread consumer detriment'. The report includes four draft recommendations aimed at addressing the ACCC's concerns.

Context? The regulators received approximately 2000 reports about loyalty schemes in the five years to December 2018. The regulator found that loyalty schemes are both widespread and profitable for the companies who operate them. Almost nine in ten adults are members of a loyalty scheme, with the average Australian carrying between four to six loyalty cards. According to the ACCC, loyalty schemes can contribute to a significant proportion of a company's profits. Some loyalty schemes generate $110 million – $370 million in earnings each year.

Focus on three issues: The ACCC's review of the major customer loyalty schemes in Australia focused on the following issues: 1) consumer issues (whether consumers are properly informed and receive the benefits advertised by loyalty schemes); 2) data practices (the collection, use and disclosure of consumer data by loyalty schemes and their partners) and 3) competition issues (the potential impact of loyalty schemes on competing firms, in particular on new entrants).

Concerns identified? Concerns identified in the report include loyalty schemes that: a) do not present their terms, conditions and privacy policies in a way that consumers can readily understand; b) make unilateral changes to their terms and conditions in a way that may be unfair to consumers; and c) collect, use and disclose consumer data in ways that do not align with consumers' preferences (eg by failing to provide 'meaningful consumer control' over the collection/use/disclosure of consumer data).

ACCC Chair Rod Sims commented, 'The privacy policies of these schemes are frequently very vague and don't tell consumers who their data is being shared with or how it is being used, shared or monetised. The data that loyalty schemes collect can be used to profile consumers and produce insights about their purchasing behaviour. These insights about consumers may then be shared with or sold to third parties. Consumers may also be shocked to find that some schemes collect their data even when they don't scan their loyalty cards, or that they combine it with data from other sources that they might not even be aware of'.

Four draft recommendations

The report includes four draft recommendations to address these concerns.

1. **Clearer communication with consumers**: Loyalty scheme operators should review their approach to presenting the terms and conditions of loyalty schemes to ensure they comply with the Australian Consumer Law, including by avoiding statements that are incorrect or likely to create a false impression, and avoiding unfair contract terms.

2. **Prohibit UCT and unfair trading practices:** Consistent with the Digital Platform Inquiry Final Report's recommendations, the ACCC recommends that the Australian Consumer Law be amended: a) to prohibit unfair contract terms; and b) to include a prohibition against certain unfair trading practices. The ACCC notes the current work on this issue being undertaken as part of the Consumer Affairs Australia and New Zealand (CAANZ) process, and says that it will progress its support for the recommendation through that forum.

[Note: The ACCC's Digital Platform Inquiry Final Report was released on 26 July. For expert insight into the impact of the report see: ACCC calls for competition reforms that will impact digital platform operators and beyond. For an overview of the report and the ACCC's 23 recommendations see: Governance News 31/07/2019]

3. **Improve data practices:** The ACCC observes that privacy policies of the customer loyalty schemes in the review are 'opaque' and that consumers are often unable to make informed choices about/have limited control over the collection, use and disclosure of their data. To address this, the ACCC proposes that loyalty schemes 'review their approach to presenting consumers with information about how they handle consumer data and provide consumers with meaningful control over their data'. More particularly, the regulator encourages loyalty schemes to take steps to: a) review their 'clickwrap agreements for unfair contract terms', including by assessing the potential consumer detriment of unilateral variation terms; b) improve the clarity, accessibility, navigability and readability of privacy policies, including by using definitions consistent with those in the Privacy Act; c) minimise information overload for consumers by prominently presenting relevant aspects of their terms, conditions and privacy policies to consumers during key interactions; d) end the practice of automatically linking customers' payment cards to their profile to track their purchasing behaviour and transaction activities when they do not scan their loyalty card; e) outline who data is being shared with and for what purposes; f) disclosing to consumers the sources of third party advertising; and g) provide consumers with more 'meaningful controls over the collection, use and disclosure of their data'.

4. **Strengthen Privacy Act protections:** Consistent with the Digital Platforms Inquiry Final Report's recommendations, the ACCC recommends strengthening the Privacy Act by: a) updating the definition of personal information in line with current and likely future technological developments to capture any technical data relating to an identifiable individual; b) strengthening notification requirements to ensure that the collection of consumers' personal information directly or by a third party is accompanied by a notice of the collection that is concise, intelligible and easily accessible, written in clear and plain language, provided free of charge, and accompanied by appropriate measures to reduce the information burden on consumers; c) strengthening consent requirements to require that consents are freely given, specific, unambiguous and informed and that any settings for additional data collection must be preselected to 'off'; d) ensuring consents are required whenever personal information is collected, used or disclosed by an entity subject to the Privacy Act, unless the personal information is necessary to perform a contract to which a consumer is a party, required under law, or otherwise necessary in the public interest; e) requiring entities subject to the Privacy Act to erase the personal information of a consumer without undue delay on receiving a request for erasure from the consumer, except in certain circumstances; and f) introducing

direct rights for individuals to bring actions or class actions before the courts to seek compensation for an interference with their privacy under the Privacy Act.

As well as these recommendations for targeted amendments to the Privacy Act, the ACCC says that it is also recommending broader reform of the Australian privacy regime to maintain effective protection of consumers' personal information in the longer term including consideration of the current objectives and scope of the Privacy Act, and the introduction of a statutory tort of privacy as recommended by the Australian Law Reform Commission

The ACCC has called on loyal scheme operators to take steps to address the concerns identified

The ACCC says that competition and consumer issues arising from customer loyalty schemes are a priority in 2019. 'Having placed the industry on notice, the ACCC encourages consumers to contact us and report concerns where these practices are continuing with their customer loyalty schemes. The ACCC will consider these reports in deciding whether enforcement action will be required to effect broader change'.

Next steps? The deadline for submissions on the draft report is 3 October. A final report will be published in 'late 2019'.

[Source: ACCC media release 05/09/2019; ACCC Report: Customer Loyalty Schemes [Draft Report]

The House of Representatives, Standing Committee on Economics has announced that APRA Chair Professor Graeme Samuel will appear at the next public hearing on 11 September

Chair of the Australian Prudential Regulation Authority Capability Review (APRA), Professor Graeme Samuel is due to appear before House Economics Committee on 11 September as part of the Committee's review of the performance and operation of the regulator.

Committee Chair Tim Wilson commented that the 'Capability Review identified APRA's internal culture regulatory approach needed improvement, and that it had to establish an additional focus on superannuation, while recognising that it was an impressive and forceful regulator in relation to financial risks.' Mr Wilson said 'the hearing will allow the committee to question Professor Samuel on the panel's assessment of APRA's capability to deliver upon its statutory mandate and respond to an environment of growing complexity and emerging risks for APRA's regulated sectors.'

[Sources: House Standing Committee on Economics media release 09/09/2019; Public Hearing Program]

Corporate Social Responsibility and Sustainability

Top Story | A 'case for law reform'? In a recent speech UK Supreme Court Justice Lord Sales suggested that 'there is a clear case' for law reform to provide a 'greater impetus to boards and individual directors to accord greater attention and weight to climate issues than has until now been considered appropriate'

Key Takeouts

1. Presently, the challenges raised by climate change/wider environmental issues are 'primarily accommodated within the general framework of wide and open-textured directors' duties, with certain statutory overlays' in both the UK and Australia.
2. The 'direction of travel' in both the UK and Australia is clear in that 'environmental considerations may and, increasingly, must be taken into account by directors, particularly where there may be financial impacts on the company'.
3. Lord Sales considers that there is a clear case for law reform 'to provide a greater impetus to boards and individual directors to accord greater attention and weight to climate issues than has until now been considered appropriate'.

4. Lord Sales outlines three proposed reforms: 1) the inclusion of a s172 type section in Australia requiring consideration of environmental impacts by directors; 2) streamlined climate disclosure; and 3) the imposition of a new requirement for boards to include a designated member environmental impact issues.

In a recent speech to the Anglo-Australasian Law Society — Directors' duties and climate change: Keeping pace with environmental challenges — Lord Sales, Justice of the UK Supreme Court outlined the extent to which existing 'company law frameworks' in Australia and England, enable and (increasingly oblige) directors to take into account environmental considerations.

He concluded that overall, 'the basic direction of travel in both jurisdictions seems clear. With respect to the legislative scheme, environmental considerations may and, increasingly, must be taken into account by directors, particularly where there may be financial impacts on the company'. He went on to observe that this is 'especially true in England given section 172(1)(d). But it is also in practice so in the Australian context, by application of section 180(1). It is clear that the very traditional view of the undemanding nature of directors' duties is now outmoded in both jurisdictions'.

[Note: Section 172(1) of the UK Companies Act 2006, the Duty to promote the success of the company, lists matters directors should 'have regard to' in discharging their duty, including s172(1)(d) the impact of the company's operations on the community and the environment.]

However, Lord Sales considers that 'procedural reform' in both England and Australia is justified to raise the profile of consideration of environmental impacts in director decision making. 'The clear message to be taken away from this lecture is that company law in England and Australia alike is still undergoing a process of coming to terms with the new challenges raised by climate change and wider environmental issues. These challenges are, at present, primarily accommodated within the general framework of wide and open-textured directors' duties, with certain statutory overlays…There is a clear case for these company laws to be modified, by legislation, to provide a greater impetus to boards and individual directors to accord greater attention and weight to climate issues than has until now been considered appropriate'.

Three suggested 'procedural' reforms

Lord Sales suggests three reform proposals, all of which he says are 'procedural in nature, but would have the objective of raising the profile of consideration of environmental impacts in decision-making by directors'. The proposed changes would he said 'respect the existing basic pattern of legal responsibilities, so that directors would continue to have the freedom and responsibility to take the business decisions for their companies without being compelled to act in particular ways'.

The proposed changes are as follows.

1. The inclusion of a s172 type 'enlightened shareholder principle'?

Lord Sales suggests that an 'obvious reform proposal in Australia' would be the explicit adoption of the principle of 'enlightened shareholder value' in section 172 of the Companies Act 2006 into the Australian Corporations Act 2001. He suggests that this could be done by making 'specific provision requiring consideration of environmental impacts by directors'. Lord Sales observes that while it seems that s 180(1) 'is capable of being construed so as to have an effect similar to that of the section 172 duty in the English Act, as Noel Hutley SC contends in his Opinions, it might be thought to be unsatisfactory to leave such a significant issue to the subtleties of interpretation and inference'.

[Note: On 7 October 2016, Noel Hutley SC and Sebastian Hartford-Davis provided an opinion considering the extent to which the duty of care and diligence imposed upon company directors by s 180(1) of the Corporations Act 2001 (Cth) permitted or required Australian company directors to respond to climate change risks (2016 Opinion) (see: Governance News 07/11/2016). In April of this year, The Centre for Policy Development (CPD) released a supplementary opinion, responding to developments since the original opinion was finalised. For a summary see: Governance News 05/04/2019]

2. Streamlined climate disclosure

Further thought should be given, Lord Sales suggests in both Australia and England, to statutory 'standalone environmental disclosure duties'. 'The idea would be to require specific reporting with the relevant legislation or a supplementary best practice code providing clear parameters for which aspects of environmental impact should normally be covered' Lord Hales said. He suggested that examples might include: reporting on supply chain management, corporate waste disposal, company investment profiles, environmental impact assessments for major projects and energy consumption.

3. The imposition of a new requirement for boards to include a designated member environmental impact issues

Lord Sales suggests the introduction of a legislative or, as a preliminary step, regulatory best practice requirement, to appoint a designated board member for environmental impact issues. 'This director would provide a dedicated voice on the board to ensure that such issues are indeed brought into account by directors when the board acts. The director would be the focal point for the company's environmental responsibilities, and would provide the lead to ensure fulfilment of the company's duties regarding environmental disclosures and reporting' Lord Sales said. In suggesting this change, Lord Sales clarified that he is not proposing that responsibility for environmental impact issues be 'siphoned off' to one designated member of the board. Rather he says that the purpose of designating a specific board member is to 'give environmental impact issues due prominence in the decision making process of the board as a whole'. Lord Sales further observed that larger companies are already beginning to appoint senior environmental officers at various tiers in their organisations and that his proposal is a 'natural progression'.

Alternately, Lord Sales suggests that there could be a legislative requirement or best practice provision in a Code calling for the appointment of an environmental consultant to the board. Further, he suggests that depending on the size and resources of the company, another option would be to require the setting up of an internal environmental committee reporting to the board (which could first be trialled in a best practice code).

'Ever more tailored and specific duties of a procedural nature'?

Lord Sales concedes that his suggested changes may create a risk of being overly prescriptive, but argues that they would also sharpen directors' attention on environmental factors as a 'substantive matter'. He observes 'the tenor of these suggestions is clear. In line with reform proposals in the "Time to Act" report in Canada and regulatory calls for action by the Bank of England and the APRA, the way forward in this area, legally, seems to be ever more tailored and specific duties of a procedural nature. While this might create a risk of over-proceduralisation, possibly at the expense of substance, it would have the clear benefit of imposing concrete procedural obligations at board level. These can be policed effectively, and it is to be hoped that duties to consider specified environmental impacts would also sharpen the attention and awareness of directors regarding environmental factors as a substantive matter'.

Lord Sales observed that despite the 'increasingly high likelihood' that the 'financial consequences of inaction may even curb the need, speaking purely pragmatically, for extensive further legislation in England and Australia', the importance of the issue warrants consideration to be given to the proposed reforms. 'The gravity of the issue of climate change and the leadership role performed by both the UK and Australia on these issues on the international level, it seems desirable for their company laws to keep pace with and indeed assume a position in the lead in the current trends in favour of disclosure, reporting and risk management' he said.

[Source: Speech by Lord Sales, Justice of the Supreme Court to the Anglo-Australasian Law Society: Directors' duties and climate change: Keeping pace with environmental challenges 27/08/2019]

Investment in adapting to climate change makes sound economic sense? The Global Commission on adaption report calls for urgent action on climate adaption, arguing among other things that doing so could deliver significant economic returns

The Global Commission on Adaption (led by Ban Ki-moon, 8th Secretary General of the United Nations, Bill Gates, Co-chair of the Bill and Melinda Gates Foundation, and Kristalina Georgieva, CEO of the World Bank) has released a report — Adapt Now: A Global Call for Leadership on Climate Resilience — calling on governments and businesses to take urgent action to innovate, invest in and advance climate adaptation solutions.

Some Key Points

Urgency of action? The report argues that climate change 'is one of the greatest threats facing humanity, with far-reaching and devastating impacts on people, the environment, and the economy. Climate impacts affect all regions of the world and cut across all sectors of society. People who did the least to cause the problem—especially those living in poverty and fragile areas—are most at risk'. Despite this, the report argues that the pace of change is not happening at the speed/scale required in part because the risks are not sufficiently visible or factored into current business planning/solutions and also because investment is not flowing at the pace/scale required.

Adaptation can deliver high rates of return, bringing multiple benefits to people and the economy: The report argues that taking action to address climate challenges in key systems — food, water, cities, infrastructure, and disaster management — could deliver a 'triple dividend' in that doing so could: 1) reduce/avoid future losses; 2) generate positive economic gains through innovation; and 3) deliver additional social and environmental benefits.

'Adapting now is in our strong economic self-interest'? Apart from delivering environmental and human benefits, the report identifies that investing in early warning systems, climate-resilient infrastructure, improved dryland agriculture, mangrove protection, and investments in making water resources more resilient could deliver significant financial returns. Specifically, the report found that that investing $1.8 trillion globally in five areas from 2020 to 2030 could generate $7.1 trillion in total net benefits.

Next steps: The report states that the next 15 months are critical to mobilising action on climate change and support global development. The Commission will champion a set of 'Action Tracks' at the UN Climate Action Summit in September 2019 and throughout the coming year, including importantly at the Climate Adaptation Summit in the Netherlands in October 2020. The Commission will also aim to encourage countries to raise the level of ambition on adaptation in the lead up to the international climate summit, COP26, in December 2020.

A 'coming wave of investment? Investors are 'bound to get on board'?

Macquarie Group CEO Shemara Wikramanayake, who the AFR comments is one of only two global chief executives appointed a commissioner of the United Nations sponsored Global Commission on Adaptation, is quoted in the AFR as drawing a comparison between the coming wave of investment in adaption to the early days of infrastructure investment which Macquarie led 20 years ago and to the early days of investment in renewables 15 years ago. Reportedly, Ms Wikramanayake's view is that 'investors are bound to get on board with investment in adaptation because it makes asset valuations more resilient'.

Commenting on the role of superannuation funds in supporting 'adaption' investment, Ms Wikramanayake reportedly said that 'under the best interest duty they're forming a view that trustees can take a bunch of things into account for their members not just financial return… That's obviously a judgment call for them'. The article quotes Ms Wikramanayake as saying that Macquarie has found it is able to deliver both strong financial returns and strong social outcomes in terms of climate change. 'We think that's good for our shareholders because it gives us a long term licence to operate if we make sure we're adding value on the community side as well' she reportedly said.

[Note: As part of its broader response to the Financial Services Royal Commission, The Australian Council of Superannuation Investors (ACSI) recently released a policy paper — Towards Stronger Investment Stewardship — outlining two proposals to strengthen investment stewardship in line with global best practice and in line with growing ESG expectations. For a summary of ACSI's proposals see: Governance News 08/05/2019]

[Sources: Global Commission on Adaption Report: Adapt Now: A Global Call for Leadership on Climate Resilience; World Resources Institute media release 10/09/2019; [registration required] The AFR 10/09/2019; 10/09/2019]

Retail investors care about non-financial considerations? A report from KPMG/Acuity research has found that Australian retail investors expect more of companies than short term financial returns

Report overview | KPMG/Acuity Research, Shareholder value: Shareholder Values

Key Takeouts

- A report by KPMG/Acuity Research surveyed 1510 active Australian retail investors in order to identify what considerations this group takes into account when making investment decisions.
- According to the report, the majority of Australian retail investors would accept lower financial returns if it meant companies they invested in always behaved ethically towards customers, employees, and community.
- KPMG Chair Alison Kitchen said that the key finding to emerge from the study is that 'investors are not looking for directors and management with a laser focus on short term returns'. Rather, the findings indicate that retail investors 'expect more [than strong financial returns] of corporate leadership and will shift their investment elsewhere if they don't get it'.

A report from KPMG/Acuity into retail investor attitudes towards investment decisions has identified that retail investors are not purely focussed on delivery of short-term financial returns, but rather place value on non-financial considerations including ethical conduct and transparency and sustainability (as regulators and institutional investors do).

Commenting on the findings, KPMG Chair Alison Kitchen said that the 'what this new piece of research from KPMG Acuity makes clear for the first time is that institutional investors do not have a monopoly on sophisticated judgment. The data shows that Australian retail investors are now keenly aware of the importance of reputation, transparency, ethical behaviour, values alignment, and social responsibility'.

A high level overview of some of the key findings of the research is below.

Some Key Findings

- **The five most important considerations retail investors take into account when determining which shares to buy** are (ranked most important to least important): 1) positive financial returns to investors/shareholders (60% of respondents ranked this as the key consideration); 2) transparent and honest company (51%); 3) offers quality services or products (42%); 4) conducts their business ethically (42%); and 5) balances the needs of shareholders with employees and the community (37%)
- **Lower financial returns would be acceptable if a company acted ethically?** Overall, the study also found that 57% of shareholders overall would accept lower financial returns (of this group, 34% would accept lower returns and 8% said they would accept 'much lower' financial returns) if it meant companies they invested in always behaved ethically towards customers, employees and the community. 34% of respondent said that they would not accept lower financial returns. Digging deeper, the report found that the 41-50 year old age group were most likely to focus on purely financial matters (and to care least about non-financial ethical, social and/or governance concerns) when buying shares as compared with those in older and younger age groups. For example, the only 49% of the 41-50 age group rated ethical behaviour as a key consideration (as compared with 54% on average, 66% of the under 30 age group, 57% of the 31-40 age group and 55% on the under 60 age group). In addition, the report found that female investors are overall more likely to consider non-financial matters (ethical behaviour, environmental sustainability and whether companies in which they invest are paying their fair share of tax) when making investment decisions.
- **The top five reasons shareholders sell shares?** 1) Inconsistent financial returns (57%); 2) not transparent and honest (46%); 3) failure to conduct business ethically (43%); 4) poorly regarded leadership (41%); and 5) excessive leadership/executive pay (38%). The report characterises 'excessive pay' as a 'major trigger'.
- **Sponsoring and supporting charities, sports or culture was not found to significantly help make companies more attractive to shareholders** with only 27% of respondents indicating this was an extremely important/very important consideration. Likewise, only 23% of shareholders said that they consider sponsoring culture and the arts as an important consideration.
- **The majority of retail investors are reading annual reports and they're not only looking at financial performance.** Rather, the report found that 95% of shareholders are also focused on future strategy (which they expect to include the company's environmental, social and governance (ESG) plans); board

and executive remuneration (89%) and the CEO/Chair's report/message (88%). Digging deeper, the report found that 16% of shareholders read the annual report in detail and 73% read key parts/skim all sections of the annual report. Only 10% of shareholders said that they do not read annual reports.

Conclusions?

- The report found that retail investors, like regulators, institutional investors and customers also desire for increased transparency and higher standards of honesty. 'Corporations need to be aware that the onus now lies squarely on them to not only disclose what is legally required, but to actually conceive of what else might be relevant to report' the report comments. As such, the research 'challenges a number of the myths you hear about investor behaviour. For example, the traditional view of retail investors is they're there to book gains and little else. This new …research confirms just what a myth this is'.

- Heightened expectations, with respect to behaviour and quality of reporting, pose challenges for boards and for management particularly with respect to communication. Effective communication is identified as key to rebuilding trust. Companies need to communicate effectively and honestly and ensure the most relevant information is prioritised and understood. With respect to executive remuneration, the report comments that the 'core point for boards is you can't fudge the issue. The best way to convince investors your executive packages are connected to your strategic purpose and reasonable is to ensure that they genuinely are'. The report suggests that 'boards need to focus on ensuring a culture of transparency permeates the organisation' in order to meet this challenge. In addition, it's suggested that boards need to 'get better at listening' to customers and to stakeholders more generally.

About the survey: KPMG Acuity conducted a nationwide online survey of 1,510 Australian retail shareholders between March and April 2019, asking them about what is important to them when making investment decisions.

[Sources: KPMG media release 05/09/2019; KPMG report: Shareholder value: Shareholder values September 2019; Investor Daily 09/06/2019; [registration required] The Australian 05/09/2019; [registration required] The SMH 05/09/2019]

Insights from UK FRC Chair Sir Win Bischoff on the theme of rebuilding trust and the role of strong governance in this context: Speech to the Governance Institute of Australia National Conference

Key Takeouts

- **Culture of accountability (the role of boards in challenging management):** Sir Win said that he agrees with Commissioner Hayne that boards bear ultimate responsibility for corporate conduct (misconduct) and that in order to be successful, boards 'should not be comfortable places all the time. Only through effective debate can issues be resolved'. This is especially the case, he suggested when key decisions are being made.

- **Five questions for boards to consider in the context of setting/monitoring long-term strategy:** 1) 'Are we playing an active role in shaping long-term investment plans to underpin delivery of our strategy and value creation? 2) What behaviours are required given the financial targets we set? 3) How competent is our management to deliver the strategy? 4) How does executive remuneration link to our strategy and KPIs? and 5) Are we thinking long-term or are we simply extending one-year budgets to the medium term?'

- **Remuneration:** Sir Win emphasised that remuneration committees should focus on the strategic rationale for executive pay and the links between remuneration, strategy and long-term sustainable success and work to simplify the structure of remuneration policy. He said that 'where performance-based incentive plans are used, the choice of a range of financial, nonfinancial and strategic measures can help ensure that targets are aligned with value over the long-term. Metrics need to be reliable and credible to satisfy shareholders, and their purpose should be explained'.

- **Reform of the audit sector?** Commenting on the recent Kingman review, Sir Win observed that some stakeholders had suggested that there is a case for introducing something similar to the US Sarbanes-Oxley (SOX) regime into the UK audit market as a means of increasing assurance around internal controls. Sir Win said that that the '[pros and cons of such a regime should at least be considered, and then consulted upon, paying special attention to proportionality'

- **Promoting active stewardship:** Sir Win said that the new Stewardship Code, which is 'largely completed' though as yet unpublished, 'demands that fund managers not only explain their policies, but also then report on the outcomes they have achieved'. He observed that this 'proposed major change, the disclosure of outcomes, rather than spelling out policies only, will be far-reaching and should allow clients and customers to make better informed and differentiated judgements on the distribution of their fund management mandates'

- **Climate change:** Commenting specifically on the issue of climate change, Sir Win said that 'it is a defining issue of our time and presents far-reaching primary, secondary and tertiary financial risks' which should be reflected in reporting.

Overview | Keynote address by Sir Win Bischoff to the Governance Institute of Australia's National Conference: The not-so-secret path to longevity of business success

In his keynote address to the Governance Institute National Conference, UK Financial Reporting Council (FRC) Chair Sir Win Bischoff spoke on the topic of respect, trust and challenge (which was also the title of the conference). Reflecting on his five years as Chair of the UK Financial Reporting Council Sir Win looked back on the changes in attitude in corporate governance and in stakeholder engagement, as well as in regulation over the period and outlined some of the work the FRC has done to promote strong governance and stewardship. Sir Win emphasised that 'without respect, you cannot achieve trust. To achieve that, boards must be held to account to challenge senior management and the decisions they make for long-term viability of their company. For this challenge to work, it has to be realised that culture is an important factor of business success'.

Some Key Points

- **Measures to promote/support trust in the business sector:** Sir Win described some of the work undertaken by the FRC to strengthen corporate governance and in so doing, rebuild/promote trust in the business sector in the wake of the global financial crisis and in the wake of a number of high profile corporate failures. These measures include the revision of the UK Corporate Governance Code and the release of updated guidance on board effectiveness. Sir Win said that the revised Corporate Governance Code 'emphasises the importance of building trust by forging strong relationships with key stakeholders. Boards should be more transparent about their pay policies and how they link them to company culture and behaviours. The Code also introduces alternatives for engaging with the workforce. Employees should be satisfied that their views have been noted and how they have been dealt with' .

[Note: Following consultation, the Financial Reporting Council (FRC) released a revised 'shorter, sharper' Corporate Governance Code on 16 July 2018. The final version, appears to be largely consistent with the version circulated for consultation in December of 2017. For a summary of the consultation see: Governance News 15/12/2017. For a summary of the post-consultation changes (which clarify FRC expectations with respect to the respective roles of the board and remuneration committee and FRC expectations of workforce engagement and to provide more 'flexibility' in meeting some requirements) see: Governance News 23/07/2018.]

- **Observations on culture, regulation and the audit market:** Sir Win observed that the UK audit sector is under 'particular scrutiny' at present and briefly outlined the three separate, but linked reviews into the sector: the Kingman Review, the Competition and Markets Authority review into competition in the audit sector and the Brydon Review (which is ongoing and due for completion by December).

  - **SOX 'lite' should be considered?** Commenting on the Kingman review, Sir Win observed that some stakeholders had suggested that there is a case for introducing something similar to the US Sarbanes-Oxley (SOX) regime into the UK audit market as a means of increasing assurance around internal controls. Sir Win commented that the '[pros and cons of such a regime should at least be considered, and then consulted upon, paying special attention to proportionality'.

  - **Parallels between the FRC and the Australian Prudential Regulation Authority (APRA)?** Sir Win also drew a parallels between calls for the FRC to be more transparent about the outcomes of annual audit quality/corporate reporting reviews, and to act more swiftly and transparently when resolving complaints, and the findings of the Hayne Commission with respect to the Australian Prudential Regulation Authority (APRA).

- **Ultimately boards bear responsibility for corporate conduct (and misconduct):** Finally, Sir Win observed that culture was a theme of both Commissioner Hayne's final report and the Kingman review and expressed support for the view put forward in Commissioner Hayne's final report, that ultimately boards bear responsibility for corporate conduct (and misconduct) and that this must have consequences for the board's role, priorities and accountability. 'This robust challenge, not surprisingly, is already increasingly being required of boards in financial services and is something I strongly endorse. It seems to be working in that industry and deserves applicability more generally' Sir Win said. He added, 'As a side comment, while auditors are blamed in many quarters for the failure of companies, the prime responsibility must lie with a company's board of directors and its management. Yes, auditors need to be more sceptical and consistent, but theirs is likely to be a contributory rather than prime factor in any corporate failure. Let me hasten to add that this does not excuse auditors' shortcomings!'

- **Measuring corporate culture?** Sir Win observed that when the FRC published its report in 2016 on Corporate Culture and the Role of Boards, one of its key findings was that any indicators and measures should be aligned to desired outcomes and should be material to the business. He suggested that a range of measures could be used as benchmarks for the 'temperature of an organisation when measuring corporate culture' eg employee surveys, exit interviews, whistleblowing reports and their outcomes, net promoter scores, and staff turnover rates. This data, he observed, is in fact already being gathered by corporations, but is 'simply are not made enough use of'.

- **Non-financial metrics play an increasingly important role in investor decision making:** Sir Win said that the work done by the Financial Reporting Lab has identified that non-financial information, whatever it is labelled — ESG, pre-financial information, wider metrics, non-financial or extra-financial metrics — are playing an increasingly important role in investor decision making. Further he said that the Lab identified that boards/management gain credibility where they are willing to discuss and disclose 'what they are doing in the area of ESG'. Sir Win went on to observe that presently investors feel they do not receive sufficient information and in particular, have asked for more data around which nonfinancial metrics are being monitored and managed by boards. Commenting specifically on the issue of climate change, Sir Win said that 'it is a defining issue of our time and presents far-reaching primary, secondary and tertiary financial risks'. Sir Win said that the 'FRC's expectation in this area is clear – boards should address, and where relevant report on, the effects of climate change. Reporting should set out how the company has taken into account the resilience of the company's business model, and the risks, uncertainties and viability in both the immediate and longer-term in light of climate change. Also, how the company intends to respond to climate change, and how climate change has been considered in its strategic planning'. Sir Win added that the FRC has been that 'impressed to see some of the activity from Australian regulators, and Australian investors and in the AASB/AuASB statement around climate change and materiality'.

- **The role of boards in challenging CEOs:** Sir Win observed that 'boards, of course, should regularly challenge the CEO and his executive committee's views. Group-think occasionally does, but should not influence how key decisions are made. Rather, long-term thinking should be the lode-star…Successful boards should not be comfortable places all the time. Only through effective debate can issues be resolved'. Sir Win went on to say that this only becomes more important where big decisions need to be made, 'hubris and complacency are the enemy! It is natural for board members, including the non-executives, to bathe in the success of their company. While understandable, that can lead to disaster. All chairs, and indeed many directors at some time or the other, have had to fight against these instincts' he said.

- **Remuneration**: Observing that the issue of executive remuneration is a critical issue for shareholders in many parts of the world, Sir Win said that the FRC used the recent update of the UK Corporate Governance Code to strengthen the role of the remuneration committee. 'Most critically, however, Remuneration Committees should focus on the strategic rationale for executive pay and the links between remuneration, strategy and long-term sustainable success. They should also work to simplify the structure of the remuneration policy' Sir Win said. He went on to observe that 'where performance-based incentive plans are used, the choice of a range of financial, nonfinancial and strategic measures can help ensure that targets are aligned with value over the long-term. Metrics need to be reliable and credible to satisfy shareholders, and their purpose should be explained'.

[Note: Principles P-R and Provisions 32-41 of the revised UK Corporate Governance Code deal with the issue of remuneration. Among other things, the new Code emphasises that remuneration committees should take into account workforce remuneration and related policies when setting director remuneration (see, provision 33 at p13).]

- **The boards role in setting strategy — five questions for boards to consider:** Sir Win said that he considers that culture and strategy are not separate, but 'symbiotically intertwined'. 'An effective board defines the company's purpose and then sets a strategy to deliver it, underpinned by the values and behaviours that shape its culture and the way it conducts its business'. He added that though strategy should be kept under review, to ensure competing demands are appropriately balanced, it is by its nature 'long term' and therefore does not require making short term changes to 'satisfy fashion or investor preferences'. He also listed a number of 'key attributes' directors should consider in the context of strategy discussions. Namely: 1) 'Are we playing an active role in shaping long-term investment plans to underpin delivery of our strategy and value creation? 2) What behaviours are required given the financial targets we set? 3) How competent is our management to deliver the strategy? 4) How does executive remuneration link to our strategy and KPIs? and 5) Are we thinking long-term or are we simply extending one-year budgets to the medium term?'

- **The role effective investor engagement plays in good governance:** Sir Win said that good governance can be 'kept under review' by effective investor engagement, and that promotion of investor engagement is a key focus of the recent consultation on proposed revisions to the UK Stewardship Code. Sir Win said that the new Stewardship Code, which is 'largely completed' though as yet unpublished, 'demands that fund managers not only explain their policies, but also then report on the outcomes they have achieved'. He observed that this 'proposed major change, the disclosure of outcomes, rather than spelling out policies only, will be far-reaching and should allow clients and customers to make better informed and differentiated judgements on the distribution of their fund management mandates'.

[Note: As part of its broader response to the Financial Services Royal Commission, The Australian Council of Superannuation Investors (ACSI) recently has released a policy paper outlining two proposals to strengthen investment stewardship in line with global best practice and in line with growing ESG expectations. For a summary of ACSI's proposals see: Governance News 08/05/2019]

- **Extending governance Code like principles to larger private/non-listed companies:** As part of the broader review of the UK's corporate governance framework over the past 12 months, Sir Win noted the release of the Wates Principles (see: Governance News 17/12/2018). The Principles, he observed, form part of the broader governance framework and recognise the 'important economic and social contribution made by larger private companies.' More particularly, Sir Win noted that the Wates Principles suggest larger private companies take into account issues such as company culture and purpose, board diversity and dialogue with wider stakeholders (consistent with their own particular circumstances) as public companies should do. Sir Win said that Larger Private Companies will begin to report on their governance arrangements from 2020 and that before then, the FRC will give increased prominence to the Principles to ensure they are successful in achieving the requisite governance in private companies. He added that the Wates Principles, are expected to develop over time (just as the Governance Code has done).

- **Regional governance initiative?** Sir Win described a governance initiative involving five European countries (France, Germany, the Netherlands and the UK) meeting annually to discuss developments in their own countries, comparing best practice and highlighting similarities. He suggested that this might provide a potential blueprint for a similar initiative in our region. 'There is more that companies in Asia have in common, than divides them, and I believe an initiative along these lines involving say Australia, Japan, Singapore and Hong Kong as a start might prove productive' he said.

[Source: Sir Win Bischoff Chair, Financial Reporting Council, Speech to the Governance Institute of Australia's National Conference, The not so secret path to longevity of business success]

BHP will reportedly review its membership of lobby groups in response to investor pressure

Background: As previously reported in Governance News (4/09/2019) a shareholder resolution calling for BHP to review its membership of industry associations including (among others) the Minerals Council of Australia was recently filed by the Australasian Centre for Corporate Responsibility (ACCR). The group is reportedly concerned that the industry groups' lobbying efforts are inconsistent with the goals of the Paris agreements and with BHP's climate stance.

BHP to review its membership of industry associations? Reportedly, BHP has advised shareholders to vote against the ACCR resolution on the basis that industry associations are important in 'advancing the development of standards, best practice and constructive policy…the resolution makes no reference to the broader benefits that industry associations can provide.'

However, The FT reports that BHP has nevertheless committed to review its industry association memberships. According to the FT, BHP will use the same methodology as its December 2017 industry membership review. The FT quotes BHP as stating that 'The review includes comparison of the positions taken by relevant industry associations since January 2018 as against the position held by BHP in climate and energy policy…The board is being updated in relation to the review and will endorse the outcomes.'

[Sources: [registration required] The FT 06/09/2019; [registration required] The Australian 06/09/2019]

In Brief | The AFR reports that Medibank will exit the Business Council of Australia in the interests of cost cutting. The AFR comments that decision comes as the BCA faces increasing pressure from conservation groups over its climate stance

[Source: [registration required] The AFR 04/09/2019]

In Brief | MSCI has announced that its subsidiary, MSCI Barra (Suisse) Sàrl, will acquire Zurich-based environmental fintech and data analytics firm, Carbon Delta AG, a 'global leader' for climate change scenario analysis. MSCI and Carbon Delta plan to create 'an extensive climate risk assessment and reporting offering for the institutional market', providing global investors with solutions to help them better understand the impact of climate change on their investment portfolios and comply with mandatory and voluntary climate risk disclosure initiatives and requirements

[Sources: MSCI media release 09/09/2019]

Financial Services

Top Story | Loan and swap structuring in a low interest rate environment

The focus on negative interest rates has sharpened in recent months in Australia with back to back RBA interest rate reductions, and signposting of further reductions to come. MinterEllison's John Elias has written an article highlighting the risks of a low interest rate environment and providing practical insights into how to assess if there is an issue, and some possible solutions.

The full text of the article is available on the MinterEllison website here: https://www.minterellison.com/articles/loan-and-swap-structuring-in-a-low-interest-rate-environment

The government is consulting on a proposed model to implement an industry-wide deferred sales model for add-on insurance products (excluding policies of comprehensive motor insurance) in response to recommendation 4.3 of the Financial Services Royal Commission

Context: On 4 February 2019, the government responded to Financial Services Royal Commission Recommendation 4.3 (no 'hawking' of insurance) by agreeing to implement an industry wide deferred sales model for add-on insurance products. The government's implementation roadmap released on 19 August indicated the government's intention to consult on/introduce legislation to implement the recommendation by 30 June 2020 (see: Governance News 21/08/2019). Treasury has now released a consultation paper outlining a proposed model.

The objective of the proposed model

The objective of the proposed deferred sales model is to 'promote informed purchasing decisions' by introducing an enforced pause in the sales process between the purchase of a primary product and their decision to purchase add-on insurance. This deferral period is intended to enable/encourage consumers to consider the merits of the add-on insurance being offered and to consult alternate providers.

In recognition of the diversity of add-on insurance products available and the varying degrees of consumer harm they may cause, the government proposes a tiered approach to enable different categories of product to be regulated differently.

What is 'add on insurance'?

The paper notes that there is no existing statutory definition of 'add on insurance. The majority of products fall under the definition of 'general insurance' in the Corporations Act 2001 (Cth).

For the purposes of the proposed model, add-on insurance is intended insurance sold 'as "additional" to a primary product or financing agreement' and is offered/sold at the same time as when a consumer purchases the primary product/enters into the financing agreement.

It's proposed that 'add-on insurance' sold in a standalone market would remain outside the scope of the model. This is intended to encourage consumers to consider and compare insurance offered in the standalone market, and to enable decision-making about insurance to occur outside of high-pressure sales environments.

Which products will the deferred sales model apply to? A three tiered approach is proposed

The paper proposes a 'tiered' deferred sales model to ensure that add-on insurance products sold or offered at the same time as their associated primary products or financing agreements are automatically subject to a deferred sale.

- **Tier one products (products causing significant consumer detriment):** Tier one will be reserved for the most 'egregious add-on insurance products where there is evidence of significant consumer detriment (eg poor value for consumers in terms of claims ratios and widespread unfair sales practices) and will be regulated through the Australian Securities and Investments Commission's (ASIC's) existing product intervention power.

- **Tier two will be the 'default tier' for all add-on insurance products (not in tiers 1 or 3).**

- **Tier three (case by case exemptions):** It's proposed that this category will capture products which ASIC deems to be appropriate for an exemption from deferred sales requirements. This is intended, to 'protect consumers where the benefits of being able to purchase add-on insurance immediately outweigh the benefits of deferring the purchase'. The government proposes the following criteria for tier three add on insurance products: historically good value for money; strong competition; high risk of underinsurance; well understood by consumers'. The paper adds that there are 'also other products that may need to be exempted from deferred sales requirements, such as add-on insurance required under law as a condition of the primary product purchase' and that the government has also agreed to exempt policies of comprehensive car insurance.

Feedback sought on which products should fall into which tier: Feedback is sought on why a particular type of add-on insurance product should be classified under a particular tier. The consultation paper suggests that this could include details of the sales process, claims ratios and distribution channels for different add-on insurance product lines. The paper specifies that 'As per Commissioner Hayne's final report, exemptions should only arise where there is overwhelming quantitative evidence of product value and consumer understanding'.

When and how will the deferred sales model apply to Tier 2 products?

Under the government's proposal for the tier two deferred sales model, the deferral period would be triggered by the consumer making a 'concrete' financial commitment (eg paying a deposit or making an application for finance) to purchase the primary good/service and/or arranging finance, and by the retailer providing prescribed information about the add-on insurance product (including details of the deferral period). This 'trigger event' the paper explains is intended to ensure that the deferral period commences only after consumer has made a concrete decision to purchase or acquire the primary product.

The government proposes that the format, content and mode of delivery of the prescribed information be determined by ASIC.

It's proposed that the 'tier two' deferred sales model will operate neutrally across all sales channels, including intermediaries, external sellers, and online.

[Note: Figure 2 at p11 of the proposal outlines how the deferred sales model is intended to operate.]

Feedback sought on how the proposed 'trigger event' corresponds to 'current business practices in selling add-on insurance products'. The paper suggests that this could include information on the number and frequency of customer touchpoints in the sales process and/or at what point in the process financial commitments are typically made by consumers.

Proposed four day deferral period (with flexibility for consumers to shorten it to one day)?

The government proposes a deferral period of four days for the tier two deferred sales model. At the conclusion of the deferral period, the government proposes that the intermediary or the insurer will be able to contact the consumer via written correspondence, but only on one occasion. This is to ensure that the four day period does not simply defer the mis-selling that could otherwise have occurred at the time of sale.

The government also proposes that, consistent with the UK's deferred sales model for GAP insurance, the sale of an add-on insurance product can be concluded the day after the deferral period has commenced 'if, and only if, the customer initiates completion of the sale. A customer initiating contact with the add-on distributor indicates engagement with the sales process and a deliberate purchasing decision'.

Further, the government considers there could be an option for the consumer to reject the sale entirely during the deferral period.

Enforcement?
It's proposed that ASIC be responsible for monitoring and enforcing the deferred sales regime. The government proposes that 'criminal, civil and administrative penalties will be introduced for breaches of the deferred sales model'.

Timing and next steps? The deadline for submissions on the proposed model is 30 September. The government plans to consult on and introduce legislation by 30 June 2020 to implement the model.

The Government proposes providing a period of time between: the passage of legislation and the date when providers of tier two products will be expected to comply with the deferred sales model's requirements to enable ASIC to assess applications for products to be exempt and to give certainty to entities about which tier their add-on insurance resides in.

[Source: Treasury media release 09/09/2019; Proposal paper: Reforms to the sale of add-on insurance products 09/09/2019]

Still a live issue? ASIC has filed an appeal against the recent responsible lending test case against Westpac

Revised casenote: MinterEllison's original casenote on the decision in Australian Securities and Investments Commission v Westpac Banking Corporation (Liability Trial) [2019] FCA 1244 has been updated to reflect ASIC's announcement that it has filed an appeal. The revised casenote can be accessed on the MinterEllison website here: https://www.minterellison.com/articles/summary-responsible-lending-test-case-asic-v-westpac

Some key points to note

On 10 September, the Australian Securities and Investments Commission (ASIC) announced that it had filed an appeal with the Full Federal Court against the decision in Australian Securities and Investments Commission v Westpac Banking Corporation (Liability Trial) [2019] FCA 1244.

ASIC Commissioner Sean Hughes said that ASIC filed an appeal because it 'considers that the Federal Court's decision creates uncertainty as to what is required for a lender to comply with its assessment obligation, nor does ASIC regard the decision as consistent with the legislative intention of the responsible lending regime'.

[Note: ASIC's notice of appeal available on the ASIC website here provides further detail].

Broader context: ASIC's consultation on updated responsible lending guidance

ASIC is currently consulting on updates to its responsible lending regulatory guidance – Regulatory Guide 209: Credit licensing: Responsible lending conduct. (see: Consultation paper - CP 309; Update to RG 209: Credit licensing: Responsible lending conduct; for a summary see: Governance News 20/02/2019).

ASIC writes that during recent public hearings on the issue, industry representatives, consumer groups, academics and service providers indicated they would appreciate the guidance including further clarification to support compliance (eg the inclusion of additional case studies and examples). In addition, ASIC notes that industry supports the continuation of guidance giving licensees flexibility.

ASIC says that it intends to publish an updated RG 209 by the end of the year.

[Sources: ASIC media release 10/09/2019; [registration required] The AFR 10/09/2019]

Consumer groups support the appeal: Writing ahead of ASIC's announcement, Fiona Guthrie (CEO of Financial Counselling Australia) and Gerard Brody (CEO of the Consumer Action Law Centre), said that 'The judgment has effectively neutered the responsible lending laws, just six months after a banking royal commission that called for a tougher approach…[there is a] need to rise to Commissioner Hayne's challenge and ensure the laws work as intended' they write.

[Source: [registration required] The Age 10/09/2019]

Why not litigate (again)? The Australian Securities and Investments Commission (ASIC) has commenced proceedings against Bendigo and Adelaide Bank and separately, against the Bank of Queensland over (alleged) unfair small business loans

The Australian Securities and Investments Commission (ASIC) has commenced proceedings against Bendigo and Adelaide Bank and separately, against the Bank of Queensland over (alleged) unfair small business loans.

MinterEllison has prepared a summary, including insights into the possible business impact, which can be accessed on the MinterEllison website here: https://www.minterellison.com/articles/asic-announces-uct-test-case-against-bendigo-and-adelaide-bank

Should penalties be in place for breach of UCT provisions?

Referencing the Australian Securities and Investment Commission's (ASIC's) action against Bendigo and Adelaide Bank, and separately against the Bank of Qld (discussed in the post above), the AFR reports that Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Kate Carnell, has said that the case supports ASIC's calls for the introduction of penalties for breach of unfair contract terms (UCT).

'You can't have the scenario where companies game the system until somebody takes action because the ramifications [of keeping the terms in contracts] are not that bad…I don't think institutions leaving clauses in contracts which are not in line with laws, until they are actually taken on, meets community expectations of what we expect' Ms Carnell is quoted as saying.

The AFR suggests that following the release of draft legislation proposing to extend unfair contract protections to standard form insurance contracts, insurers are on notice to review their contracts.

[Note: An exposure draft of Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019 was released for consultation on 30 July. The draft Bill proposes to enable the UCT regime to apply to insurance contracts covered by the Insurance Contracts Act where at least one party to the contract is a consumer or a small business and the contract is a standard form contract. The draft Bill also proposes tailor the existing UCT regime in its application to insurance contracts. Consultation ended on 28 August. For a summary see: Governance News 30/07/2019]

[Source: [registration required] The AFR 06/09/2019]

ASIC takes action on FSRC insurance case study: ASIC has commenced proceedings in the Federal Court against Select AFSL for (alleged) breaches of the law arising from phone sales of life and accidental injury insurance

The Australian Securities and Investments Commission (ASIC) has commenced civil proceedings in the Federal Court alleging breaches of the law arising from telephone sales of life and accidental injury insurance by AFSL Pty Ltd (Select), BlueInc Services Pty Ltd (BlueInc), Insurance Marketing Services Pty Ltd (IMS) and director Russell Howden. The action follows Select's appearance before the Financial Services Royal Commission last year.

[Note: For Commissioner Hayne's discussion of what he considers 'the Select case study showed', see: Financial Services Royal Commission Interim Report, Volume 2 at pp466-470. For an overview of the possible open findings identified by Counsel see: Governance News 16/07/2019]

ASIC's allegations

ASIC alleges that in their dealings with 14 consumers (12 of whom were allegedly 'vulnerable'), Select, BlueInc and/or IMS, engaged in conduct in breach of provisions of the Australian Securities and Investments Commission Act 2001 (Cth), including: unconscionable conduct when selling insurance and/or taking payment details over the phone, and when consumers attempted to cancel their insurance policies; undue harassment; coercion; and/or making false and/or misleading representations.

ASIC's also alleges that Select, BlueInc and Mr Howden breached provisions of the Corporations Act 2001 (Cth) in relation to the provision of conflicted remuneration to sales agents.

[Note: Schedule 1 of the Concise Statement which is available on the ASIC website here, summarises ASIC's allegations.]

Relief sought?

ASIC is seeking declarations, civil penalties, injunctions, advertising orders, probation orders requiring implementation of a compliance program and consumer redress against the companies.

Against Mr Howden, ASIC is seeking declarations, civil penalties, injunctions and disqualification orders.

Broader context: ASIC consultation on the proposed ban of unsolicited telephone sales

- On 30 August 2018, ASIC released REP 587 The sale of direct life insurance which summarised the findings and recommendations from ASIC's review of the sale of direct life insurance products including term life, accidental death, trauma, total and permanent disability (TPD) and income protection insurance. Select was one of 11 firms included in that review. Among other things, the report committed ASIC to a range of further actions including enforcement action against individual firms as appropriate, and a ban on outbound sales calls which were linked to particularly poor consumer outcomes. For a summary of REP587 see: Governance News 03/09/2018. In addition, the regulator notes that the action against AFSL Select follows a number of other reviews relating to life insurance.
- ASIC recently consulted on a proposed ban of unsolicited telephone sales of direct life insurance and consumer credit insurance (CCI). The public consultation period closed on 29 August 2019. For a summary see: Governance News 24/07/2019. ASIC states that it is currently reviewing submissions from consumer groups, industry and other interested parties.

[Sources: ASIC media release 09/09/2019; [registration required] The AFR 09/09/2019; InvestorDaily 09/09/2019]

Should banks be required to notify customers that they are outsourcing mortgage application processing to third parties located overseas?

The Courier Mail reports that based on its own investigations, three of the big four banks — ANZ, National Australia Bank and Westpac — use offshore third parties located in China and India to assist in mortgage application processing. Reportedly, this is done to reduce costs.

According to the Courier Mail, in most instances the banks do not alert customers that their information, including personal details and financial data, is being 'shared overseas'.

The Courier Mail quotes University of Melbourne cyber security expert Dr Suelette Dreyfus as saying that it is acceptable for banks to outsource their data checking provided appropriate security is in place. Having said this, Dr Dreyfus also suggested that banks should disclose when documents are being assessed overseas to customers. 'The banks need to come clean and tell customers in a really forthright and honest way who is accessing their sensitive financial information…Data sovereignty is an emerging trend and also knowing where is it stored…we know there is a public mood on better transparency on this stuff. Post the banking inquiry [Financial Services Royal Commission], consumers don't just want to be told "it'll be right" by the banks' Dr Dreyfus is quoted as saying.

Reportedly the banks have responded by confirming that customers' documents are not sent overseas, and instead are accessed by personnel using the banks' secure online portals. In addition, offshore staff can reportedly only access the information in a secure location.

[Source: [registration required] The Courier Mail 07/09/2019]

In Brief | Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Bill 2019 (which proposes to implement the government's response to FSRC recommendation 2.4) has progressed to third reading stage in the House of Representatives

[Source: Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Bill 2019]

In Brief | APRA is consulting on revisions to the capital framework for authorised deposit-taking institutions (ADIs) to implement 'unquestionably strong' capital ratios and the Basel III reforms. More particularly, the regulator has started a second consultation on the requirements of a draft prudential standard that aims to strengthen the framework for interest rate risk in the banking book (IRRBB). APRA is proposing changes to both the capital calculation and the risk management requirements. The deadline for submissions is 6 December 2019. The proposed implementation date of APS117 (once finalised) is 1 January 2022 to align with the Basel Committee's internationally agreed implementation of the risk-based capital framework

[Sources: Response to Submissions - Interest rate risk in the banking book for authorised deposit-taking institutions September 2019; Draft Prudential Standard APS 117 Capital Adequacy Interest Rate Risk in the Banking Book; [registration required] The Australian 05/09/2019]

In Brief | ASIC has extended licensing relief for foreign financial services providers until to March 31, 2020, to allow them to provide 'certain financial services' to Australian wholesale clients without needing to hold an Australian financial services licence

[Sources: ASIC media release 10/09/2019]

In Brief | Treasury is consulting on an exposure draft Bill and Regulations, and supporting explanatory materials proposing to implement 'minor and technical amendments' to the Treasury portfolio laws relating to taxation, superannuation, corporations and credit to correct 'technical or drafting defects', remove anomalies and address 'unintended outcomes'. Consultation closes on 27 September

[Sources: Treasury media release 06/09/2019; Miscellaneous Amendments Bill Exposure Draft; Miscellaneous Amendments Regulations; Miscellaneous Amendments Bill Explanatory Memorandum; Miscellaneous Amendments Regulations Explanatory Statement]

In Brief | Increased competition? Reportedly, 86 400 has become the first publicly available neobank in Australia to offer transaction and savings accounts. APRA has also recently granted Xinja Bank Limited a licence to operate as an authorised deposit-taking institution (ADI) without restrictions under the Banking Act 1959. Xinja Bank Limited was previously licensed by APRA in December 2018 as a Restricted ADI. Reportedly Xinja intends to also offer transactions accounts

[Source: APRA media release 09/08/2019; Yahoo7 09/09/2019; [registration required] The Australian 10/09/2019; Business Insider 10/09/2019]

In Brief | Reportedly Lloyds Banking Group and Barclays have each said that their initial estimates of the cost of compensating customers for missold payment protection insurance (PPI) were too low because they each failed to anticipate the spike in complaints in the run up to the 29 August deadline. Reportedly both lenders will increase provisions accordingly. Lloyds reportedly expects to take another PPI charge of between £1.2bn and £1.8bn in the third quarter, and Barclays expects to put aside between £1.2bn and £1.6bn

[Sources: The Guardian 10/09/2019; Bloomberg 10/09/2019; [registration required] The FT 10/09/2019]

Risk Management

Why does unethical behaviour occur and how can the risk of unethical behaviour most effectively be mitigated? Research from Macquarie Business school identifies considerations leaders should keep in mind

Snapshot | Research paper, The role of risk climate and ethical self-interest climate in predicting unethical pro-organisational behaviour

Key Takeout

To reduce the risk of employee unethical workplace behaviour/a situation in which employees are motivated to behave unethically for the organisation's benefit, leaders should:

1) promote concern for multiple stakeholders such as customers, rather than self-interest;

2) ensure that risk issues and policy breaches are never tolerated, ignored or downplayed;

3) instil 'proactive behavioural norms' for identifying, reporting, analysing, discussing and escalating issues of concern; and

4) ensure that managers throughout the organisation are effective role models and advocates for risk management.

A study by Macquarie Business School — The Role of Risk Climate and Ethical Self-interest Climate in Predicting Unethical Pro-Organisational Behaviour — led by Professor Elizabeth Sheedy, Patric Garcia and Denise Jepsen investigates the links between a climate/culture in which employees perceive that the organisation implicitly condones self-interested behaviour (ethical self-interest climate (ESI)) and the impact of four aspects of risk culture on unethical pro-organisational behaviour (UPB).

What is unethical pro-organisational behaviour (UPB)? UPB is a particular type of employee unethical workplace behaviour that benefits the organisation, but is not part of the formal job requirements. In some organisations, employees may be motivated to behave unethically for the organisation's benefit. Examples include: manipulating accounts to overstate financial results, or selling to vulnerable customers who neither understand nor need the products being sold to the them. The researchers note that despite focus on reducing the risk of this kind of behaviour since the global financial crisis, it continues to occur.

Key conclusion: The research found, based on analysis of the surveys of three superannuation fund employees, that there is a link between a climate/culture in which employees perceive that the organisation does not condone self-interested behaviour (low rates of ESI) and low rates of avoidance (ie the perception that risk issues and policy breaches are ignored, downplayed or excused) and reduced risk of UPB. That is, that both risk and ethical climates have a role to play in reducing UPB risk.

How can the risk of unethical pro-organisational behaviour (UPB) best be addressed? From a practical perspective, the researchers conclude that to reduce the risk of unethical pro-organisational behaviour, leaders should focus on building workplace climate (culture) that is low in self-interest and that encourages employees to consider external stakeholders. More particularly, they identify four key messages for senior leaders to focus on, to help mitigate the UPB risk. Leaders should: 1) promote concern for multiple stakeholders such as customers, rather than self-interest; 2) ensure that risk issues and policy breaches are never tolerated, ignored or downplayed; 3) instil 'proactive behavioural norms' for identifying, reporting, analysing, discussing and escalating issues of concern; and 4) ensure that managers throughout the organisation are effective role models and advocates for risk management.

Implications? The researchers argue that the findings have implications for performance measurement and reward mechanisms, for employee/manager training programs, for resourcing of the risk function, and for organisational communications including statements of organisational value.

[Sources: Sheedy, Elizabeth A. and Garcia, Patrick and Jepsen, Denise, The Role of Risk Climate and Ethical Self-interest Climate in Predicting Unethical Pro-Organisational Behaviour (July 22, 2019). Macquarie Business School Research Paper. Available at SSRN: https://ssrn.com/abstract=3425675 or http://dx.doi.org/10.2139/ssrn.3425675; Financial Standard 05/09/2019; [registration required] The AFR 04/09/2019]