Governance News

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Contents

Diversity

Some (slow) progress? The number of women on boards globally is on the rise, but boards appear to be drawing on the same pool of female directors according to MSCI report

Report overview | MSCI report, Women on boards: 2019 progress report

MSCI has released its annual update on the state of women's representation on boards. The report is based on analysis of the board and executive management structure at 2,765 companies (constituents of the MSCI ACWI Index) as of October 31, 2019.

Some Key Findings

- **2019 saw some (slow) progress:** MSCI found that women accounted for 20% of director roles in 2019 (up from 17.9% in 2018 and 17.3% in 2017). This shift was driven primarily by Japanese firms (45% of Japan-based firms in the study had all male boards in 2018 compared with 33% in 2019). MSCI predicts that at the current pace, a 50/50 gender split among global directors is possible by 2044.
- **The number of majority female boards has increased**: The number of companies with majority female boards doubled in 2019 compared with 2018. However, MSCI comments that these 22 firms accounted for fewer than 1% of the companies in the study. 98.7% of the boards remained male-dominated.
- **Gender quotas?** Companies based in jurisdictions with mandatory quotas attained greater overall gender diversity at the board level, with 71.8% having at least 30% female directors as at 31 October 2019 and 57.3% exceeding quota requirements. Of the companies in the study, Italy and France had the highest percentage of companies with more women board members than required under the quota. By contrast, MSCI found that non-compulsory targets were less correlated with gender diversity. MSCI qualifies this by noting given the small number of countries with mandatory quotas and the limited historical data, it is not possible to draw any conclusions on what may be driving companies to exceed mandatory quotas.
- **The technology sector appears to be focused on gender diversity.** The technology sector had the highest increase (12.8%) in the number of companies with three of more female directors since the last report. In 2018, 15.5% of companies in the technology sector had three or more female directors. In 2019 this increased to 28.3%.
- **Overboarding:** More women (22%) than men (12%) were overboarded (serving on three or more boards) globally and further, that this dynamic was present in countries in which quotas apply. MSCI suggests that this finding 'may imply that despite the broad availability of educated and experienced female professionals, some companies have continued to rely on a limited pool of candidates.

[Sources: MSCI report: Women on boards: 2019 progress report; [registration required] The FT 16/12/2019]

Only 12 months late? There are more than 30% female directors on ASX 200 boards for the first time

The Australian Institute of Company Directors (AICD) has announced that the voluntary target set in 2015 for 30% of directors on ASX 200 boards to be women by the end of 2018 has now been reached.

Snapshot

Female directorship (as at 30 November 2019):

- **Larger companies are leading the way on board diversity** with women accounting for 35.2% of the ASX 20 board positions, 33%of ASX 50 positions, and 31.8% of ASX 100 roles
- **The ASX 200 has (overall) cracked the 30% target for the first time**, with women accounting for 30% of board roles, though there are still seven companies in the ASX 200 with all male boards
- **Smaller companies have some way to go?** In the ASX 300, women account for 27.7% of board roles, decreasing to 24% in the ASX All Ords

Commenting on the findings AICD CEO and Managing Director, Angus Armour said that 'while the target was reached later than planned, this is a great achievement. We should celebrate the progress that has been made, which is evidence that meaningful change can be achieved through voluntary targets. It is clear that Australia's largest companies see the value of board diversity; a diverse mix of views and perspectives around the table increases board performance and reduces the risk of group think'.

He added that the ASX 100 should be applauded for leading the way and surpassing the 30% target.

Job is not yet done?

30% Club Australia Chair, Nicola Wakefield Evans welcomed the progress and the efforts of senior chairs, directors, executive search firms, fund managers, investors and advocates in achieving it.

However, Ms Wakefield emphasised that there is more work to be done. 'While this is significant step in our journey, it's important to remember that 30 per cent is the floor, not the ceiling – so while we applaud the ongoing hard work of each board that is addressing gender diversity, we will ensure there is continued pressure on those who don't, to continue increasing the number of female directors.'

Mr Armour expressed a similar view stating that the challenge now 'is to stay focused and maintain momentum' and for smaller companies to also 'demonstrate' that they are 'committed to the benefits of diversity'.

A stepping stone to a 40% target?

Commenting in the Australian, BWP Management director Alison Quinn is quoted as calling for a 40% target. 'It would be great to see the thresholds being pushed higher than 30 per cent…The 30 per cent should be a floor to take the next step to 40 per cent.'

[Sources: AICD media release 19/12/2019; [registration required] The AFR 19/12/2019; [registration required] The Australian 19/12/2019]

Related News: slipping backwards gender diversity more broadly?

The World Economic Forum's 2020 Global Gender Index has ranked Australia overall at 44 out of 153 countries and fourth in the East Asia and Pacific region, behind New Zealand (ranked 6th globally), the Philippines (16th globally) and Lao PDR (43rd globally).

All in all, Australia has only closed 73% of the gap between men and women, having dropped five places in two years.

[Source: World Economic Forum media release 19/12/2019; Gender Index 2020]

In Brief | Women outnumber men on US payrolls for the first time since 2010 accounting for 50.4% of jobs. The increase is attributed to the growth in female dominated sectors such as health care and education which are adding jobs (many of which are low paid/part time)

[Sources: Fortune 13/01/2020; [registration required] The WSJ 10/01/2020]

Remuneration

United Kingdom | High Pay Day 2020: FTSE 100 CEOs pay has already surpassed the amount an average worker earns in a year

According to the High Pay Centre, 'high pay day' — the day on which FTSE 100 CEO pay surpassed the amount earned by an average full time employee over a year — fell on 6 January.

Some Key Points:

- FTSE 100 CEOs starting work on Thursday 2 January 2020 only needed to work for three days (33 hours) until just before 17.00 on Monday 6 January to match average worker pay for a year
- By the end of the year, FTSE 100 CEOs will earn 117 times the annual pay of the average UK worker (as compared with 133 times last year).

- In 2018 (latest available data) the average FTSE 100 CEO earned £901.30 an hour (equivalent to £3.46 million a year). By contrast, the average full-time worker took home an annual salary of £29,559 in 2018, equivalent to £14.37 an hour.

CEO pay predicted to be a key issue in 2020?

The High Pay Centre predicts that CEO pay will again be a key issue in 2020, as this is the first year that publicly listed firms with more than 250 UK employees are required to disclose the ratio between CEO pay and the pay of their average worker. Under changes to the Companies Act (2006), firms must now provide their CEO pay ratio figures and a supporting narrative to explain the reasons for their executive pay ratios.

The High Pay Centre comments that 'CEOs are paid extraordinarily highly compared to the wider workforce, reflecting an approach to business that has made the UK one of the most unequal countries in the developed world. If we want to raise incomes for low and middle earners, measures that will enable them to get a fairer, more proportionate share of the spend on pay distributed by big companies will be of critical importance'.

The FT quotes UK Business Secretary Andrea Leadsom as saying that the figures will be 'eye-watering for the vast majority of hard-working people across the UK. The numbers are better than they were . . . but the situation is still concerning, especially in those cases where executives have been rewarded despite failing their employees and customers.' Ms Leadsom reportedly went on to say that the new reporting requirement will 'increase transparency around how directors meet their responsibilities and future plans to ensure companies cannot shy away from required reporting on executive pay'.

[Sources: High Pay Centre 05/01/2020; [registration required] The FT 06/01/2020]

Related News

No relationship between highly paid CEOs and future profit?

Noting arguments that paying CEOs more may be required/justified given the expanded role of CEOs and the increased challenges associated, the FT questions whether this is actually the case.

Citing an (unnamed) study from Vlerick Business School, the FT questions whether there is any relationship between paying CEOs more, and profitability. Reportedly, the research concludes that 'better performing firms do not pay their CEOs more', rather it is profit performance, not share prices, that determine long-term investment returns and job creation.

On this basis, the FT suggests that linking CEO pay to future profit is more likely to deliver results, than new backward-looking disclosure requirements.

[Source: [registration required] The FT 07/01/2019]

Not a question of quantum per se, but rather a question of making pay fairer?

Writing in The Conversation, University of Bristol Teacher Tobore Okah-Avae outlines some of the reasons behind the widening gap between employee and executive pay including the rise of shareholder primacy (measuring a company's success by its share price, and linking this to executive but crucially not, to employee pay), the impact of globalisation, rapid automation and the subsequent loss of worker bargaining power.

He argues that the wide differential between CEO and average pay touches on wider social concerns around growing inequality in society more generally and the idea that modern companies enrich top executives at the expense of everyone else..

Mandating an 'appropriate' gap between the lowest wage and the highest wage within companies? He observes that UK efforts to address the issue rely on transparency to drive change, but that a further and 'more controversial step' would be to introduce caps on executive pay.

More particularly, he suggests that indexing executive pay to the lower earnings within the firm ie setting an appropriate gap between CEO pay and the lowest wage within a firm, could be effective in narrowing the gap. The underpinning objective of any executive pay reform agenda should be less about reducing top pay levels, as it should be about making pay fairer, he argues. A similar approach, he notes, has been adopted in Israel and Switzerland has considered (but not implemented) mandating a pay gap.

The advantage of the approach he argues, is that 'just like the proverbial tide that lifts all boats, every rise in executive pay would trigger similar rises in the wages of the lowest paid. In this case, both the luxury yacht and the basic dinghy would rise higher'.

[Source: The Conversation 06/01/2020]

A 'systemic compensation issue'? Analysis of discretionary pay trends over five years has identified that bonuses are increasingly being awarded by default (in the US)

Based on analysis of five years of data, the Ontario Teachers' Pension Plan has identified issues with the use of discretionary compensation, especially in US companies.

Some Key Points

- 34% of companies in the study granted discretionary compensation in at least three of the last five years
- 89% of all dollars paid in discretionary compensation came from US-based companies. Since 2015, US based companies have increasingly awarded discretionary payments, with mid-cap (34%), large cap (31%) and smaller companies (23%) most likely to do so and nano-cap (3%) and mega cap companies (2%) much less likely to do so.
- The bulk of awards (80%) are made with zero performance conditions attached
- The most frequent use of discretionary compensation (54%) is for sign-on and retention purposes
- Five sectors accounted for the bulk of the reported discretionary awards, namely: consumer discretionary, financials, health care, industrials and information technology
- Companies reporting discretionary awards over multiple years awarded a greater proportion of total discretionary awards

Call for issuers and investors to act to address the issues identified

Based on the findings, the Ontario Techers' Pension Plan expresses concern that discretionary compensation is not being used in a manner consistent with good compensation governance, as such it's argued that it has become a systemic compensation issue that needs to be addressed.

The Ontario Techers' Pension Plan calls on issuers to ensure discretionary awards are: 1) tied to the individual achieving specific and measurable performance targets linked to strategy; and 2) supported by a compelling rationale describing the need to make the award. Issuers are also called on to recognise that discretionary awards should be infrequent rather than default.

Finally, investors are called on to review discretionary compensation to ensure the awards are used infrequently and to recognise exceptional performance, supported by a strong rationale and tied to the achievement of specific performance conditions.

[Source: Harvard Law School Forum on Corporate Governance and Financial Regulation 07/01/2020]

US public attitudes to CEO Pay: A high degree of cynicism

The Stanford Rock Centre for Corporate Governance has released a paper — Pay for performance….but not too much pay — presenting the findings of a survey into public attitudes to CEO pay in the US.

Some Key Findings

- **86% of Americans believe CEOs of large, public US companies are overpaid.** This response was found to be broadly consistent across political party affiliation and household income levels and stable over time. A similar 2016 survey found 83% of Americans believed CEOs were overpaid.
- **Respondents agree that CEO pay should vary with company size but believe the differential between size and pay should be much lower than it is in practice.** For example, a typical respondent

believes the CEO of a large company by sales ($25 billion) should be paid only 50% more than the CEO of a smaller company by sales ($25 million) — despite a 1,000-fold difference in revenue between the companies.

- **Most respondents believe that CEOs should be rewarded for promoting growth** with 54% of respondents agreeing that CEOs of companies that are growing and hiring US employees should be paid more than CEOs of companies that are shrinking/laying off US staff.
- **There are a range of opinions about how CEOs should be compensated relative to other highly paid professionals.** 68% of the public believe the CEO should always be the highest paid person in a company, whereas 38% do not.
- **How did CEOs get to be where they are?** There are a range of views around the extent to which CEOs are promoted, but a majority of respondents believe that CEOs' connections play a key role.
  - 39% of respondents believe CEOs are promoted because they worked harder than others, while 27% disagree.
  - 32% believe CEOs were promoted because they were lucky and 31% disagree.
  - 61% believe CEOs are promoted due to their connections and 8% disagree.
- **Perks are (more) acceptable than high pay?** The researchers comments that though respondents are highly critical of CEO pay levels they are much less critical of CEO perquisites. For example, 70% of respondents are of the view that it is always/sometimes appropriate to provide a private jet for work travel (30% say that this should not be provided).

Why? Two possible explanations

The survey suggests that the negative view of CEO pay levels may be attributable to two possible causes:

1. the fact that the public views compensation changes through the economic practices that exist across the bottom and middle of most organisations, where promotions are compensated with 10%, 15%, and 20% raises, rather than the economic practices in place at the top of organisations
2. the public may not view the CEO as responsible for value creation/deserving of credit for value creation at their organisations.

The researchers comment that overall, 'cynicism runs through the survey data'. The public not only expresses unfavorable views about CEO pay, but they also express healthy degrees of cynicism about how CEOs get their jobs (hard work versus luck and connections) and about CEOs who donate their wealth (to help society or for tax and reputational benefits).'

Further questions: The researchers suggest that the findings raise a number of questions around the reasons behind the negative public attitudes for example: whether negative views of CEO pay are driven by a broader scepticism or lack of esteem for CEOs, or whether the high pay levels themselves contribute to lower regard for CEOs.

In addition, the researchers suggest that the findings also raise questions about what should be done/not done to 'reform' CEO pay. For example, whether there should be a cap on CEO pay or should the 'basic economic principle of value sharing' continue to apply no matter how big/profitable companies become.

[Source: Pay for Performance . . . But Not Too Much Pay: The American Public's View of CEO Pay, Stanford Closer Look Series. Corporate Governance Research Initiative, November 2019]

In Brief | Not yet final? The AFR reports that APRA is considering a second round of consultation on its proposed changes to remuneration (proposed changes to CPS 511) in response to concerns raised about the proposed imposition of a 50% cap on use of financial metrics, and in order to enable further consideration of options not previously put forward by the regulator. Reportedly, the APRA plans to release a finalised standard in the first half of 2020

[Source: [registration required] The AFR 09/01/2020]

In Brief | Reportedly ASX 100 CEO pay since the start of 2020 has already exceeded the annual earnings of the average worker. ASX 100 CEOs received an average annual income of $5.66 million in the 2018 financial year, or around $108,846 a week before tax. By comparison, on average, full-time workers in Australia earn $1633.80 a week, or roughly $84,950 a year

[Sources: The New Daily 13/01/2020]

Other Shareholder News

United Kingdom | More than lip service is required to rebuild confidence and trust: The FRC has released its annual review of reporting against the Governance Code

Key Takeouts

- The Financial Reporting Council's latest annual review of reporting against the governance Code (both the 2016 Code) and reporting by 'early adopters' (mostly FTSE 100 companies) against the 2018 Code.
- Reporting against the 2018 Code was found to be 'mixed'.
- The FRC has indicated that going forward, its expectation is that the quality of reporting improved. FRC CEO Sir Jon Thompson commented that 'Concentrating on achieving box-ticking compliance, at the expense of effective governance and reporting, is paying lip service to the spirit of the Code and does a disservice to the interests of shareholders and wider stakeholders, including the public'.

The Financial Reporting Council (FRC) has released its latest annual review — Annual Review of the UK Corporate Governance Code January 2020 — of reporting against the governance code. In this report, the FRC reviewed reporting against the 2016 UK Corporate Governance Code and also assessed reporting by FTSE 100 'early adopters' of the revised 2018 Code (which all premium listed companies will need to report against this year).

Snapshot: More than 'lip service' is required

Overall, the FRC concluded that the quality of reporting against the 2018 Code was 'mixed'.

Commenting on the findings FRC CEO Sir Jon Thompson said that though there were some examples of high quality reporting, going forward, the regulator expects to 'see much greater insight into governance practices and outcomes reporting on a range of key issues from diversity to climate change'.

He added that the regulator expects to see more than 'box ticking'. 'Concentrating on achieving box-ticking compliance, at the expense of effective governance and reporting, is paying lip service to the spirit of the Code and does a disservice to the interests of shareholders and wider stakeholders, including the public. Where companies depart from the Provisions of the Code they need to provide compelling explanations for why non-compliance is the right approach for their particular company' Mr Thomson said.

Some Key Points

Reporting against the 2016 Code

The FRC found that the overall quality of reporting against the 2016 is 'unchanged' from last year, adding that the improvement areas identified — eg disclosure of explanations and reporting of actions taken when there has been a significant vote against AGM resolutions (20% and above) — will still be relevant under the 2018 Code.

'Mixed': Early adoption of the 2018 Code

The 2018 Code applies to premium listed companies for accounting years beginning on or after 1 January 2019 ie reporting will be part of the annual reports published in 2020. However, the FRC observed that many listed companies noted the actions that they were planning to take in preparation for full reporting in their 2019 annual reports and in some cases, started reporting against some elements of the 2018 Code (early adoption).

In relation to early adoption of the 2018 Code, the FRC comments that the quality of reporting was mixed.

- **Purpose statements**: The FRC found that 'many companies are grappling with defining purpose and what an effective culture means with too many substituting slogans or marketing lines for a clear purpose'. This approach suggests, the FRC states that some companies have not yet 'fully considered purpose and its importance in relation to culture and strategy;, or sufficiently considered the views of stakeholders. Going forward, the FRC's expectation is that companies further consider their purpose/values. Engaging in this activity should 'lead to significant improvements in disclosure in this area when companies next report'.

- **Culture:** The FRC found that despite the fact that companies appear to be taking culture seriously, there was ultimately insufficient consideration of the importance of culture and strategy, or the views of stakeholders. More particularly, the FRC found that there was: a) insufficient discussion of assessing and monitoring culture; b) limited use of metrics and c) little evidence to suggest that companies saw a role for internal audit in the assessment and/or monitoring of culture (despite the fact that the internal audit function could provide an independent and objective assessment of the company's operations). The FRC's expectation is that companies should be commenting on culture and explaining how they are monitoring and assessing it in more detail.

- **Workforce engagement:** Though some companies stated which method they will use for workforce engagement, the FRC says that it is not clear from this year's reporting how much thought firms had given to the effectiveness of the method chosen and more particularly, that there was little analysis of whether the likely method for engagement is the best way to ensure boards are made aware of key issued raised. In addition, the FRC said it is unclear whether the board were able to feed back their views and decisions once made. The FRC states that when it analyses reports in 2020 it will be looking to determine how effective engagement with the workforce has been. In particular, the FRC emphasises that 2020 reports should make it clear how employee concerns/interests have been considered in board discussions and decision making with details or real examples of what a company has done to consider, and if appropriate, take forward matters raised by the workforce.

- **Section 172 reporting:** There was limited discussion of the issues that were important to/raised by stakeholders, and the extent to which boards had considered these issues and/or the impact they had made on strategy. The FRC's expectation is that reporting 'must cover the concerns raised by stakeholders, how companies have understood the issues, and how they have thought carefully about how these impact on the long-term success of the company'.

- **Chair tenure:** The changes to the 2018 Code were aimed at prompting 'greater refreshment of boards' however, the FRC expressed concern that there remain 18 Chairs that have been on the board for 18 years or more. The FRC expects that these companies outline their 'rationale for this situation and their proposals for the future composition of their boards'.

- **Succession Planning:** The FRC found that reports lacked detail on succession planning, with many companies focussing more on their appointment process (including usage of external recruitment agencies) rather than providing information on how they plan for the various types of succession. In terms of justifying the reelection of board members, the FRC said that the best AGM notices clearly outlined the reasons for an individual's reelection specifically linking their contributions to company strategy, risks or similar key issues referenced in the annual report. The FRC states that it expects more companies to consider the requirements of provision 18 in more detail in this year's AGM notices.

- **Diversity:** Diversity reporting was found to be limited, and in particular there was generally limited reporting of diversity beyond gender. The FRC says that it expects an increase in more detailed commentary on all aspects of diversity in future disclosures.

- **Remuneration**

    - **Use of non-financial metrics:** All sampled companies used financial KPIs to measure their annual bonus and long term incentive plan (LTIP) awards, though there was some movement towards the use of additional non-financial metrics, such as diversity, culture and health and safety targets. The FRC states that it 'encourages the inclusion of these non-financial metrics as a valuable measurement to achieve long-term success. Investors should support the introduction of more non-financial KPIs of this nature'.

    - **Extent to which companies considered the wider workforce in terms of executive remuneration:** As yet, the 'clear majority' of companies have yet to provide any information about this issue. In addition, very few committees reported early on engagement with the company's workforce with most stating that this was something that would be considered further during 2019. The FRC states that this year's annual reports should provide more detail on the way in which remuneration committees have engaged with the workforce and the effect of this engagement.

- **Exercise of discretion:** The 2018 Code expects remuneration committees to report on their use of discretion to override formulaic outcomes from existing remuneration policies or schemes. A majority of reports discussed the remuneration committee's discretionary powers and the circumstances in which they would exercise discretion. A 'handful' outlined how they had already done so.

- **Malus/clawback provisions:** Provision 37 of the 2018 Code states that remuneration schemes and policies should include provisions to enable the company to recover and/or withhold sums/share awards and specify the circumstances in which it would be appropriate to do so. Most companies mentioned having malus/clawback policies with some degree of information on the circumstances in which they would exercise them.

- **Alignment of pension contribution rates for executive directors/payments in lieu with those available to the workforce:** Many FTSE 100 companies have adopted this provision early for new appointments. The FRC attributes the early adoption of this provision to investor pressure. FRC states that for current executive directors there is unlikely to be an immediate change due to contractual obligations. Going forward, the FRC expects further detail around how firms' contribution rates are aligned with that of the workforce and what their workforce's contribution rate is, especially in light of the fact that many remuneration policies are up for shareholder approval in 2020.

[Sources: FRC media release 09/01/2020; FRC Report: Annual Review of the UK Corporate Governance Code January 2020; [registration required] The FT 09/01/2020; [registration required] The WSJ 08/01/2020; Accountancy Today 09/01/2020]

In Brief | Adhering to a nine year tenure guideline as part of director succession planning: BHP has announced that Lindsay Maxsted will not stand for reelection at the 2020 BHP Annual General Meetings having served on the board since 2011. Mr Maxsted is set to resign at, or before, the 2020 AGMs. Reportedly, Mr Maxsted has separately flagged plans to exit the chairmanship at Transurban, but has not put a hard date on his exit after being elected for a further three years in 2019

[Sources: BHP ASX announcement 14/01/2020; [registration required] The AFR 14/01/2020]

Regulators

Implementing FSRC recommendations 6.9 and 6.11: Draft legislation released for consultation relating to ASIC and APRA coordination and information sharing

Treasury has released exposure draft legislation — [exposure draft] Financial Regulator Reform (No 2) Bill 2019: Governance (FSRC Recommendations 6.9 and 6.11) — and explanatory materials for consultation, proposing to implement two Financial Services Royal Commission recommendations relating to regulator coordination and information sharing.

The recommendations are:

- Recommendation 6.9 recommended that the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC): a) cooperate with the other; b) share information to the maximum extent practicable; and c) notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility has occurred.

- Recommendation 6.11 recommended that ASIC meeting procedures be formalised and that those requirements be substantially similar to the existing APRA meeting procedures as contained in the Australian Prudential Regulation Authority Act 1998 (Cth) (APRA Act).

Some Key Points

- Parts 1 and 2 of Schedule 1 to the draft Bill proposes to amend both the APRA Act and the Australian Securities and Investments Commission 2001 (Cth) (ASIC Act) to implement the government's response to Financial Services Royal Commission recommendation 6.9 to require: a) APRA and ASIC to cooperate with each other; b) APRA and ASIC to share information with each other on request; and c) for each regulator to notify the other when it forms the reasonable belief that a material breach may or has occurred, in respect of a law which the other regulator administers.
- Part 3 of Schedule 1 to this Bill gives effect to the government's commitment to implement recommendation 6.11 of the Financial Services Royal Commission to amend the ASIC Act to include provisions dealing with the places of Commissioner meetings, the quorum required, who is to preside, how voting is to occur and the passing of resolutions without meetings

Announcing the changes, Treasurer Josh Frydenberg said that the proposed reforms 'will enable the regulators to support each other in discharging their regulatory functions effectively, and ensure that there are no unnecessary barriers to their sharing information.'

Mr Frydenberg added that the proposed changes are supplemented by the released of the updated Memorandum of Understanding between APRA and ASIC, which implements Recommendation 6.10 of the Hayne Royal Commission (see: Governance News 04/12/2019 at p16).

Timeline: The deadline for submissions is 24 January 2020.

[Sources: Treasury media release 24/12/2019; Explanatory materials; Exposure draft legislation: Financial Regulator Reform (No 2) Bill 2019: Governance (FSRC Recommendations 6.9 and 6.11); Treasurer Josh Frydenberg media release 24/12/2019]

Implementing FSRC recommendation 6.12 (applying BEAR to ASIC/APRA): ASIC and APRA have separately released their accountability statements

Context: Financial Services Royal Commission Recommendation 6.12 recommended that the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) should each apply management accountability principles of the kind established by the banking executive accountability regime (BEAR), to themselves.

Both regulators previously committed to implementing the recommendation by the end of 2019. On 19 December, both ASIC and APRA released their executive accountability statements.

[Note: The government's implementation roadmap Appendix B (p11) states ASIC's commitment to implementing the recommendation by the end of 2019. APRA makes a similar commitment (p12).]

[Note: For clarity, neither ASIC nor APRA are subject to a BEAR like legislative accountability regime. Rather, the move by both regulators is in response to recommendation 6.12 of the Financial Services Royal Commission.]

ASIC Accountability Map and Accountability Statements

ASIC specifies that as an independent statutory agency, it has taken the opportunity to apply key features of the Banking Executive Accountability Regime (set out in Part IIAA of the Banking Act 1959), which ASIC has labelled ASIC's Management Accountability Regime (AMAR) to its senior staff.

AMAR applies to the accountable persons of ASIC. ASIC's accountable persons are: the Chair and accountable Authority, ASIC deputy chairs, and the four Commissioners, general counsel, executive directors, Chief Supervisory Officers and Chief Internal Audit and Operational Risk Executive.

ASIC Accountability statements are available on the ASIC website here (the Chair and each Commissioner) and here (executive directors and other 'key staff').

ASIC's AMAR accountability map is available on the ASIC website here.

In addition, ASIC has updated its committee structure to strengthen oversight of executive actions and to assist in the performance of its responsibilities.

APRA Accountability Map and Accountability Statements

APRA released a document outlining its governance arrangements — Governance and Senior Executive Accountabilities — which describes APRA's internal governance and accountability arrangements, along with accountability statements for its senior executives (covering all four APRA Members, as well as APRA's six Executive Directors, APRA's Director of Strategy/Chief Risk Officer and Chief Internal Auditor) on 19 December.

[Note: An accountability map, outlining the responsibilities of 12 APRA executives can be found on p13 of the Governance and Senior Executive Accountabilities document here.]

[Sources: APRA media release 19/12/2019; APRA governance and senior accountabilities; ASIC media release 19/12/2019; ASIC's Governance and Accountability]

All six KPIs met: APRA self-assessment against the Australian government's Regulator Performance Framework released

Key Takeouts

- The Australian Prudential Regulation Authority (APRA) released its 2018-2019 self-assessment report against the government's regulator performance framework on 19 December 2019
- APRA said it considers that it has met all six key performance indicators (KPIs) in the framework, though there are opportunities for improvement in relation to three KPIs
- Broadly, APRA considers that it could improve in two areas: 1) transparency on the assessment of costs (and benefits) for proposed policy changes; and 2) improve communication with APRA stakeholders (including around policy changes/costs & benefits)

The government's regulator performance framework comprises six Key Performance Indicators (KPIs) that articulate the government's overarching expectations of regulator performance. On 19 December, the Australian Prudential Regulation Authority (APRA) released its self-assessment against these KPIs.

Overall, APRA considers that it has met all six KPIs, though some areas for improvement were identified in relation to three KPIs.

APRA's self-assessment report was externally validated by industry associations

APRA says that overall, the six of seven industry associations who responded to APRA's request for external validation, broadly agreed that APRA's conclusions were reasonable and endorsed the opportunities for improvement identified by APRA and supported improvement plans.

APRA notes that some industry associations noted specific areas for improvement based on their (or their members) dealings with APRA. According to APRA, two of the more common responses related to more consideration of the increasing cost of regulation for their members (particularly smaller financial institutions) and opportunities for APRA to work more closely with the Australian Securities and Investments Commission (ASIC).

Summary: APRA's self-assessment against KPIs

Key Performance Indicator (KPI)	APRA's assessment	Improvement areas identified	Industry Associations' feedback	APRA's Planned actions
KPI 1: Regulators do not unnecessarily impede the efficient operation of regulated entities	APRA considers that it has met this KPI, though 'opportunities for improvement' were identified.	APRA considers that there is 'significant opportunity for it to improve transparency around the assessment of costs (and benefits) for proposed policy changes', and to 'better communicate this	According to APRA, industry associations (asked to provide external validation of APRA's self-assessment) generally agreed with its self-assessment with the 'notable exception' of private health insurance where industry believes APRA's technical expertise/	Improving transparency on the assessment of costs and benefits for proposed policy changes (such as meeting Office of Best Practice Regulation (OBPR) requirements) will be addressed as part of APRA's efforts to improve external engagement

Key Performance Indicator (KPI)	APRA's assessment	Improvement areas identified	Industry Associations' feedback	APRA's Planned actions
		process with APRA's stakeholders'.	capability has declined over the last few years. In addition, APRA says that some industry associations expressed concerns about the increasing cost of regulation (particularly for smaller industry participants) with the majority supporting the need for more transparency in relation to the costs (and benefits) of proposed policy changes and welcomed better communication of this process with APRA's stakeholders.	as outlined in the regulator's 2019-2023 Corporate Plan.
KPI 2: Communication with regulated entities is clear, targeted and effective	APRA considers that it has met this KPI, though considers there are opportunities for improvement.	APRA considers it could do more to ensure that communications are targeted and cater to all stakeholder needs.	According to APRA industry associations generally agreed with APRA's assessment of KPI 2 that it is clear, targeted and effective in its communications and agreed that there are opportunities for improvement.	APRA will address this through actions included in APRA's 2019-2023 Corporate Plan including plans to develop and implement a communications strategy and roadmap that caters to all stakeholder needs. APRA says that it is also intending to measure and report on the timeliness of regulatory decisions and advice as per its public response to the Capability Review.
KPI 3: Actions undertaken by regulators are proportionate to the regulatory risk being managed	APRA says that it considers it has met this KPI.	None identified.	According to APRA industry associations generally agreed with APRA's assessment of KPI 3 and are supportive of the approach taken by the regulator in recent years to demonstrate proportionality.	APRA says that its review of its supervision model (included in APRA's 2019-2023 Corporate Plan) aims ensure that it is fit for purpose and responsive to a rapidly changing environment, as well as one that drives consistent, risk-based, informed and comprehensive prudential supervision across the Australian financial system.
KPI 4: Compliance and monitoring approaches are streamlined and coordinated	APRA considers that it has met this KPI, though areas for improvement were identified.	APRA considers that there is opportunity to promote and coordinate more streamlined approaches across Council of Financial Regulator (CFR) agencies as well as other domestic and international peer agencies to achieve regulatory objectives.	According to APRA, industry associations generally agreed with APRA's assessment of KPI 4 that compliance and monitoring approaches are streamlined and coordinated and validated APRA's strong relationship with key regulatory agencies, particularly those within the Council of Financial Regulators. Industry associations also welcomed greater coordination between APRA and ASIC particularly in relation to data collections and extending the Executive	APRA says that it has recently established a dedicated Regulatory Affairs unit and explicitly acknowledged uplifting its capabilities in relation to collaborating with domestic and international peer regulatory agencies in its 2019-2023 Corporate Plan. Other key objectives (and related actions) included in APRA's 2019-2023 Corporate Plan include: a) developing and implementing a data strategy to facilitate greater/more effective use and sharing of data in the oversight of the financial system and defining and implementing the cross agency data sources required; and b) creating a 'modern, efficient and flexible

Key Performance Indicator (KPI)	APRA's assessment	Improvement areas identified	Industry Associations' feedback	APRA's Planned actions
			Accountability Regime to all APRA regulated entities.	solution which will serve APRA and industry for years to come in relation to data collection, storage, analysis and publication'.
KPI 5: Regulators are open and transparent in their dealings with regulated entities	APRA considers it has met this KPI.	None identified.	According to APRA, industry associations generally agreed with APRA's assessment of KPI 5 that APRA has maintained open and transparent dealing with regulated entities and strong engagement and communication with APRA personnel. One industry association did highlight that some of its members have experienced turnover in their key contacts at APRA and instances where timely notification of changes in supervision teams could be improved.	APRA says it will continue to 'work on being open and transparent in our dealings with regulated entities as part of its broader strategic objective to improve external engagement'.
KPI 6: Regulators actively contribute to the continuous improvement of regulatory frameworks.	APRA considers that it has met this KPI.	None identified.	According to APRA, industry associations agreed with APRA's assessment of KPI 6	As identified in the 2019-2023 Corporate Plan, APRA plans to adopt a 'whole of system' approach to the collective success of the financial regulatory regime through a more 'deliberate approach' to collaborating with peer domestic and international agencies on a broader range of risks and mitigation activities. APRA says it will continue to contribute to the improvement of regulatory frameworks.

[Sources: APRA media release 19/12/2019; Regulator Performance Framework - Self-assessment 2018-19; [registration required] The Australian 20/12/2019].

In Brief | ASIC's priorities? The AFR reports that in addition to a 'surge in enforcement' actions, ASIC's Corporate Governance Taskforce is set to expand its work to focus to boards of large listed companies (outside the banks) as well as to auditors and superannuation fund trustees. ASIC is also set to report early this year on the governance of executive remuneration (with a focus on exercise of board discretion)

[Source: [registration required] The AFR 14/01/2020]

In Brief | Cyber threats are a key focus for APRA: The AFR reports that APRA is working closely with the Australian Signals Directorate, the Australian Security Intelligence Organisation as well as with other international peer securities regulators on how address the threat of cyber-attacks on financial institutions

[Source: [registration required] The AFR 10/01/2020]

Shareholder Activism

Trends in Shareholder Activism in 2019: Activist campaign activity in Australia was down 8% on 2018 according to a report from Activity Insight

Activist Insight has released its activist trends report for 2019.

Some Key Points

Global trends

- **Four year low:** The number of companies subjected to public activist demands fell to a four year low in 2019 (with 839 companies targeted, down from 946 in 2018).
- **Top three sectors targeted by activists:** Companies in the consumer cyclical sector were the most targeted (134 companies (or 16%) down from 150 companies targeted 2018), followed by industrials (112 companies (13%) down from 154 in 2018) and financial services (98 companies (12%) down from 105 in 2018).
- **Uptick in activist at communications services companies:** 34 companies were publicly targeted by activists in 2019, up from 30 in 2018 and 29 in 2017. Communications was the only sector (from a global perspective) where activist activity increased in 2019.
- **Small cap companies were the most targeted** (210 companies or 25% of campaigns), followed by large cap and nano-cap companies (both 21%), micro cap (17%) and mid cap (16%).
- **Geographically, US companies continue to be the most targeted (470 companies)** followed by Australia (72), Japan (58), the UK (55) and Canada (48).

Australia

- **Activist campaign activity in Australia was down 8%** on 2018, with 72 companies targeted in 2019 (as compared with 78 in 2018)
- **43% (or 31) activist campaigns targeted companies in the basic materials sector** (up from 26 campaigns in 2018). The next most targeted sectors in 2019 were financial services (11% of activity) and technology (7% of activity).
- **Nano-cap companies (market cap less than $50m) were the most likely to be targeted** (76%) followed by micro cap (11%), small cap (7%) mid cap (4%) and large cap (1%).
- **Most (77%) of activist demands were board related.** Activists won a total of 42 seats in 2019 (down from 45 in 2018). Most of these (30) were won at meetings, with the remaining 12 gained through settlements.
- **No Australian-based companies were pushed by activists to spin off assets or break up in 2019**
- **The top three Australian activists** were Sandon Capital, Argyle Street Management and Emancipation Capital.

United States

- **Overall, 470 companies were targeted in 2019 (a decrease of 4% on 2018)**
- **Top three sectors targeted by activists:** Companies in the consumer cyclical sector were the most targeted (87 companies (19%) down from 95 companies targeted 2018), followed by technology (66 companies), and healthcare (61 companies).
- **The number of US funds targeted increased** to 30 (up from 19 in 2018). Activity in the real estate sector hit its lowest level since 2014 (15 companies targeted).
- **Large cap companies were the most targeted** (28%) followed by small cap companies (26%), micro cap (18%), mid cap (17%) and nano-cap (11%).
- **Most demands (44%) were board related** and 23% related to 'other governance' issues.

- **Activists secured 231 board seats in 2019** (down from 270 seats in 2018). The majority of seats were secured through settlements (210), with the remaining seats won at meetings.
- **The top three US Activists in 2019** were Starboard value, Carl Icahn and Elliott Management.

[Source: [registration required] Shareholder Activism in 2019 January 2020]

Barclays reportedly targeted by climate group, ShareAction

The FT reports that ShareAction has coordinated a shareholder resolution, (which has the support of 11 institutional investors) at Barclays calling on the bank to publish a plan to phase out financing companies whose activities are not aligned with the goals of the Paris Agreement (eg in the energy sector/gas/electric utilities) . According to The FT, this is it is the first climate resolution at a European bank.

Barclays has reportedly said it is engaging with the group on the issue.

ShareAction reportedly plans to lodge similar resolutions at other financial services institutions this year, signalling, the FT suggest, that investors' focus on climate change has extended beyond the resources sector. The FT comments that US, Australian and South African banks have also faced similar climate resolutions in recent years.

[Source: [registration required] The FT 08/01/2020]

Markets and Exchanges

Hong Kong | New ESG requirements: HKEX ESG Guide and Listing Rules amendments to take effect on 1 July 2020

Key Takeouts

- Following consultation, HKEX will proceed with proposed amendments to the ESG Guide and related Listing Rules, to improve ESG governance and disclosure
- Changes to take effect on 1 July 2020

Following consultation, The Stock Exchange of Hong Kong Limited (HKEX), has released it response to consultation on proposed changes to the Environmental, Social and Governance (ESG) Reporting Guide and related changes to the listing rules aimed at enhancing the ESG reporting framework.

The changes will come into effect from 1 July 2020.

Some Key Changes

According to HKEX, there was clear support for the proposed amendments, with all proposals receiving between 83 and 99% support. In consequence, all proposals (with some clarifications/modifications) will be implemented.

Some key changes are outlined briefly below.

Changes to mandatory disclosure requirements

- **Introduction of new mandatory ESG disclosure requirements** in the ESG Guide including: a requirement for boards to include a board statement setting out the board's consideration of ESG issues; requirement for issuers to disclosure the application of the Reporting Principles, 'materiality', 'quantitative' and 'consistency'; and a requirement to explain the reporting boundary.
- **Changes to climate disclosure requirements** including: a) requiring disclosure of significant climate related issues which have impacted/may impact the issuer; b) amending key performance indicators relating to emissions/energy use etc to include relevant targets; and c) revising key performance indicators to require disclosure of Scope 1 and Scope 2 greenhouse gas emissions.

- **Changes to 'social' disclosure requirements** including: a) 'upgrading' the disclosure obligation of all 'social' key performance indicators to 'comply or explain'; b) clarifying that 'employment types' should include full and part time staff and that full time and part time are non-exhaustive examples of employment types; c) requiring disclosure of the number and rate of work related fatalities that occurred over the past three years; d) requiring disclosure of practices used to identify ESG risks along the supply chain and the practices used to promote preferable products and services when selecting suppliers/how these practices are implemented and monitored; and e) requiring disclosure of anti-corruption training provided to directors and staff.

Other changes

- Encouraging issuers to seek independent assurance to strengthen the creditability of ESG information disclosed.
- Shortening the deadline for publication of ESG reports to within five months after the financial year end.
- Doing away with the requirement for printed ESG reports (unless responding to shareholders' specific requests) with a notification of online publication.

[Source: HKEX media release 18/12/2019]

Financial Services

Top Story | A customer centric approach is required: ASIC is consulting on draft guidance for the new financial product design and distribution obligation obligations

Key Takeouts

- ASIC is consulting on draft, high-level, principles based guidance on the design and distribution obligations set to commence in April 2021
- ASIC says that compliance with design and distribution obligations will require the adoption of a consumer-centric approach. This is also expected to assist in addressing the 'serious compliance issues in internal controls identified' by both the Financial Services Inquiry and the Financial Services Royal Commission.
- The AFR quotes ASIC Deputy Chair Karen Chester as saying that the 'design and distribution obligations are a cost-effective insurance policy for firms to deliver on that promise, and in doing so, stay off ASIC's radar and reduce our obligation to enforce'.
- ASIC says that it expects that its own approach, and that of industry will evolve over time and has said it expects to have a 'constructive relationship' with industry during the implementation phase. ASIC states.
- The design and distribution obligations bring Australia into line with comparable jurisdictions, including the United Kingdom, Netherlands and European Union, where similar product governance regimes are already in place. ASIC has engaged with European regulators in developing its draft guidance.
- Timing: The deadline for submissions is 11 March 2020. ASIC intends to release a finalised regulatory guide in 2020 (but no specific date is given).

Introduction: Consultation on draft DDO guidance

The Australian Securities and Investments Commission (ASIC) has released a consultation paper — Consultation Paper 325 Design and Distribution Obligations (CP 325) — and draft guidance setting out its interpretation of new design and distribution obligations (set to commence on 5 April 2021); the regulator's expectations for meeting the obligations; and ASIC's general approach to administering them.

The deadline for submissions is 11 March 2020. ASIC intends to release a finalised regulatory guide in 2020 (but no specific date is given).

An opportunity for industry to demonstrate a consumer-centric approach

Announcing the consultation, ASIC Deputy Chair Karen Chester said that the new requirements 'should drive better business and consumer outcomes. They simply require business to design products that meet genuine consumer needs and use distribution channels that will likely get them to the right consumers'.

Ms Chester added that the obligations also address the causes of much of the misconduct examined by the Royal Commission. 'Most of the Royal Commission case studies – from the mis selling of products to extremely poor value financial products – would have uniformly failed these obligations. The implementation of this reform presents a significant opportunity for industry to demonstrate they have embedded a consumer-centric approach in their business and are better managing non-financial risks', Ms Chester said.

The AFR quotes Ms Chester as saying that the new obligations are also a 'cost-effective insurance policy for firms to deliver on that promise [to take care of their customers], and in doing so, stay off ASIC's radar and reduce our obligation to enforce'.

Some Key Points

[Note: A summary of ASIC's proposals and questions on which ASIC seeks feedback, is included in CP 325 at p46]

Principles based approach

ASIC says it has intentionally adopted a 'high level and principles based' approach with some examples to assist issuers and distributors in complying with their obligations while allowing a measure of flexibility. ASIC says that it expects that its own approach, and that of industry will evolve over time. 'We expect that systems and processes will develop, be tested and be refined over time. We expect to have a constructive relationship with industry during the implementation phase' ASIC states.

Customer centric approach

Proposed guidance on developing and maintaining a customer-centric product governance framework: ASIC proposes to issue guidance that a 'robust governance framework' (ie the systems, processes, procedures and other arrangements in place to help ensure compliance with design and distribution obligations in relation to product design, product distribution, information sharing between issuers and distributors, outcomes monitoring, and the conduct of reviews) should: a) focus on the identified target market across the lifecycle of the financial product; b) be designed to reduce the risk of products being sold to consumers that are inconsistent with their likely objectives, financial situation and needs; and c) fully documented, monitored, reportedly on and regularly reviewed for currency/effectiveness.

Expectation that issuers/distributors consider consumer vulnerabilities: ASIC also proposes to give guidance that issuers and distributors should not take advantage of behavioural biases or factors that can impede consumer outcomes. In addition, ASIC expects issuers and distributors to consider consumer vulnerabilities and how these may increase the risk that products sold to consumers do not meet their needs and lead to poor consumer outcomes.

Proposed guidance for issuers

Target Market Determination

ASIC proposes to issue guidance proposing that what amounts to an 'appropriate target market determination can differ, depending on the type and particular characteristics of the financial product to be issued, the intended distribution approach and the issuer's product governance framework'.

- **New products:** ASIC proposes to issue guidance that, for new products, issuers should identify the target market and design financial products that are likely to be consistent with the likely objectives, financial situation and needs of consumers in that target market.

- **Continuing products:** ASIC proposes to issue guidance that, for continuing products, issuers should still critically assess the product (and its features) and identify the target market under the design and distribution obligations by reference to the likely objectives, financial situation and needs of consumers for whom the product would likely be consistent. Where issuers already have processes directed towards these purposes, ASIC says that they should check that the processes meet the detailed requirements of the legislation.

- **Content and form of a target market determination**

  - **No 'definitive formulation' (but examples given):** ASIC does not propose to give any definitive formulation of how a target market should be described in a target market determination, but does propose to give guidance that explains the process and key considerations for identifying and describing the target market by reference to six examples across different product sectors. Namely: credit cards, reverse mortgages, cash options in superannuation, consumer credit insurance, low value products and basic banking products. With respect to consumer credit insurance (CCI), ASIC directs issuers to have regard to the problems identified in Report 622 Consumer Credit insurance: Poor value products and harmful sales practices (see: Governance News 17/07/2019) when they consider the design and distribution obligations for CCI products.

  - **Obligation to specify certain information:** ASIC proposes to give guidance on the issuer's obligation to specify in the target market determination: a) any information that it considers is necessary to require from its distributors in order to promptly decide that a target market determination may no longer be appropriate; and b) the reporting period for the information the distributor must provide to the issuer about the number of complaints about the financial product.

- **Diversification:** ASIC proposes to give guidance that when an issuer considers it appropriate to contemplate consumers in the target market acquiring the financial product as part of a diversified portfolio, the reasonable steps obligation will require the issuer to manage the risk of the product being sold to consumers who do not have a diversified portfolio.

- **Should not be based 'predominantly' on consumer understanding:** ASIC proposes to give guidance that it does not consider a target market for a product should be predominantly based on consumer understanding of a product as it considers that consumer understanding of a product does not necessarily equate to the product being likely to be consistent with the likely objectives, financial situation and needs of consumers in the target market.

- **Who is the product clearly unsuitable for? (consideration of the 'negative target market'):** ASIC proposes to provide guidance that in making a target market determination, it will also be useful for the issuer to consider, in addition to the target market, those for whom the financial product is clearly unsuitable (the negative target market).

- **Guidance on the application of the target market determination to specific products: ASIC** proposes to give guidance on how the target market determination applies for certain products when the application of the obligation is 'not straightforward', including on the application of DDO to: a) superannuation and investor directed portfolio services (also known as 'platforms' or 'IDPS'); b) when products are offered and acquired as a 'package' or 'bundle'; and c) when products are customisable by the consumer at point-of-sale, including through choices or options (eg selecting a waiting period for an income protection insurance product).

- **Issuers' obligation to take 'reasonable steps':** An issuer has a legal obligation to take reasonable steps that 'will or are reasonably likely to result in distribution being consistent with the target market determination' for the financial product. Consistent with the principles-based approach to guidance on the DDOs generally, ASIC's proposed guidance is 'high level' and 'principles based' on the basis that it considers 'an issuer is best placed, given its knowledge and experience of its financial products and distribution channels' to consider the appropriate approach. To assist issuers, ASIC's proposed guidance lists the factors it will consider in its administration of the reasonable steps obligation including: a) the distribution conditions that are specified in the target market determination; b) the issuer's marketing and promotional materials; c) the selection of distributors; d) the supervision and monitoring of distributors; e) the issuer's ability to eliminate or appropriately manage conflicts of interest; and f) whether issuers have provided distributors with sufficient information to help them ensure that distribution is consistent with the target market determination.

- **Reviewing the target market determination:** Issuers have a legal obligation to review the target market determination periodically and in response to review triggers to ensure that it remains appropriate for the product over time. However, how frequently an issuer should review the target market determination and what circumstances should trigger a review are not specified in order, ASIC says, to enable issuers to determine the most appropriate and effective review process for its particular financial product and existing systems/processes. Accordingly, ASIC's proposed guidance does not identify standard review triggers and maximum review periods for issuers to adopt. Rather, the draft guidance sets out examples to illustrate what review triggers may be appropriate for certain types of financial products (insurance, managed fund). ASIC proposes to give guidance that, in reviewing a target market determination, it expects the issuer to take into account all available information on its financial product, using multiple data sources.

- **Factors issuers should consider when determining if there has been a 'significant dealing'?** An issuer must notify ASIC of a significant dealing (except excluded dealings) in a financial product that is not consistent with the product's target market determination. An issuer must determine whether or not a dealing is 'significant' based on the circumstances of each case. ASIC proposes to provide guidance that relevant factors may include: a) the proportion of consumers who are not in the target market acquiring the financial product; b) the actual or potential harm to consumers; and c) the nature and extent of the inconsistency of distribution with the target market determination.

Proposed guidance for distributors

- **Factors relevant to considering whether a distributor has met the reasonable steps obligation:** ASIC proposes to give high-level guidance on the reasonable steps obligation for distributors of financial products by setting out its view on factors that may be relevant to this obligation, including: a) the distribution method(s) used; b) compliance with distribution conditions; c) the marketing and promotional materials circulated by the distributor; d) the effectiveness of the distributor's product governance framework; e) the steps taken to eliminate or appropriately manage the risk that incentives for staff or contractors may influence behaviours that could result in distribution being inconsistent with the target market determination; f) whether reliance on existing information about the consumer is appropriate; g) whether the distributor has given staff involved in distribution operations sufficient training; and h) how the distributor forms a reasonable view that a consumer is reasonably likely to be in the target market.

- **General insurance renewals:** ASIC observes that the reasonable steps obligation will apply at the point of renewal and therefore, some consideration of whether the consumer remains in the target market at each renewal may be required. ASIC's proposed guidance outlines how insurers (in their role as distributor) can approach the reasonable steps obligation in the context of renewal of general insurance policies, to ensure that the renewal process results in outcomes that are consistent with the target market determination. ASIC proposes that, at the time of renewal, an insurer should: a) analyse information it holds (eg information it gathered when the customer initially acquired the product; b) note any updated details that have been provided and/or have been provided through claims that have subsequently occurred; and c) consider a number of factors, including the likelihood that a class of consumers is no longer in the target market for the policy. ASIC states that where an insurer assesses that it is likely that a consumer is no longer in the target market for an insurance policy, this should not result in an insurer declining to offer a renewal of the policy without contacting the consumer.

- **Is a consumer reasonably likely to be in the target market?**

  - ASIC expects distributors to have 'effective systems and processes in place to enable it to form a reasonable view on whether a consumer is reasonably likely to be in the target market for a product'. In most cases, ASIC considers that a distributor should have sufficient information about a consumer through its existing sales processes to form a reasonable view on whether the consumer is reasonably likely to be in the target market for a financial product. The proposed guidance suggests a number of ways which could assist distributors in forming a reasonable view including: a) the inclusion of 'knockout questions' within application processes; b) analysis of data held on the consumer or a class of consumers; and c) in some cases, asking the consumer direct questions to determine whether they are reasonably likely to be in the target market.

- In addition, the proposed guidance proposes to outline the steps that a distributor can take to reduce the likelihood that a consumer will be left with the impression that their personal circumstances have been considered, including: a) not having a relevant provider (an individual authorised to give personal advice to consumers on relevant financial products) involved in the distribution process to ask specific questions of a consumer and communicate the view that the consumer is in the target market to the consumer; and b) only asking specific questions of a consumer (when required) in the later stages of the sales process after the consumer has already made the decision to acquire the financial product.

- **Consumers outside the target market:** A distributor must comply with the reasonable steps obligation in the event that it becomes aware that it is interacting with a consumer who is outside the target market for a financial product. ASIC's proposed guidance seeks to 'provide some clarity in relation to the way in which distributors should approach these situations'. More particularly, ASIC proposes to provide guidance that the reasonable steps a distributor should take when selling a financial product to consumers who are outside the target market for the product depends on the circumstances of the interaction, the nature and degree of harm that might result, and the steps that can be taken to mitigate the harm.

- **Provision of information to issuers:** A distributor must report certain information on its distribution to the issuer. ASIC does not propose to provide specific guidance on the practical aspects of the relationship between the issuer and the distributor regarding information exchange on the basis that these are 'commercial matters that issuers and distributors can determine among themselves'. However, ASIC states that it will consider, following feedback, providing 'guidance on specific aspects of the relationship to promote consumer or competition outcomes'.

Financial advisers

Interaction with personal advice obligations: A financial adviser is a distributor under the design and distribution regime. When providing personal advice, and implementing the advice, the adviser is not required to take reasonable steps that will, or are reasonably likely to, result in distribution of a financial product being consistent with the target market determination. Financial advisers providing personal advice are under legal obligations to take into account the consumer's personal circumstances and provide advice in the consumer's best interests. ASIC proposes to provide guidance that a target market determination for a financial product should be considered by a financial adviser in providing the advice and meeting their best interests duty.

Interaction with responsible lending obligations

ASIC proposes to provide additional guidance on aspects of the interaction between responsible lending obligations and the design and distribution obligations (which ASIC considers to be distinct, but complementary) including that: a) information gathered as part of the responsible lending obligations may help the distributor form a reasonable view on whether the consumer is reasonably likely to be in the target market for a product; and b) the reasonable steps obligation does not require further steps to be taken by a distributor when assessing, for responsible lending purposes, whether the consumer can comply with their financial obligations under the contract. ASIC considers that there is scope for issuers and distributors to adopt compliance practices that are common to aspects of both regimes. The guidance seeks to outline where these practices might arise and to provide clarity about where the requirement under the two regimes differs.

Proposed guidance on the administration of the DDO

- **Applications for relief — guidance on relevant factors:** ASIC proposes to give guidance on the factors that it will take into account when considering whether to provide an exemption from/modification to the design and distribution obligations. These factors include: a) whether the objects of Ch 7 of the Corporations Act 2001 (Cth) are being promoted, including the provision of suitable financial products to consumers (see s760A(aa)); b) the policy intention underlying the design and distribution obligations to both improve consumer outcomes and require financial services providers to have a consumer-centric approach to making initial offerings of products to consumers; and c) parliament's intent (as reflected in the law) for these obligations to apply to a broad range of financial products.

- **Interaction with disclosure relief:** ASIC proposes to give guidance that, if it grants disclosure relief for a financial product, relief from the design and distribution obligations will not automatically follow. If requested, ASIC will consider whether to grant relief from the design and distribution obligations as a separate matter to its consideration of disclosure relief. ASIC explains that the proposed approach reflects the separate underlying policy rationales of the disclosure regime and the design and distribution obligations.

[Sources: ASIC media release 19/12/2019; Consultation Paper 325 Design and Distribution Obligations (CP 325); Draft regulatory guide; [registration required] The AFR 19/12/2019; The SMH 19/12/2019; [registration required] The Australian 20/12/2019]

Implementing FSRC recommendation 7.1: establishment of a compensation scheme of last resort

On 20 December, Treasurer Josh Frydenberg announced the release of a discussion paper on establishing a Compensation Scheme of Last Resort (CSLR). The discussion paper seeks views on four aspects of the proposed scheme.

1. **The appropriate coverage for the scheme**, beyond the provision of personal advice. Among other things, the government seeks feedback on whether there would be any unintended consequences from initially excluding court and tribunal decisions or from excluding voluntary members of AFCA from the scheme.
2. **Funding arrangements**: The paper notes that the government has previously said that the scheme will be industry funded. Questions on which feedback is sought include the following: a) the extent to which the funding model should be based on risk; b) how risk should be assessed; c) whether the funding model should assess risk at individual financial firm level or at the financial service class level; d) whether the funding model should apply to all scheme costs; e) the extent to which funding should be based on a firm's ability to pay/how this should be assessed; and f) whether a maximum cap should apply to annual levies imposed on participating financial firms.
3. **Compensation to be paid:** Appropriate compensation amounts, timing and types for the scheme need to balance the interests of the consumers and small businesses that have suffered loss with the interests of the financial firms required to fund the scheme. The government seeks feedback (among other things) on how compensation limits should be used by the scheme to balance the interests of consumers against those funding the scheme and how claims associated with large unexpected failures should be managed.
4. **Managing the 'evolution of the scheme'**: The government seeks feedback (among other things) on what aspects of the design and operation of the scheme should be determined by the CSLR and what aspects should be prescribed in legislation.

The deadline for submissions is 7 February 2020.

AFCA's Response: Following the release of the discussion paper, AFCA issued a statement its 'strong support' for creating an industry-funded scheme of last resort.

'A Scheme will ensure consumers who have experienced loss due to the conduct of a financial firm and have subsequently been awarded compensation as part of an external dispute resolution process, will receive that compensation. AFCA believes the establishment of a compensation scheme of last resort plays a significant role in restoring trust and confidence in the wider financial system' AFCA states.

[Sources: Treasurer Josh Frydenberg media release 20/12/2019; Treasury media release 20/12/2019; Discussion Paper: Implementing Royal Commission Recommendation 7.1 — Establishing a compensation scheme of last report discussion paper December 2019; AFCA media release 30/12/2019]

The Treasurer has issued a statement confirming the government has met with the insurance industry to discuss their response to the bushfire emergency, separately ASIC has said it is working with insurers and other stakeholders to ensure that claims are handled efficiently and fairly

Treasurer Josh Frydenberg issued a statement confirming that insurance industry representatives have met with the federal government and provided an update on actions taken to date to support policyholders and communities impacted by the bushfires.

The Treasurer said that industry representatives provided assurances of the insurance industry's commitment to working in partnership with policyholders, governments, the building industry and other stakeholders to carry out the required repair and rebuilding work. This included a commitment to focus on local building and construction businesses and suppliers in fire-affected communities to carry out the necessary work.

Response from industry

- Mr Frydenberg said that since September 2019, around 8500 bushfire related insurance claims have been lodged, valued at around $700 million. Of these, approximately 20% have been processed and around half of these have been settled.
- Mr Frydenberg said that emergency response teams of assessors and claims specialists have been deployed to help customers' process claims and emergency accommodation and cash advances have been provided. In addition, he said that insurers have implemented a triage process to ensure the worst-affected policyholders receive urgent attention.
- The Insurance Council is working directly with the States and emergency services and is operating a 24-hour hotline, to enable those impacted by the fires to access information about claims and recovery.

Discussion about ongoing cooperation between industry/government

In addition, the Treasurer said that there was discussion about how insurers and government can continue to work together, including sharing detailed data about the response, to help support insurers, government and others respond to the needs of communities in a timely manner.

The Treasurer added that the government will continue to work with the insurance industry to support those devastated by the fires.

[Source: Treasurer Josh Frydenberg media release 07/01/2020]

ASIC statement

The Australian Securities and Investments Commission (ASIC) has issued a statement confirming its commitment to helping those impacted by the bushfires and confirming that ASIC is working with insurers and other stakeholders to ensure that claims are handled efficiently and fairly.

ASIC Deputy Chair Daniel Crennan QC said that ASIC's expectation is that 'those involved in handling these insurance claims to act with the utmost good faith'.

ASIC also reminded consumers unhappy with their insurer's claim response that they could consider lodging a complaint with the Australian Financial Complaints Authority.

Assistance available

The statement goes on to advise those impacted by the fires should deal directly with their insurers or an authorised, trusted insurance broker or financial adviser. ASIC Commissioner Sean Hughes reminded consumers that insurers may be able to provide emergency accommodation and financial support (as part of the claim).

ASIC also said that information on what to do after a natural disaster is available on ASIC's MoneySmart website.

Acknowledgement of the steps being taken by industry

ASIC noted that the Insurance Council of Australia has also announced its emergency assistance program and welcomed announcements by the Australian Banking Association and the Customer Owned Banking Association about the assistance their members are able to provide to their customers.

ASIC encouraged all banks and other lenders to respond appropriately to financial difficulties arising directly or indirectly from the fires.

ASIC relief for various company-related fees

ASIC is offering assistance for customers, including small businesses, who are affected by the bushfires by providing relief from various company-related fees that may be payable. Details of how to apply for fee relief or contact us for other assistance is available on ASIC's website.

Caution to consumers

ASIC cautioned consumers and small business owners to be on the lookout for fictitious or unscrupulous tradespeople, repairers or firms offering to assist them with their insurance claim. ASIC said that should consumers have any concerns about the conduct of firms/individuals who do contact them regarding their claim, they should contact ASIC.

[Sources: ASIC media release 09/01/2020; [registration required] The Australian 10/01/2020]

Related News: Response from the business community

The Business Council of Australia is keeping a running list of actions being taken by businesses to in response to the bushfires, including additional (paid) leave for volunteers assisting in the response effort and donations. The list can be accessed on the BCA site here.

[Source: BCA media release 10/01/2020]

Consumer Data Right timeline deferred

The Australian Competition & Consumer Commission (ACCC) has provided an updated timeline for implementation and launch of the Consumer Data Right (CDR) in the banking sector, deferring the launch of certain aspects from February to July 2020.

Revised timeline

- Consumers will be able to direct major banks to share their credit and debit card, deposit account and transaction account data with accredited service providers from 1 July 2020.
- Consumers' mortgage and personal loan data will be able to be shared after 1 November 2020.
- The ACCC says that the deferral will allow additional implementation work and testing to be completed and better ensure necessary security and privacy protections operate effectively.

Next steps: The ACCC says it will make the CDR Rules in January 2020 that reflect the adjusted timetable. The ACCC will also conduct further consultation regarding any consequential changes to other phases of the CDR.

[Source: ACCC media release 20/12/2019]

Buy now pay later code of conduct announced

In response to ASIC Report 600 Review of Buy now pay later arrangements (see: Governance News 03/12/2019) and the Senate Economics Reference Committee, which recommended the development of a Code of Practice for the Buy Now Pay Later market, The Australian Financial Industry Association (AFIA) — of which Afterpay, Brighte, flexigroup, Latitude, OpenPay, Payright and Zip Co are members — has announced that it plans to publicly consult on a Code in mid-January, ahead of the proposed implementation date is 1 July 2020.

Some Key Points

AFIA says that the include obligations for buy now pay later providers to:

- assess customers to ensure the product will be suitable to them before providing it and provide additional controls for customers identified as potentially more vulnerable through this assessment process
- disclose a summary of key product features to improve customers' understanding of the product and ensure customers are properly informed about the products' terms and conditions
- ensure customers have access to internal complaints handling
- provide hardship assistance to customers that experience financial difficulties
- ensure vendors and merchants act consistently within buy now pay later provider guidelines

A Code Compliance Committee (CCC), independent of AFIA and the BNPL providers, comprising both industry and consumer representatives will be established to monitor code compliance and deal with potential non-compliance.

[Source: AFIA media release 20/12/2019]

ASIC has commenced civil penalty proceedings against a Volkswagen subsidiary for alleged breach of responsible lending laws

The Australian Securities and Investments Commission (ASIC) has commenced proceedings in the Federal Court of Australia against Volkswagen Financial Services Australia Pty Limited (Volkswagen), for alleged contraventions of responsible lending obligations under the National Consumer Protection Act 2009 (Cth) (NCCP Act) in connection with consumer loan contracts for the purchase of new and used cars.

Allegations

[Note: The Originating Application, Concise Statement and Statement of Claim are available on the ASIC website here]

ASIC alleges that during the period 20 December 2013 to 15 December 2016, Volkswagen contravened responsible lending provisions of the NCCP Act in respect of 49,380 loan contracts.

Broadly, ASIC alleges that Volkswagen:

- contravened ss128 (d) and 130 (1)(b) of the National Credit Act by failing to make reasonable inquiries about borrowers' living expenses (in relation to a subset of loans)
- contravened ss 128(d) and 130(1)(c) of the National Credit Act in relation to each of the loans by failing to take reasonable steps to verify borrowers' living expenses
- contravened s 128 (c) of the National Credit Act by failing to make an assessment ()in accordance with s 129 of the National Credit Act) as to whether each of the loan contracts was unsuitable for the relevant consumer
- contravened s 47 of the National Credit Act which required Volkswagen to engage in credit activities efficiently, honestly and fairly and to comply the National Credit Act. ASIC notes that there is no penalty for contravention of this provision.

Relief sought

ASIC is seeking declarations of contravention; pecuniary penalties; costs and such further or other orders as the Court considers appropriate.

ASIC notes that a maximum penalty for one contravention of the relevant provisions during the period of the contraventions was 10,000 penalty units which equates to $1.7 million in the period to 31 July 2015 and $1.8 million thereafter.

The proceeding will be listed for a first case management hearing on a date to be determined by the Court.

Context

Responsible lending decision pending: The requirement to undertake a proper assessment of unsuitability under section s 128 of the NCCP Act was considered in Australian Securities and Investments Commission v Westpac Banking Corporation (Liability Trial) [2019] FCA 1244 (see: Governance News 11/09/2019). In dismissing ASIC's case, Justice Perram found that a lender 'may do what it wants in the assessment process' and is not obliged under the NCCP Act to take into account a prospective borrower's actual/declared expenses when assessing whether a loan will be unsuitable to consumers. ASIC announced that it would appeal the decision on 10 September. ASIC says that it considers the decision to be 'inconsistent with the legislative intention of the responsible lending provisions'; that it creates uncertainty as to the requirements under the NCCP act, and further, that it may result in 'an erosion of improvements in responsible lending standards over recent years to the point that lenders are applying bare minimum standards'. ASIC states that its decision to bring the action against Volkswagen for contraventions which include the failure to make assessments in accordance with s 129 of the National Credit Act in relation to whether each loan contract was unsuitable, is consistent with ASIC's position on responsible lending which has been articulated in regulatory guidance since 2010.

Car finance industry review: ASIC is currently undertaking a review into the car finance industry's compliance with responsible lending, debt collection and hardship obligations. ASIC says it intends to publish a report in early 2020 and will assess whether further regulatory action is required.

[Sources: ASIC media release 20/12/2019; Originating Application; Concise Statement; Statement of Claim]

A costly distraction (or not)? Reportedly questions have been raised about APRA's plans to assess the performance of 40,000 Choice products following the release of the MySuper heatmaps last year

The AFR reports that Director of the Centre for Law, Markets and Regulation at the University of NSW, Scott Donald has written an article, to appear in an upcoming issue of the Australian Superannuation Law Bulletin, assessing the Australian Prudential Regulation Authority's (APRA's) superannuation heatmap initiative.

No need to review Choice products? Currently the heatmaps assess MySuper products, but the initiative is set to expand to include Choice products going forward. According to The AFR, Mr Donald queries whether this expansion to review the performance of 40,000 superannuation Choice products is necessary on the basis that:

- ratings agencies already perform the analysis
- the resource commitment required to undertake a review of 40,000 choice products 'will distract APRA' from its focus on the MySuper sector. 'The last thing we need is for APRA to get swamped, and for its findings to be diluted, by the generation of heatmaps on such an ambitious scale' Mr Donald is quoted as stating.
- MySuper options are 'different' from Choice offerings and this 'arguably justifies closer regulatory oversight'.

APRA's methodology: Reportedly, Mr Donald does not accept claims by some critics of the heatmap that APRA does not 'compare apples with apples'. However, he reportedly does suggest that improvements could be made to the process including providing more detail about the methodology employed and basis for APRA's assessments.

No chance that APRA will reconsider the heatmaps? Mr Donald is quoted as saying that he sees no scope at this stage, for APRA to dump the initiative in response to industry criticism. 'One challenge for the industry is that its self-interested lobbying in the early parts of this decade, and the devastating findings of the royal commission, have deprived it of much of the political credibility it would need to force APRA to reconsider the heatmap initiative in any meaningful way…Claims that the initiative is misleading and potentially dysfunctional will fall on ears deafened by years of denial and parochialism…At best, there may be an opportunity for fine-tuning of some of the technical details at the margins but a fundamental review is nowhere on the political horizon' Mr Donald is quoted as saying.

AIST is of the view that Choice products should be held to the same standard as MySuper products?

According to the AFR, Australian Institute of Superannuation Trustees (AIST) CEO Eva Scheerlinck has responded to Mr Donald's comments by questioning why Choice products should not be held to the same standard as MySuper products. 'A lot of people have been transferred out of MySuper into these underperforming choice products, to their detriment…The members' best interests duty applies to all types of funds, not just MySuper, and reporting and transparency are key for comparability and fairness' Ms Scheerlinck is quoted as saying.

Responding to concerns the data task is too onerous, Ms Scheerlinck said in her view it is not unreasonable for providers to supply data to APRA. Given ratings agencies already look at Choice products there should be no problem in the same information being supplied to APRA.

Reportedly, Ms Scheerlinck went on to suggest that the 'the inability of product providers to provide data on fees and performance raises the question as to how the trustee monitors member outcomes and satisfies its fiduciary duty.'

[Source: [registration required[The AFR 13/01/2020; 14/01/2020]

APRA super data transformation project: second APRA discussion paper released

The Australian Prudential Regulation Authority (APRA) has released a second consultation package (two topic papers and draft reporting standards) as part of its broader project to enhance superannuation data collection. The proposals aim to address 'the most urgent gaps in APRA's data collection, particularly for choice products and investment options'.

Proposals: The following papers/standards have been released for consultation.

- **Topic Paper 2: Performance** is aimed at facilitating the assessment of member outcomes and performance for choice products, investment menu and investment options.
- **Topic Paper 3: Member Accounts** is aimed at providing more granular information on member demographics data.
- **Three draft reporting standards:** 1) Draft Reporting Standard SRS 611.0 Member Accounts; 2) Draft Reporting Standard SRS 705.0 Components of Net Return; and 3) Draft Reporting Standard SRS 705.1 Investment Performance and Objectives

Timeline: The deadline for submissions on the proposals are due by 14 February 2020.

[Sources: APRA media release 19/12/2019; Consultation on APRA's Superannuation Data Transformation: Topic Paper 2 – Performance; Topic Paper 3 - Member Accounts; Draft reporting standards: Draft Reporting Standard SRS 611.0 Member Accounts; Draft Reporting Standard SRS 705.0 Components of Net Return Draft Reporting Standard; SRS 705.1 Investment Performance and Objectives]

In Brief | Transforming data collection/analytics in the UK financial sector: The Financial Conduct Authority (FCA) and the Bank of England (Bank) have outlined plans to develop their data and analytics capabilities. The Bank of England has also published a Discussion Paper, setting out a framework for assessing the issues and an initial range of potential options for transforming the hosting/use of regulatory data going forward. The Discussion paper marks the start of a review into how the timeliness and effectiveness of data collection from firms across the financial system might be improved (as recommended by the Future of Finance Report)

[Source: Joint FCA BoE media release 07/01/2020; BoE discussion paper: Transforming data collection from the UK financial sector 07/01/2020]

In Brief | The ACCC's latest Northern Australia Insurance Inquiry Interim Report has found that high premiums are leading to a rise in uninsured homes in northern Australia with the highest rate of non-insurance in northern Western Australia. According to the report, home and contents insurance premiums in northern Australia are on average almost double those in the rest of Australia (and even higher in some areas). Among other things, the report recommends: abolishing, or re-basing, stamp duty on home, contents and strata insurance products; prohibiting conflicted remuneration for insurance brokers; and revising and mandating standard cover to help consumers choose and compare options. The due date for the final report is 30 November 2020

[Source: ACCC media release 20/12/2019; Northern Australia insurance inquiry: second interim report 2019]

More recommendations for reform of the UK audit sector: Brydon Review Released

Key Takeouts

- The Review concludes that 'audit is not broken but it has lost its way and all the actors in the audit process bear some measure of responsibility'.
- Recommendations relate not only the role of auditors, but the role of others (boards, the new regulator the Audit Reporting and Governance Authority (ARGA), shareholders, stakeholders) in the audit process.
- In his introduction to the report, Sir Donald Brydon emphasises that in order for his recommendations to be implemented 'with appropriate urgency' it is important that a recommendation by the Kingman Review, the establishment of the Audit, Reporting and Governance Authority (ARGA), the successor body to the Financial Reporting Council be implemented 'as soon as possible'.
- Key recommendations include (among others): a) a redefinition of audit and its purpose; b) the establishment of a separate audit profession (ie separate from the accounting profession) governed by its own principles and overseen by the new audit regulator (once that regulator is established); c) the extension of the concept of auditing to areas beyond financial statements; d) the replacement of the requirement to certify accounts as 'true and fair' with a new requirement to certify that accounts 'present fairly, in all material respects'; e) expansion of audit to include audit of key performance indicators and alternative performance measures used to determine executive pay; and f) a number of recommendations clarifying responsibilities for detecting and preventing fraud including enhanced education, greater disclosure of anti-fraud measures taken, a fraud register and an 'independent sanctions regime' which are aimed at 'restoring confidence in auditors in this area'.

Following the release of two earlier reviews into the audit sector — The Independent Review of the Financial Reporting Council, led by Sir John Kingman (Kingman Review) and the Competition and Markets Authority's study of competition in the audit market, published in April 2019 — The Independent Report into the quality and effectiveness of audit led by Sir Donald Brydon (Brydon Review), was published on 18 December 2019.

The report includes recommendations relating not only the role of auditors, but the role of others (boards, the new regulator the Audit Reporting and Governance Authority (ARGA), shareholders, stakeholders) in the audit process. Ultimately, the report concludes that 'audit is not broken but it has lost its way and all the actors in the audit process bear some measure of responsibility'. The recommendations are intended, in conjunction with other action being taken by government and regulators, to 'help auditors earn back shareholder and wider public confidence'.

Further, to this the report states that the recommendations should not 'create a significant extra cost other than where work that should be done is currently being neglected'.

Snapshot

Broadly, the recommendations include the following measures (among others).

- a redefinition of audit and its purpose
- the establishment of a separate corporate auditing profession governed by a set of principles
- the extension of the concept of auditing to areas beyond financial statements
- new obligations to acknowledge external signals of concern
- the introduction of 'suspicion into the qualities of auditing'
- measures to improve both the transparency and the quality of information
- the introduction of a corporate audit and assurance policy; a resilience statement and a public interest statement
- greater clarity around the role of audit committees

- measures to strengthen and clarify the role of auditors (and others) with respect to fraud detection and prevention
- mechanisms to encourage greater engagement of shareholders with audit and auditors
- suggestions to inform the work of Business Energy and Industrial Strategy (BEIS) on internal controls and improve clarity on capital maintenance

Further detail: Some key recommendations

Establishment of the ARGA should be a priority

In his introduction to the report, Sir Donald Brydon emphasises that in order for his recommendations to be implemented 'with appropriate urgency, it is important that the Audit, Reporting and Governance Authority (ARGA), the successor body to the Financial Reporting Council, be established with the necessary powers as soon as possible'. The ARGA he say should have clear responsibility for driving the implementation of the recommendations (other than those requiring a change in the law).

[Note: The Kingman Review recommended, among other things, the replacement of the Financial Reporting Authority 'as soon as possible' with a new independent regulator, the ARGA, with clear statutory powers and objectives. For a brief outline of the proposed recommendations see: Governance News 16/01/2020]

A redefinition of audit and its purpose

The report found that audit lacks a 'clearly understood and fully encompassing purpose'. To address this, it's suggested that a 'fresh definition' of the purpose of audit — 'The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements' — should be legislated and endorsed/adopted by ARGA (once established). In addition, the report recommends increased emphasis/reinforcement on the need for audits to provide 'decision useful' information.

Further, the report recommends that ARGA together with auditors and the Plain English Campaign 'produce an appropriately concise guide to audit, explaining clearly what the different elements of an audit report mean as redefined in this Report and what, just as importantly, they do not mean'.

New information

To satisfy the revised purpose (outlined above) the report recommends that:

- auditing 'should provide information that is useful to present and potential investors, lenders, creditors and other users in making rational investment, credit and other decisions and assessments about the company'.
- auditors should be 'free to include original information, materially useful to a wide range of users, in their audit report and at the AGM, and not be confined to commenting on that which has already been stated by directors'. The report makes clear that there would be no obligation on the auditor to seek such information, but that when discovered in the course of audit work and 'passing the materiality test', such information would need to be disclosed.
- The obligation on audits to read and consider other information in the Annual Report and to report if they consider it to be materially misstated should be extended to material outside the Annual Report that is used in investor presentations and RNS announcements. The report comments that 'The threat of this process should prove powerful in improving directors' disclosures'.

A separate corporate auditing profession

Rather than being an 'adjunct' or 'extension of the accounting profession' the report recommends that auditing should be an 'independent profession in its own right with its own governing principles, qualifications and standards.'

As such, the report recommends that the new regulator, the ARGA (once established):

- 'should facilitate the establishment of a corporate auditing profession based on a core set of principles' and act as the statutory regulator of the profession. The report further recommends ARGA should develop a coherent framework for corporate audit that includes, but is not limited to, the statutory audit of financial statements.

- ensure that 'training and, if necessary, retraining, should take place consistently' across the new audit profession to ensure auditors have the necessary skills to deliver quality audits. With respect to the skills necessary, the report suggests that 'a key part of the education necessary to be a successful auditor is to be found in the current training afforded to forensic accountants. The psychology of suspicion that accompanies forensic accounting should be more widely taught, equipping auditors with the ability to choose between scepticism and suspicion in different circumstances'. The report recommends that the development of a specific auditor qualification, including education and training, should become a high priority for ARGA over the coming years.
- 'should revisit the existing definition of professional judgment with a view to strengthening, and demonstrating better, the use of judgment in audit'.

More than meeting the legal standard required: Proposed Principles of Corporate Auditing

The report includes a proposed set of overarching principles around the purpose of auditing — The Principles of Corporate Auditing — that aim to 'integrate and give more prominence' to auditor behaviours set out in existing standards and codes, while also incorporating new additional principles around openness, independence, challenge and the public interest. The principles are intended to provide an 'overarching framework for the behaviour of auditors beyond that which simply follows standards and the law' on the basis that 'more is required of auditors'.

'It is, I believe, important to remember that law and regulations are not the only answer to ethical problems. The rule of law is of course essential, but ethics are driven by something more and should have an influence on behaviour that goes beyond compliance with rules' the report states.

The suggested principles are as follows.

- Auditors act with integrity, fulfilling their responsibilities with honesty, fairness, candour, courage and confidentiality
- Auditors are appropriately qualified and exercise professional judgment and appropriate scepticism or suspicion throughout their work
- Auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders
- Auditors maintain independence from the entity and its officers on whom they are engaged to report
- Auditors are objective and provide findings and opinions unaffected by bias, prejudice, compromise and personal or corporate conflicts of interest
- Auditors work to verify and encourage openness and honesty in financial and other company reporting
- Auditors ask the directors to report any material information that may legitimately be disclosed to assist the understanding of users of an audit report, and, if necessary, disclose it themselves
- Auditors provide appropriate challenge to management, assessing critical information and explanations received for signs of over-optimism, judgmental bias or possible fraud
- Auditors' reports contain clear findings and expressions of opinion setting out all information necessary for a proper understanding of the opinion and its basis
- Auditors' reports give transparency to any differences of view with management and how they were resolved
- Suggestions to inform the work of the BEIS on internal controls and to improve clarity on capital maintenance

The report further recommends that each audit report contain a statement that, in conducting the audit, the auditor has acted faithfully in accordance with the Principles of Corporate Auditing.

The report also expresses the hope that courts will consider adherence to the Principles as part of any defence against future legal action which may claim that an auditor's opinion has harmed the audited company and further, that the ARGA (once established) should also assess how auditors have followed the audit principles as part of their annual Audit Quality Reviews. 'All testing of the quality of an audit would start by assessing the extent to which an audit has been conducted in line with these principles' the report suggests.

The Audit Report: Replacing 'true and fair' with the term 'present fairly, in all material respects'

The report suggests that the existing requirement in UK company law for 'true and fair' financial statements to be prepared, should be replaced by the term 'present fairly, in all material respects'.

This change is required, the report explains due to the fact that 'both preparers and auditors appear to treat this in practice [the requirement to provide 'true and fair' financial statements] as being synonymous with compliance with accounting standards' (rather than with providing assurance that company accounts are free of material misstatements). Further, the change is necessary because of the difficulties associated with expecting auditors or directors to 'communicate effectively that modern company accounts are "true" in accordance with any reasonable person's understanding of the word'.

Not watering down the existing requirement?

The report makes clear that the change is not intended to, and should not in practice, water down existing requirements. 'Lest anyone considers this may weaken the force of the opinion, I consider, to the contrary, that its accuracy will strengthen the value of that opinion. Directors should have a legal obligation to state that the financial accounts they present each year have been fairly presented in all material respects, and the auditor should have a corresponding duty to assess whether this is the case (in addition to fulfilling their continuing duties to assess whether the accounts have been "properly prepared" in accordance with standards and whether they have been prepared in accordance with the law)' the report states.

Enhancing the informative nature of the audit report

Other recommendations aimed at 'enhancing' the informative value of the audit report include recommendations to: a) create continuity between successive audit reports; b) provide greater transparency over differing estimations (perhaps disclosing graduated findings); and c) 'calling out' inconsistencies in information and referencing external negative signals and how they have informed the audit.

Obligations to acknowledge external signals of concern

The report recommends that it be 'formally incumbent on the auditors to consider any external factors (as well as internal factors) which might signal' concerns (and therefore the need for additional work'. As such, the report recommends:

- the introduction of a new obligation on the auditors to report to both the audit committee and the shareholders on the extent to which their work has been influenced and informed (or not) by any external signals which might imply enhanced risk in the company whose financial statements are being audited'.
- the introduction of new obligation for auditors to report to both the audit committee and the shareholders on the extent to which their work has been influenced and informed (or not) by any external signals which might imply enhanced risk in the company whose financial statements are being audited. In particular, the report suggests that auditors should 'demonstrate the reason why the relevant signals, if any, did not impact the work undertaken'.
- ARGA (once established) should develop a menu of possible signals and the auditors should report against the relevant parts of that menu. These might include: a) extent of short positions; b) negative analyst report on viability; c) significant and rapid fall in the share price; d) major changes in the share register; e) widening swaps spreads; f) directors selling shares; g) sustained negative commentary; h) loss of banking facilities; i) deteriorating trade credit terms; j) falling credit rating; k) covenant breaches; l) not paying creditors on time; m) z-scores; n) extended late payments; o) late filings; and p) disputes with pension fund trustees.

'Decision useful information': Enhanced transparency/communication around how judgments were reached

The report includes a number of recommendations aimed at increasing the transparency around how judgments are reached with the aim of providing more useful, 'decision useful information'.

The report recommends that where an audit committee is presented with evidence of differing views between management and auditors over the value or construction of particular items, the audit committee should be required to describe the content of the debate and its outcome, including the justification for the agreed treatment. For example, where differences of view would have led to material changes in valuation, even when these differences have been resolved, the audit committee should report on the range of the initial views and where in that range the agreed valuation lies. The report states that 'such differences exist should not be seen as a negative signal, but rather a sign of a culture where the identification and resolution of differences or concerns between management, audit committee and auditor is the norm and is therefore the sign of a healthy and well-functioning audit'.

In addition, the report recommends that the consequences of potential differences in treatment of goodwill and intangibles considered by management and the auditor should also be made transparent.

The report also recommends that ARGA (once established) should develop a series of examples which would illustrate, non-exclusively, the types of culture that auditors should reference in their report where there is an 'observed disconnect between the culture of the company claimed by the directors and the behaviour observed by the auditors'.

Directors' reporting

The report recommends that directors should present to the shareholders a three-year rolling Audit and Assurance Policy outlining: a) their approach to the appointment of auditors; b) the scope and materiality of all auditing (including that of the financial statements); c) the assurance budget; and d) the relationship of any audit to identified risks. Shareholders would be invited to express their views on this policy in an advisory vote.

Further, the report recommends the introduction of a corporate Audit and Assurance Policy, a Resilience Statement and a Public Interest Statement.

More particularly, the report recommends that directors be required to:

- publish a statement of principal risks and uncertainties before determining the scope of each year's audit and actively seek shareholder and other views on the appropriate emphases;
- publish a Resilience Statement (ie an expansion of the 'going concern' statement) which would incorporate a going concern opinion for the short term, a statement of resilience in the medium term and a consideration of the risks to resilience in the long term; and
- present an annual Public Interest Statement, explaining the company's view of its obligations to the public interest, whether arising from statutory, self-determined or other obligations, and how the company has acted to meet this public interest over the previous year.

Further, the report recommends that directors, in proposing a dividend, would need to make a statement that the payment of the dividend 'in no way threatens the existence of the company'. The statement would need to be consistent with the Resilience Statement, and be assured in accordance with the Audit and Assurance Policy.

Audit Committee

With respect to funding assurance work, the report recommends that audit committees agree an annual assurance budget, within which they have primary responsibility for negotiating and agreeing the audit fees, and which sets a framework for company spending on any other assurance work. In addition, the report recommends 'enhanced transparency as to the audit fees'.

Further, the report recommends a number of measures aimed at enabling shareholders to influence the scope of audit and to hold the audit committee and auditor to account.

Shareholders

To complement directors' new disclosure requirements, the report recommends that:

- A process be established in which the company's shareholders are given a formal opportunity to propose any matters they wish to be covered in the audit. Audit Committees would retain their decision-making rights but would be obliged to explain their reasons if they rejected such requests.

- There be a standing item on audit at the company's general meeting, to permit questioning of the Audit Committee Chair and the auditor.
- The existing, Audit Quality Forum be replaced with a new body, the Audit Users Review Board, to be co-ordinated by the Investment Association and bringing together a range of users of audit, including the Audit Committee Chairs Independent Forum, The 100 Group, institutional and retail shareholder representatives, and other users.

Other Stakeholders

- The Principles of Corporate Auditing (as outlined above) include a statement that auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders.
- The audit report should include a new section in which the auditor states whether the director's section 172 statement is based on observed reality, on the basis of the auditor's knowledge of the company and its processes.
- That directors actively seek the views of employees regarding the scope of any audit activity and report back to them how their views have been taken into account.

Auditing performance measures underpinning executive remuneration

The report recommends that any Alternative Performance Measures reported by a company, and any use of Key Performance Indicators (KPIs) to underpin executive remuneration, should be subject to audit.

Clarification of auditor liability

The report recommends that company law be amended to provide that any use of Liability Limitation Agreements by company boards, proposed in good faith, do not represent a breach of directors' responsibilities.

Measures around fraud detection and prevention

The report includes a number of recommendations clarifying responsibilities for detecting and preventing fraud including enhanced education, greater disclosure of anti-fraud measures taken, a fraud register and an 'independent sanctions regime' which are aimed at 'restoring confidence in auditors in this area'.

These include the following.

- **Obligation for auditors to 'endeavour to detect material fraud':** The report recommends that ARGA (once established), amend ISA (UK) 240 'to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways'.
- **Additional training for auditors:** In addition, the report recommends that auditors be trained in both forensic accounting and fraud awareness as part of their formal qualification in auditing, and continuous learning process, in order to practice as a financial statements auditor and that in developing qualifications for auditors of other areas of activity, parallel training should be established.
- **Clearer communication**: The report recommends that the auditor's report state explicitly the work performed to conclude whether the directors' statement regarding the actions they have taken to prevent and detect material fraud is appropriate. Further, the auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud eg stating any material frauds of which the auditor has experience in companies in the same industry and what tests it applied to address the risk of a similar fraud having occurred.
- **The report recommends that directors be required to report on the actions they have taken to fulfil their obligations to prevent and detect material fraud** against the background of their fraud risk assessment.

Other measures

- **New fraud register:** The report recommends that ARGA (once established) maintain an open access case study register detailing corporate frauds that have occurred in order that auditors can learn in real time from these frauds. To support this, the report recommends the introduction of a requirement for auditors to file a case study (suitably anonymised) with ARGA of each material fraud discovered to keep this register up to date.

- **New Auditor Fraud Panel:** To assess the potential culpability of an auditor in failing to detect a fraud, the report recommends that ARGA establish an independent Auditor Fraud Panel (modelled on the Panel on Takeovers and Mergers) to which it would refer the results of any investigations into auditor failure to detect material frauds and that such a Panel should be equipped with the ability to levy sanctions on auditors as appropriate. The report suggests that the 'Panel would give auditors confidence in the process of adjudication to which they would be subject and lessen the risk of court proceedings'.

Whistleblowing

To allow employees legitimately to raise concerns and related information directly to the auditor provided that they meet the public interest criteria set out in the Public Interest Disclosure Act, the report recommends that the 'the Statutory Auditor be added to the list of 'prescribed persons' under the Public Interest Disclosure Act.'

Further, the report recommends that the government consider widening the to enable customers and suppliers to raise concerns with the statutory auditor.

Payments to suppliers

To address the 'relative lack of information' around payments to suppliers in annual reports, the report recommends that existing voluntary and statutory company disclosures on supplier payment performance be brought into the annual report, and be subject to a level of audit as described in the company's Audit and Assurance Policy.

Technology

The report recommends that BEIS and ARGA work with auditors to create the necessary protections and policies for audit to be able to use data from the companies they audit in order to promote better quality audits. Further, the report recommends that auditors be required to explain in audit reports any use of sampling techniques.

Further action

The report recommends that that there should be an Independent Implementation Review in 2025 to report publicly on the progress made in relation to the recommendations made by each of these three Reviews.

FRC's response to Sir Donald Brydon review

In a short statement, the Financial Reporting Council (FRC) said it will 'study Sir Donald Brydon's report with interest. Many of the recommendations, if accepted by the government, will have significant implications for the FRC in respect of our activities and resource requirements.' The statement goes on to say that the FRC have already implemented a number of the recommendation s of the independent review of the FRC and 'anticipate being involved in delivering the broader reforms to the UK audit market that the government has initiated.'

2019 Queen's speech: plans for audit reform?

On the 19 December 2019, The Queen delivered the Queen's Speech to MPs in which she outlined the government's priorities for the coming year. With respect to audit reform, notes accompanying the speech state that, the government intends to 'develop proposals on company audit and corporate reporting, including a stronger regulator with all the powers necessary to reform the sector. These proposals aim to improve public trust in business, following the three independent reviews commissioned in 2018. It will also help workers employed by a large company in future to know how resilient it is'. No specific timeframes are given.

[Sources: Full text of the Brydon Review: Report of the Independent Review into the Quality and Effectiveness of Audit December 2019; [registration required] The FT 18/12/2019; FRC media release 18/12/2019; Board Agenda 03/01/2020; The Guardian 19/12/2019; CityAM 18/12/2019; Queen's speech December 2019: background briefing notes] [registration required] The AFR 19/20/2019; [registration required] The FT 18/12/2019; 19/12/2019; Accountancy Age 02/01/2020]

United Kingdom | New Industry Code of Practice for auditors

The UK Chartered Institute of Internal Auditors (CIIA) has released a new Code of Practice — Internal Audit Code of Practice — for auditors with a view to strengthening corporate governance and increasing the effectiveness of internal audit functions, following a series of high-profile collapses (eg Carillion) linked to governance deficiencies.

Some Key Points

The new code aims to increase the status, scope and skills of internal audit and makes 38 recommendations including the following.

- Unrestricted access for internal audit so it is not stopped from looking at any part of the organisation it serves and key management information.
- The right to attend and observe executive committee meetings.
- A direct line to the CEO and a direct report to the Audit Committee Chair to increase the authority and status of internal audit.
- The direct employment of Chief Internal Auditors in every business even when the internal audit function is outsourced. This is to ensure Chief Internal Auditors have sufficient and timely access to key management information and decisions.
- Regular communication and sharing of information by the Chief Internal Auditor and the partner responsible for external audit to ensure both assurance functions carry out their duties effectively.

The Internal Audit Code of Practice was developed by an independent Steering Committee set up by the Chartered Institute of Internal Auditors and chaired by Brendan Nelson – Audit Committee Chair of BP.

Launching the Code Mr Nelson urged boards and more particularly, audit committees to apply the Code 'increase the effectiveness of their internal audit functions, in the pursuit of stronger corporate governance and risk management'.

Response to the Code

- The CIIA says that the new Code was welcomed in Sir Donald Brydon's recently published independent review into the quality and effectiveness of audit, and quotes Sir Donald as describing the new code as 'important step to improving the quality and delivery of internal audit services.' The CIIA states that the new code complements the Brydon Review recommendations.
- CEO of the Financial Reporting Council Sir Jon Thompson commented, that 'internal audit is a vital part of the overall assurance that companies provide their investors and stakeholders, which helps to build trust in business. This is a significant time in the evolution of audit in the UK in light of the Kingman, Brydon and CMA reviews. I commend the IIA for developing and introducing this new Code of Practice which sets a high standard of best practice and should be considered an important part of the overall risk management and assurance framework.'
- Director General of the Institute of Directors (IoD) Jonathan Geldart said that the 'very much welcomes the introduction of the Internal Audit Code of Practice by the Chartered Institute of Internal Auditors which serves to codify the essential elements of internal controls required as the basis of any good business.'
- Institute of Chartered Accountants in England and Wales (ICAEW) CEO Michael Izza said that the new code is an 'important step forward for corporate governance. It provides a benchmark for best practice and a measure for boards and audit committees to assess the effectiveness of their internal audit functions. I encourage organisations to examine the code and consider signing up to it.'

[Sources: CIIA media release 08/01/2020; CIAA: Internal Audit Code of Practice; [registration required] The WSJ 09/01/2020; The Business Times 10/01/2020; Insider.co.uk 09/01/2020]

In Brief | The Financial Reporting Council (FRC) has updated its Practice Aid to reflect developments since the first edition was issued in 2015 and better assist audit committees in evaluating audit quality in their assessment of the effectiveness of the external audit process

[Sources: FRC media release 19/12/2019]

In Brief | The FRC has issued a statement deferring the date for completion of the first phase of its investigation into KPMG in connection with its audit work on Carillion due to the complexity of the case and its decision on whether to bring enforcement action. The FRC says that though its investigation is well advanced, it expects to complete the first stage of its investigation by 'summer 2020' rather than January as initially planned

[Source: FRC media release 10/01/2020; [registration required] The FT 11/01/2020]

Risk Management

Climate Risk

Top Story | BlackRock CEO Larry Fink's Annual Letter 2020: 'Climate risk is investment risk'

Key Takeouts

- **Top investor concern:** Climate change is almost invariably the top issue that clients around the world raise with BlackRock.
- **Climate risk is investment risk:** The evidence on climate risk is compelling investors to reassess core assumptions about modern finance and to recognise that 'climate risk is investment risk'. The letter states that 'we are on the edge of a fundamental reshaping of finance'.
- **The reshaping of finance is expected to occur (relatively) quickly:** 'Because capital markets pull future risk forward, we will see changes in capital allocation more quickly than we see changes to the climate itself. In the near future – and sooner than most anticipate – there will be a significant reallocation of capital' Mr Fink states
- **New initiatives:** BlackRock has announced a number of initiatives to put sustainability at the centre of its investment approach including among others, exiting investments that 'present a high sustainability-related risk' (eg thermal coal) and launching new investment products that screen fossil fuels.
- **Time to report against TCFD and SASB requirements:** BlackRock is asking companies to: a) publish a disclosure in line with industry-specific SASB guidelines by year-end/disclose a similar set of organisation-specific data; and b) disclose climate-related risks in line with the TCFD's recommendations including plans for operating under a scenario where the Paris Agreement's goal of limiting global warming to less than two degrees is fully realized, as expressed by the TCFD guidelines.
- **Holding boards individual directors and boards accountable:** Where BlackRock will be 'increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them'.
- **Committing to enhanced transparency:** In a letter to clients, BlackRock commits to a number of initiatives aimed at enhancing engagement, voting and transparency in stewardship. For example: moving to quarterly (as opposed to annual) voting disclosure and committing to enhance disclosure around engagement activity (eg the topics discussed during each engagement with a company) including in the stewardship annual report.
- **'A fantastic start' that may 'raise the bar' for BlackRock's competitors?** Media reports comment that BlackRock has come under pressure over its voting record on climate issues. Some groups have reportedly welcomed Mr Fink's announcement. For example, the Sunrise Project is quoted as saying that 'divestment of coal in its actively managed funds, is a fantastic start and instantly raises the bar for competitors such as Vanguard and State Street Global Advisors.' However, the group also considers that more is needed. 'Even with today's announcements, based on its size BlackRock will still remain

one of, if not the largest, investors in fossil fuels. So we will be looking for additional leadership from the company'.

- **Implications?** MinterEllison's Sarah Barker said 'Mr Fink's 2020 letters follow significant stakeholder pressure on BlackRock to operationalise climate-related position statements with more ambitious, consistent investment and stewardship action. In one fell swoop, the letters cut down a number of misconceptions on which corporations (and asset owners) commonly rely to justify a 'business as usual' approach – among them that climate risk cannot be managed in passive portfolios, that divestment of companies in climate-exposed industries should not be pursued on financial grounds, that markets are already efficiently pricing the relevant risks, and that climate change is not an issue warranting board-level oversight and accountability. As the letters state bluntly: "Climate risk is investment risk"'.

Sustainability risk (including climate risk) is the theme

BlackRock Inc has released its chairman and CEO Larry Fink's 2020 annual letter to CEOs. The necessity of managing, planning for and reporting sustainability risk, and more particularly, climate risk is the theme.

A high level summary of the points raised by Mr Fink is below.

Climate change is the 'almost invariably the top issue' for clients

Mr Fink says that 'climate change is almost invariably the top issue that clients around the world raise with BlackRock' (including in Australia). More particularly he says that investors are 'seeking to understand both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy'.

In a separate letter to clients (released at the same time as his annual letter to CEOs), Mr Fink nominates climate change, not only in terms of the physical risk associated with rising global temperatures, but also transition risk as the 'most significant' of the broader sustainability risks facing investors and companies going forward.

The 'reshaping of finance'

Mr Fink writes that the evidence on climate risk, and the level of stakeholder concern and increased understanding of how sustainability-related factors can affect economic growth, asset values, and financial markets as a whole, is compelling investors to 'reassess core assumptions about modern finance' and ultimately to recognise that 'climate risk is investment risk'. As such, he considers that 'we are on the edge of a fundamental reshaping of finance'.

Mr Fink goes on to say that he expects this shift to occur (relatively) quickly. 'Because capital markets pull future risk forward, we will see changes in capital allocation more quickly than we see changes to the climate itself. In the near future – and sooner than most anticipate – there will be a significant reallocation of capital' Mr Fink states.

An immediate wholesale shift is not yet technically feasible, or responsible?

Mr Fink cautions that an immediate shift is neither feasible (as yet) or necessarily 'fair'. 'Despite recent rapid advances, the technology does not yet exist to cost-effectively replace many of today's essential uses of hydrocarbons' and in consequence, it's necessary to 'be mindful of the economic, scientific, social and political realities of the energy transition'.

He adds that the transition must also be accomplished responsibly, 'governments and the private sector must work together to pursue a transition that is both fair and just – we cannot leave behind parts of society, or entire countries in developing markets, as we pursue the path to a low-carbon world'.

Sustainability to be central to BlackRock's investment approach: new initiatives announced

Mr Fink writes that though government must 'lead the way' and ultimately set the pace for the transition to a low carbon economy, both companies and investors have a 'meaningful role to play'. 'Every government, company, and shareholder must confront climate change' he writes.

The letter flags that BlackRock has written to clients to announce a number of initiatives aimed at putting sustainability at the centre of its investment approach. These initiatives include:

1. making sustainability integral to portfolio construction and risk management.

2. exiting investments that present a high sustainability-related risk, such as thermal coal producers.

3. launching new investment products that screen fossil fuels; and

4. strengthening BlackRock's commitment to sustainability and transparency in its investment stewardship activities

Mr Fink's letter to clients provides further detail around these initiatives.

With respect to exiting thermal coal producers the letter states that BlackRock is 'in the process of removing from our discretionary active investment portfolios the public securities (both debt and equity) of companies that generate more than 25% of their revenues from thermal coal production, which we aim to accomplish by the middle of 2020'. The letter goes on to say that part of BlackRock's process of evaluating sectors with high ESG risk, it will 'closely scrutinize other businesses that are heavily reliant on thermal coal as an input, in order to understand whether they are effectively transitioning away from this reliance. In addition, BlackRock's alternatives business will make no future direct investments in companies that generate more than 25% of their revenues from thermal coal production'.

Improved sustainability disclosure (including climate disclosure) is required

Echoing previous letters, Mr Fink emphasises the importance of sustainability and link between long-term sustainability and profitability. 'The importance of serving stakeholders and embracing purpose is becoming increasingly central to the way that companies understand their role in society. As I have written in past letters, a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders… Ultimately, purpose is the engine of long-term profitability' he writes.

Mr Fink goes to call for increased transparency, in the form of 'improved disclosure', around sustainability efforts. 'We believe that all investors, along with regulators, insurers, and the public, need a clearer picture of how companies are managing sustainability-related questions. This data should extend beyond climate to questions around how each company serves its full set of stakeholders, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data. Each company's prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders' he writes.

Time to report against the SASB guidelines and TCFD recommendations

Despite the strides that have been made towards integrating and reporting on sustainability, Mr Fink considers that there is a need for 'more widespread and standardised adoption' and as such calls on companies to both:

- publish a disclosure in line with industry-specific Sustainability Accounting Standards Board (SASB) guidelines by year-end, or to disclose a similar set of organisation-specific data; and

- disclose climate-related risks in line with the Taskforce on Climate related Financial Disclosures (TCFD's) recommendations including plans for operating under a scenario where the 'Paris Agreement's goal of limiting global warming to less than two degrees is fully realised, as expressed by the TCFD guidelines'.

Mr Fink states that BlackRock will use these disclosures, in combination with engagement efforts, to assess the extent to which risks are being 'properly managed' and the extent to which organisations are 'adequately planning for the future'. He cautions that in the 'absence of robust disclosures, investors, including BlackRock, will increasingly conclude that companies are not adequately managing risk' and that this may be reflected in BlackRock's voting behaviour.

BlackRock to provide TCFD aligned disclosure by the end of the year: Reflecting on BlackRock's own reporting against these requirements, Mr Fink observes that it is 'not yet where we want to be' but is 'continuously working' to improve. He points out that SASB-aligned disclosure is already available on the BlackRock website, and that BlackRock will release TCFD-aligned disclosure by the end of 2020.

Increase and improve disclosure or else?

The letter identifies two potential negatives in failing to provide increased disclosure.

1. First, Mr Fink states that companies that fail to respond to stakeholder calls for increased transparency around management of sustainability risks 'will encounter growing scepticism from the markets, and in turn, a higher cost of capital'. In contrast, 'companies and countries that champion transparency and demonstrate their responsiveness to stakeholders, by contrast, will attract investment more effectively, including higher-quality, more patient capital'.

2. Second, referencing BlackRock's voting record over the last year, and more particularly the fact that BlackRock voted against or withheld votes from 4,800 directors at 2,700 different companies, Mr Fink states that 'where we feel companies and boards are not producing effective sustainability disclosures or implementing frameworks for managing these [sustainability] issues, we will hold board members accountable'.

Mr Fink concludes by saying that 'given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them'.

BlackRock commits to increased transparency

BlackRock's letter to clients outlines a number of initiatives aimed at enhancing engagement, voting and transparency in stewardship.

These include: a) joining Climate Action 100+; b) clarifying expectations of companies through mapping engagement priorities to specific UN Sustainable Development Goals (eg Gender Equality and Affordable and Clean Energy) and incorporating key performance indicators in engagement policies; c) moving to quarterly (as opposed to annual) voting disclosure; d) committing to prompt disclosure of how BlackRock voted and the reasons why for 'high profile votes'; and e) enhancing disclosure around engagement activity (eg the topics discussed during each engagement with a company) including in the stewardship annual report.

Response from climate groups?

'A fantastic start' that raises the bar for BlackRock's competitors?

Reportedly some climate groups have welcomed Mr Fink's announcement and suggested that it may push BlackRock's competitors to take a similar stance. For example, Diana Best, of the Sunrise Project is quoted as saying that 'divestment of coal in its actively managed funds, is a fantastic start and instantly raises the bar for competitors such as Vanguard and State Street Global Advisors'.

However, the group is also reportedly of the view that more is required, 'Even with today's announcements, based on its size BlackRock will still remain one of, if not the largest, investors in fossil fuels. So we will be looking for additional leadership from the company'.

Other groups are reportedly more cynical?

Some media reports have referenced recent criticism of BlackRock's climate record. Extinction Rebellion has reportedly said the announcement will make little difference. 'BlackRock remains waist-deep in fossil fuel investments and the world's top backer of companies that destroy the Amazon rainforest and ignore the rights of indigenous people' the group is quoted as saying.

Implications?

MinterEllison's Sarah Barker said 'Mr Fink's 2020 letters follow significant stakeholder pressure on BlackRock to operationalise climate-related position statements with more ambitious, consistent investment and stewardship action. In one fell swoop, the letters cut down a number of misconceptions on which corporations (and asset owners) commonly rely to justify a 'business as usual' approach – among them that climate risk cannot be managed in passive portfolios, that divestment of companies in climate-exposed industries should not be pursued on financial grounds, that markets are already efficiently pricing the relevant risks, and that climate change is not an issue warranting board-level oversight and accountability. As the letters state bluntly: "Climate risk is investment risk"'.

Expert guidance on climate risk

MinterEllison has prepared a plain language guide to climate risk and the associated risks and opportunities for business. The guide can be accessed on the MinterEllison website here.

[Sources: BlackRock Annual CEO Letter 2020: A fundamental reshaping of finance; BlackRock client letter 2020; [registration required] The Australian 14/01/2020; The Guardian 15/01/2020; 15/01/2020; The New York Times 14/01/2020; Fortune 14/01/2020; [registration required] The FT 10/01/2020]

Corporate governance reform is urgently needed? 76 academics have signed the Corporate Governance for Sustainability Statement calling for urgent reforms to address the failure of corporations to consider environmental, social or long-term, economic sustainability

Seventy six academics have released a statement in support of the European Commission's Action Plan on Financing Sustainable Growth, and putting forward their own proposed reforms to support and progress its implementation.

The European Action Plan on Financing Sustainable Growth: The Action Plan sets out an agenda to develop integrated reforms in the areas of sustainable finance, directors' duties, and corporate reporting with the aims of:

- addressing the root causes of short-termism in capital markets and corporate governance;
- correcting the failure of relevant actors to manage the financial risks associated with climate change; and
- moving business towards greater sustainability.

Proposed reforms to support/contribute to the development Action Plan's agenda

- **Sustainable Finance:** In order to encourage investment in companies that implement long-term sustainability plans (even at the expense of short term returns) the statement proposes that:
  - every level of the investment chain, including upon institutional investors and asset managers be legally required to identify, consider and disclose environmental, social and governance (ESG) risks
  - boards be required to develop, disclose and implement a corporate sustainability strategy
  - reform of corporate disclosure rules to improve the quality and comparability of the non-financial information provided to shareholders and other stakeholders about key sustainability risks.
- **Directors' duties and corporate board obligations:** In order to: counteract the pressures imposed on directors by financial markets to maximise short-term shareholder value; increase director accountability; and ensure a proper consideration of corporate long-term interests and sustainability risks, the statement recommends that:

- directors should be subject to a legally-binding obligation to develop, disclose and implement (on behalf of the company), a forward-looking corporate sustainability strategy that identifies and addresses material environmental and social issues and significant impacts connected to the company's business model, operations and supply chain. Though directors should have discretion with respect to identifying which issues are material for the corporate sustainability strategy, the law should clarify that the purpose of requiring companies to produce such a strategy is to ensure 'respect for the planetary boundaries and human rights, as well as integration of ESG considerations into all aspects of the company's operations'. Further, in order to ensure that the strategy covers relevant matters, the law should specify a limited set of sector-specific issues and public objectives that should be addressed on a 'comply or explain' basis.
- a specified percentage of the key performance indicators (KPIs) and remuneration of executive management should be linked to the achievement of measurable targets set in the company's sustainability strategy (and national remuneration disclosure laws should be amended to require publication of these matters).

- **Directors' accountability:** In order to ensure directors' accountability for this responsibility, the statement proposes that:
  - boards be required to include in the corporate sustainability strategy verifiable targets and a commitment to making sufficient resources available to management
  - boards should be mandated to discuss and sign off on an annual progress report, which should be included in the company's non-financial report
  - a non-executive committee, composed of independent experts and chaired by a designated non-executive director, should be set up and tasked with monitoring and reviewing the content and implementation of the sustainability strategy
  - non-executive directors should have a duty of care to monitor the implementation of the strategy
  - failure to implement the corporate sustainability strategy should be considered a breach of executive directors' duty of good faith (where deliberate) or duty of care (where accidental) and could be enforced by the shareholders by derivative action where the failure causes long-term harm to the company
  - a national regulatory body should be empowered to bring proceedings against the executive directors where non-implementation has caused serious harm to third parties or unlawful harm to the environment.
- **Corporate non-financial reporting:** The statement recommends that the rules relating to corporate disclosures should:
  - clarify that information on sustainability matters should be disclosed if it is material either from a financial or from a social and environmental perspective
  - stipulate minimum general and sector-specific requirements for form and content of disclosures. Minimum requirements should be imposed in relation to certain matters eg climate change-related targets, strategies and performance, and the results of environmental and human rights due diligence covering supply chains

Call for urgent action to implement the proposals (outlined above) in support of the EC Action Plan

The statement concludes with a call to urgently implement the proposals (outlined) in support of the EC Action plan agenda. 'Current corporate governance practice is contributing to a number of systemic risks, as well as devastating social, environmental and economic impacts. With less than a decade left in which to address the catastrophic threat of climate change, and with investors, companies, accountants, policymakers and academics expressing a shared sense of urgency, now is the time to act to reform corporate governance. The signatories to this Statement call on all those concerned about climate change and sustainability to work together to support and implement the proposals in this statement and to contribute to the achievement of the EC Action Plan's goals'.

[Source: Harvard Law School Forum on Corporate Governance and Financial Regulation 07/01/2020]

Targeting a superfund over its (alleged) failure to support shareholder climate proposals: Market Forces is targeting superannuation fund UniSuper to divest members' retirement savings from fossil fuel companies

Market Forces has launched a campaign to pressure superannuation fund, UniSuper, to divest members' retirement savings from fossil fuel companies by the end of the financial year ending 30 June 2020.

According to Market Forces, the campaign has been launched in response to the fact that UniSuper is the default fund for academics/scientists/academics and should therefore be 'at the vanguard of climate policy' and because the fund has not voted in favour of a single climate change-related shareholder resolution in Australia, based on the fund's disclosed proxy votes to 30 June 2019.

Market Forces has called on UniSuper members to sign an open letter calling on the fund to divest from all companies that are 'actively undermining' climate change action.

The AFR reports that UniSuper has responded to the campaign by saying that its preferred strategy is engagement with companies as opposed to divestment. 'Being an investor enables us to be part of the conversation and use company engagement and proxy votes to encourage management in these companies to improve their practices' UniSuper is quoted as saying.

[Sources: Market Forces media release 13/01/2020; open letter; [registration required] The AFR 13/01/2020]

In Brief | BlackRock has joined Climate Action 100+ which requires its signatories to push companies to reduce greenhouse gas emissions in line with the goals of the Paris Agreement, implement a strong governance framework articulating the board's accountability/oversight of climate change risks/opportunities and provide enhanced corporate disclosure in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). The addition of funds BlackRock manages, brings total assets under management represented by investors participating in Climate Action 100+ to more than $41 trillion

[Sources: Climate Action 100+ media release 09/01/2020; [registration required] The FT 10/01/2020; [registration required] The WSJ 09/01/2020; [registration required] The AFR 10/01/2020]

Cybersecurity, privacy and technology

Cyber resilience in Australian financial firms is improving: ASIC Report 651 released

Report Overview | ASIC Report 651 Cyber resilience of firms in Australia's financial markets: 2018–19 (REP 651)

Key Takeouts

- Financial Services firms report that they are more cyber resilient than they were in 2017 — overall, firms' cyber resilience has improved an average of 15% since the last report.
- Awareness and training improved in both SMEs and large firms Though there has been improvement, firms have found it challenging to meet their original targets. ASIC attributes this to: a) setting overly ambitious targets; b) the continually changing threat environment; c) limited organisational capability; and d) limited access to specialised skills/resources.
- Improvement areas? For SMEs, ASIC considers that there is still opportunity to improve in risk management (particularly supply chain risk management). Likewise, for large firms, Asset management and supply chain risk management are identified as areas for improvement.

Context: On 17 November 2017 the Australian Securities and Investments Commission (ASIC) released report — Rep 555 Cyber resilience of firms in Australia's financial markets. Firms were asked to assess their cyber resilience against the National Institute of Standards in Technology (NIST) Cybersecurity Framework (NIST Framework).

In 2017 and 2018, ASIC asked firms to reassess their cyber resilience against the updated NIST Framework to determine how their progress was tracking. Report 651 presents insights from those self-assessments and identifies emerging trends and challenges.

Some Key Points

Some of the key findings in Report 651 are below**.**

Overall insights

Cyber-resilience has improved since 2017

- Firms' cyber resilience has improved an average of 15% since the last report.
- 80% of firms now have formal processes for information risk management and governance in place (16% improvement since the last report).
- 80% consider their response and recovery practices to be well managed (20% improvement since the last report).

Commenting on the improvement, ASIC Commissioner Cathie Armour said, all firms recognise 'cyber risk as a strategic, organisation-wide issue that is attracting increasing investment'.

Challenges

Overall, though there has been improvement, firms have found it challenging to meet their original targets. ASIC attributes this to: a) setting overly ambitious targets; b) the continually changing threat environment; c) limited organisational capability; and d) limited access to specialised skills/resources.

Commenting on this, Commissioner Armour said that 'continued investment and strong leadership from senior management is critical to ensuring a firm's ability to meet these targets and maintain strong cyber resilience'.

Trends?

- Overall, the gap between large firms and small-to-medium enterprises (SMEs) identified in REP 555 is gradually closing, with the overall improvement in cyber resilience across the industry largely driven by small and medium-sized entities (SMEs). Larger firms tend to 'demonstrate greater confidence in their cyber resilience'.
- Supply chain risk management is now accepted as an industry-wide challenge that requires attention over the next period. ASIC expresses concern at the trend towards outsourcing of non-core functions to third party providers on the basis that it has created difficulties in the management of cybersecurity risks in the supply chain.

Some sector-specific insights

The NIST Framework allows firms to assess their cyber resilience against five functions — identify, protect, detect, respond and recover — using a four stage maturity scale ranging from least mature to mature.

The table below provides a snapshot of some of the insights to emerge in relation to each of the five NIST areas.

NIST framework	SMEs	Large Firms
Identify: This function assists in developing an organisational understanding of how to manage cybersecurity risk to systems, people, assets, data and capabilities.	80% of SMEs assess themselves as 'repeatable' or better in cybersecurity risk governance (a 27% improvement since the last report). However, ASIC considers that there is still opportunity to improve in risk management which showed the least progress. In particular, supply chain risk management emerged as a significant challenge, with 42.9% of SMEs 'partial' or 'risk-informed'. All participants indicated this would be an area of focus over the next 18–24 months, but improvement is expected to be gradual.	Cybersecurity governance, risk strategies and management have continued their upward trend since the last report – up 5% to 90% 'repeatable' or 'adaptive'. Asset management and supply chain risk management are identified as areas for improvement.
Protect: This function supports the ability to limit or contain the impact of potential cybersecurity events and outlines safeguards for delivery of critical services.	The two areas that showed the most improvement since the last report include awareness and training programs (77% 'repeatable' or 'adaptive') and user access management (91% 'repeatable' or 'adaptive'). However, ASIC considers that there is still room for improvement given the importance of employees as a line of defence against cybersecurity events.	Large firms continued investment in staff awareness and training, resulting in an improvement of 10% since the initial self-assessment. User access management is also tightly managed with 91% of firms indicating a 'repeatable' or 'adaptive' rating. Within the next 18–24 months, 13% of the firms rated as 'risk-informed' for data security and preventative technologies are targeting a rating of 'repeatable' or higher. ASIC comments that this 'conservative improvement' is indicative of the time/effort required to implement such capabilities across an organisation.
Detect: This function defines appropriate activities to identify cybersecurity events in a timely manner.	There was 'significant improvement' in detection capabilities, particularly in the area of continuous monitoring (25% improvement). Anomaly and events detection and formal detection procedures also improved by 16% but are still lagging behind, with 23% of firms reporting a 'partial' or 'risk-informed' rating.	Large firms are extending the limits of their monitoring and detection capabilities – with 60% 'repeatable' and 20–25% 'adaptive'. Many have invested in security operation centres that have skilled teams proactively monitoring threats against their organisations.
Respond: This function identifies appropriate activities to minimise the impact of cybersecurity events. **Recover**: This function identifies appropriate activities to maintain cyber resilience and restore services affected by cybersecurity events.	A major proportion of the improvements reported by SMEs can be attributed to the response and recover functions. Improvements range from 25% to 31.5% for recovery practices, which were identified as a specific area of concern in the last report.	Firms 'have made significant strides' towards improvement in this area eliminating 'partial' and 'risk-informed' practices within this functional area. For example, there has been a 19.4% improvement to response planning and a 16.1% improvement in mitigation planning/improvements to ensure events, when they occur, are contained, do not propagate and are neutralised as quickly as possible. Plans over the coming period indicate that all response and recovery

NIST framework	SMEs	Large Firms
		practices will be 'repeatable' or 'adaptive'.

- **Cyber resilience of credit rating agencies (CRAs):** Overall, ASIC found that though there was improvement since the last report, there was also a 'recalibration' across all CRAs – with over 30% downgrading their 'adaptive' ratings to 'repeatable'.
  - **With respect to cybersecurity strategy and governance** ASIC found that: a) there is an inconsistent approach to board-level ownership of cybersecurity matters (some boards drive their organisation's cybersecurity strategy, while others are led by management or IT); and b) some CRAs did not have a 'single, coordinated cybersecurity strategy' in place, but rather a collection of documents that described the strategy, framework and policies making the strategy difficult to navigate/update.
  - **With respect to cybersecurity and response playbooks,** there was found to be significant disparities in the quality of event response playbooks.

Next steps

ASIC will continue to monitor, assess and measure improvements over time by: a) engaging and collaborating with regulated firms, other regulators and government; b) raising awareness of cyber risks in the financial markets sector and highlighting good practices and areas for improvement; and c) assessing the cyber resilience of regulated firms and measuring their progress against their targets.

[Sources: ASIC media release 18/12/2019; ASIC Report 651 Cyber resilience of firms in Australia's financial markets: 2018–19]

'Imperative' that the financial services sector acts to invest in, and to implement regtech: ASIC Regtech initiative report released

Report Overview | ASIC Report 653 ASIC's regtech initiatives 2018–19

On 7 August 2018, the Australian Securities and Investments Commission (ASIC) received federal government funding for financial years (FY) 2018–19 and 2019–20 to promote Australia as a world leader in developing and adopting regtech solutions to risk management and compliance problems relating to financial services. ASIC used this additional funding in FY2018–19 to develop a series of regtech initiatives focused on the potential use of technology to help businesses deal with conduct of business compliance issues.

On 20 December, ASIC has released a report — ASIC Report 653 ASIC's regtech initiatives 2018–19 — summarising its regtech initiatives and events conducted during FY2018–19.

Some Key Points

ASIC undertook four regtech initiatives in FY2018–19, namely: 1) Monitoring Financial Promotions Demonstration and Symposium; 2) Financial Advice Files Demonstration and Symposium; 3) Voice Analytics and Voice-to-Text Trial and Symposium; and 4) Technology-Assisted Guidance (TAG) Tool Trial.

Results/findings?

- the initiatives listed above were able to identify incidents of potential non-compliance across mandatory disclosure requirements, in both financial promotions and personal financial advice and p[potential conduct breaches in financial advice files eg statements of advice
- there is 'promise' that in future, voice analytics will be able to locate signal identifiers of poor sales practices in stored, non-compressed, phone call records (the example used by demonstrators were life insurance phone call records)
- a viable proof-of-concept chatbot to provide guidance on whether a business needs a financial services or credit licence was developed for ASIC by procured regtech vendors

ASIC concludes from the findings that that there is potential for regtech to be used by ASIC, and other regulators, in supervisory work (ie as supervisory technology, known as suptech).

Implications/actions for the financial services industry?

- **'Imperative' to implement regtech**: ASIC considers that given the volume and exponential growth in data, there 'is an imperative' for the financial services industry to implement regtech which enables analysis of large high data volumes at speed and in real time, in order to undertake risk management and compliance functions. Commenting on the findings, Commissioner John Price said that 'Particularly in the financial services and superannuation sectors, regtech has enormous potential to help firms save time and money on regulatory matters…ASIC believes that we will soon reach the tipping point where not investing in regtech R&D will cost firms more in the long run.'
- **A need for improved standards on data capture and storage:** Poor quality data and the problem of 'garbage in, garbage out' is an issue. Improving practices and setting standards around data capture and storage remains a challenge for industry.
- **Resourcing needed:** Currently, due to the experimental nature of regtech, there are limits on how much resourcing flows from firms towards regtech initiatives (though there is, ASIC observes, a high level of activity). ASIC states that 'this will need to change'.
- **Capability needed:** Given the difficulty of implementing regtech, industry needs to invest in dedicated subject matter and software development experts to design, implement and refine regtech on an ongoing basis.
- **Increased cybersecurity/privacy risks:** Use of cloud-based systems for storing, monitoring, tracking and processing data will require financial services firms and regulators to consider the attached cybersecurity and privacy risks involved.
- **Technology will supplement but crucially, will not replace, humans:** 'Regtech applications will not replace humans in risk management and compliance roles' ASIC states. Rather, regtech will augment/supplement the role of humans through enabling greater focus on more significant compliance matters identified from a larger, more complete sample sizes.

Next steps for ASIC? ASIC plans to continue to promote regtech by conducting more regtech initiatives in the remainder of FY2019–20 with a focus on exploring opportunities for machine learning (ML) to monitor compliance with regard to responsible lending; a report on the state of digital record keeping within the financial services industry; and a showcase on the publication of structured financial information in public companies.

[Sources: ASIC media release 20/12/2019; ASIC Report 653 ASIC's regtech initiatives 2018–19]

Other Developments

In Brief | Not 'fit and proper': The FCA has written to CEOs of wholesale general insurance firms following 'incidents of non-financial misconduct' setting the 'clear expectation that you should be proactive in tackling such issues'. The letter states that non-financial misconduct will be a key focus for the supervision of firms and senior managers going forward and that the regulator's expectation is that firms and senior managers act promptly to address any cultural gaps/shortcomings

[Sources: FCA Letter: Non-financial misconduct in wholesale insurance firms 06/01/2020; [registration required] The FT 08/01/2020]

Insolvency and Restructuring

ASIC report on corporate insolvencies 2018–19 released

Overview | ASIC Report 645 Insolvency statistics: External administrators' reports (July 2018 to June 2019)

The Australian Securities and Investments Commission (ASIC) has released a report providing an overview of corporate insolvencies in Australia for financial year 2018-2019.

Some Key Findings

- The total number of external administrators' reports lodged in 2018–19 was 8,089 (down from 8,202 in 2017–18). Initial external administrators' reports comprised almost 93% of this total (or 7,498 reports). Nearly all 8,089 external administrators' reports were lodged electronically, except for 19 reports (ie 99.8% were lodged electronically) (up from 36.8% in 2002–03 when electronic lodgement first became available).
- 72.7% of reports were lodged within six months, and 9.3% were lodged after 12 months or more (as compared with 67.3% lodged within six months in 2017-2018 and 11.5% lodged after 12 months or more in 2017-2018).
- Most initial external administrators' reports related to companies with a registered address in New South Wales (2,721 reports or 36.3%), followed by Victoria (1,753 reports or 23.4%) and Queensland (1,646 reports or 22.0%).
- Most reports in 2018–19 (92.5%) were lodged by liquidators for the purpose of complying with s533 of the Corporations Act 2001 (Cth).
- In 2018–19, most reports (76.5%) related to companies with less than 20 employees (small to medium enterprises). 85% had assets of $100,000 or less, 76% had fewer than 20 employees and 38% had liabilities of $250,000 or less.
- The three industries with the highest number of reports lodged were: 1) other (business and personal) services (2,114 reports or 28.2%); 2) construction (1,601 reports or 21.4%); and 3) accommodation and food services (1,159 reports or 15.5%). Retail trade (8.2%), transport/postal/warehousing (4.9%) and manufacturing (3.1%) had the next highest number of reports. The top six industries have not changed position from the previous year.
- The top three nominated causes of failure for companies are the same as last year. Namely: 1) inadequate cash flow or high cash use (3,841 or 51.2% of reports); 2) poor strategic management of business (3,216 or 42.9% of reports); and 3) trading losses (2,915 or 38.9% of reports).
- In 2018–19, external administrators alleged misconduct in 6,638 or 88.5% of reports.
- In 2018–19, 10.8% of all reported misconduct related to post-appointment misconduct.
- Alleged breaches of civil obligations are the most common breaches (16,874 or 84.4% of all reported misconduct). The top three nominated civil breaches for companies in 2018–19 were the same as in the previous five years: 1) Section 588G(1)–(2) Insolvent trading (71.4% of reports); 2) Section 180 Care and diligence—Directors' and officers' duties (55.2% of reports); and 3) Sections 286 and 344(1) Obligation to keep financial records (43.9% of reports).
- The top three nominated criminal breaches for companies for 2018–19 were: 1) Section 184 Good faith, use of position and use of information (3.2% of reports); 2) Sections 286 and 344(2) Obligation to keep financial records (2.5% of reports); and 3) Section 590 Offences by officers: (1.9% of reports). Insolvent trading was the fourth-most nominated criminal breach for 2018–19, having fallen out of the top three in 2016–17, for the first time since reporting commenced in the 2004–05 financial year. External administrators reported that they held evidence for 592 (76.7%) out of 772 possible criminal breaches reported in 2018–19.
- External administrators confirmed they had documentary evidence to support alleged pre-appointment misconduct for 5,844 reports (77.9%) for 2018–19. Of these, they considered that only 2,613 reports (34.8%) warranted ASIC's inquiry into the alleged misconduct, based on their assessment of the information and documentary evidence available.
- ASIC requested supplementary reports (or Schedule C reports) for 594 (22.7%) of the 2,613 reports where external administrators alleged misconduct and advised that they held evidence and recommended further inquiry by ASIC. ASIC requested a further 281 supplementary reports (875 in total for 2018–19) where external administrators had not recommended further inquiry but the matter met ASIC's risk assessment criteria.

- External administrators advised that in nearly 50% of reports where they alleged a civil breach for insolvent trading, they had either commenced or were contemplating initiating recovery actions for insolvent trading.
- Generally, due to a lack of evidence or because ASIC considered no further action was required given the circumstances, over the last three years on average, fewer than 20% of these supplementary reports resulted in further regulatory action.

[Sources: ASIC media release 18/12/2019; ASIC Report 645 Insolvency statistics: External administrators' reports (July 2018 to June 2019)]

In Brief | The Australian reports that that ASIC has established an investigative unit targeting pre-insolvency advisers and directors it believes are coaching others on how to illegally 'phoenix' businesses to avoid paying creditors. Reportedly, the regulator is understood to be focusing industries where it believes the problem is most prevalent, with construction, labour hire, and transport and logistics the top three priorities

[Source: [registration required] The Australian 13/01/2020]