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The Hon Kenneth Hayne AC QC
Commissioner
Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

Dear Commissioner Hayne

Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) – Round Six (Insurance) Hearings

Thank you for the opportunity to provide a submission to the Royal Commission in relation to the policy related issues arising from the Round Six (insurance) hearings.

The Australian Institute of Company Directors (**AICD**) has a membership of more than 43,000 including directors and senior leaders from business, government and the not-for-profit sectors. The mission of the AICD is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society.

We understand that several of the policy questions raised in the Round Six hearings extend beyond the insurance sector and are relevant to the financial services industry more broadly. Given the focus of the AICD, we have concentrated our response on those questions that relate to broad governance or regulatory issues, as set out in **Annexure A** to this submission.

We intend also to make a submission in relation to certain policy questions arising out of the Royal Commission's interim report of 28 September 2018 (**Interim Report**), which will cover a number of related issues. Our two submissions are intended to be read together, as we have sought to avoid repeating material.

If you would like to discuss any aspect of this submission, please contact Christian Gergis, Head of Policy, on (02) 8248 2708 or at cgergis@aicd.com.au, or Sally Linwood, Senior Policy Adviser, on (02) 8248 2718 or at slinwood@aicd.com.au.

Yours sincerely

ANGUS ARMOUR
Managing Director & Chief Executive Officer

ANNEXURE A

1.	Question 35: What is the purpose of infringement notices? Would that purpose be better achieved by increasing the applicable number of penalty units in section 12GXC of the Australian Securities and Investments Commission Act 2001 (Cth)? Should there be infringement notices of tiered severity?

The Attorney-General's Department's Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers (September 2011) states the principle that an infringement notice scheme "may be employed for relatively minor offences, where a high volume of contraventions is expected, and where a penalty must be imposed immediately to be effective".[1] The Guide goes on to state that "serious offences should be prosecuted in court and should not be capable of being excused by an administrative assessment".

The AICD strongly supports this approach to infringement notices. We have previously expressed strong opposition to the expansion of the infringement notice regime in ASIC-administered legislation.

The AICD submission to the ASIC Enforcement Review Taskforce in 2017 agreed with the positions stated previously by the Law Council of Australia and the ALRC[2], and expressed the view that the imposition of infringement notices is a form of "lazy regulation" that undermines the credibility and transparency of regulatory action. ASIC should be sufficiently resourced and equipped to pursue contraventions through the courts, which have a critical role to play in the proper functioning of the corporate regulatory system[3].

Given the revelations of potential misconduct arising out of the Royal Commission, the AICD considers that it is an opportune time to evaluate whether the regime has been effective in addressing unlawful conduct. Indeed, the AICD queries whether the regime has potentially had adverse impacts at a system-wide level by reducing the likelihood that ASIC will consider court-based enforcement action.

The AICD is also concerned that the use of an infringement notice for anything other than a minor offence[4] sends the wrong signal to regulators and business that regulatory action for unlawful conduct is a 'cost of doing business', rather than conduct that is deserving serious penalty and sanction.

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[1] Commonwealth Attorney-General's Department, "A Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers", September 2011 edition.

[2] The ALRC has recommended that an infringement notice scheme should only apply to minor offences of strict or absolute liability (ALRC, 'Principled Regulation: Federal, Civil and Administrative Penalties in Australia', 13 March 2003, 462). The Business Law Section of the Law Council of Australia in a submission to the 2014 Financial System Inquiry noted that the infringement notice regime was introduced on the presumption that the regime would be one to deal with minor potential breaches of the legislation on a timely and efficient basis. Instead, it appears that ASIC has used the infringement notice regime in cases where it does not wish to risk time, money and potential loss in the courts in pursuing alleged breaches of legislation.

[3] AICD submission in response to the ASIC Enforcement Review Taskforce's position paper on strengthening corporate and financial sector misconduct, http://aicd.companydirectors.com.au/advocacy/policy/strengthening-penalties-for-corporate-and-financial-sector-misconduct, 22 November 2017.

[4] We note that the Guide to Framing Commonwealth Offences, Infringement Notices, and Enforcement Powers states that 'an infringement notice scheme may be employed for relatively minor offences, where a high volume of contraventions is expected, and where a penalty must be imposed immediately to be effective. The offences should be such that an enforcement officer can easily make an assessment of guilt or innocence. An infringement notice scheme should generally only apply to strict or absolute liability offences.', https://www.ag.gov.au/Publications/Pages/GuidetoFramingCommonwealthOffencesInfringementNoticesandEnforcementPowers.aspx.

2.	Question 36: Is there sufficient external oversight of the adequacy of the compliance systems of financial services entities? Should ASIC and APRA do more to ensure that financial services entities have adequate compliance systems? What should they do?

The AICD strongly agrees with the Commissioner's observation that, ultimately, entities are responsible for their own compliance systems. We note that the Royal Commission itself is driving change within both entities and regulators, through bringing conduct to light and interrogating cultural and governance practices.

To encourage entities to bolster their compliance systems, more proactive enforcement of laws (for example, through ASIC bringing civil or criminal proceedings) could assist in deterring misconduct and encouraging entities to review and strengthen their compliance systems.

Periodic regulatory reviews, combined with increased thematic disclosure of the outcomes of these reviews, also have the potential to prompt entities to review compliance systems and make improvements where necessary. For example, the CBA Prudential Inquiry Final Report released by APRA in May 2018 (**APRA Report on CBA**) has prompted entities, and boards in particular, to consider governance frameworks and to undertake self-assessments, and then to make improvements to systems and processes as a result. We note that ASIC's new 'close and continuous monitoring' program [5] will focus on a number of relevant issues including the specific governance issues raised by the CBA prudential inquiry, and that the new ASIC Corporate Governance Taskforce will undertake targeted reviews of corporate governance practices in large listed entities.

We also note that ASIC's recent report on breach reporting, *REP 594 Review of selected financial services groups' compliance with the breach reporting obligation* (**ASIC Report 594**)[6], has highlighted major deficiencies in breach reporting and compliance systems within Australian financial services (**AFS**) licensees. We expect this report to similarly prompt significant introspection, including at a board level, in relation to questions around whether:

- the board has appropriate oversight of the way that breach management systems and processes are working in practice;
- there is adequate audit focus on breach reporting and remediation;
- breach reporting policies are sufficiently robust;
- investigation of breaches and remediation of consumers is prioritised as a matter of course;
- investments need to be made on systems and processes to support breach reporting;
- breaches are treated as learning opportunities that lead to improvements;
- values and public statements align with what occurs in the business; and

[5] See 'ASIC's strategic focus and key priorities over the next year: improving conduct and restoring trust', ASIC Commissioner, John Price, address to the Risk Management Association Annual Chief Risk Officer Conference, 2018, 4 September 2018, https://asic.gov.au/about-asic/news-centre/speeches/asic-s-strategic-focus-and-key-priorities-over-the-next-year-improving-conduct-and-restoring-trust/.
[6] See 'ASIC review finds unacceptable delays by financial institutions in reporting, addressing and remediating significant breaches', https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-284mr-asic-review-finds-unacceptable-delays-by-financial-institutions-in-reporting-addressing-and-remediating-significant-breaches/, 25 September 2018.

- the organisation's approach to consequence management is appropriate.[7]

Our comments in relation to the formulation of the breach reporting obligations are outlined at section 3.2 below.

3.	Question 37: Should there be greater consequences for financial services entities that fail to design, maintain and resource their compliance systems in a way that ensures they are effective in preventing breaches of financial services laws and other regulatory obligations; and ensuring that any breaches that do not occur are remedied in a timely fashion?

3.1 Enforcement of existing laws

If existing laws were effectively enforced, financial services entities would necessarily experience greater consequences for ineffective compliance systems.

The AICD supports the Government's aim to strengthen penalties for corporate and financial sector misconduct, and has provided a submission to the Government on their proposed draft legislation and accompanying materials to achieve this.[8] The AICD recognises that some penalties for corporate misconduct within ASIC-administered legislation no longer represent an adequate deterrent to wrongdoing.

However, we agree with the Commissioner's comment in the Interim Report that the effect of such changes depends upon the way in which they are implemented and that, in particular, increased penalties for misconduct will have limited deterrent or punitive effect unless there is a greater willingness to take legal action. While not excusing any of the misconduct highlighted by the Royal Commission, we would also agree with the observation made in the Interim Report that the complexity of financial services laws has contributed to a mindset of "Can I do this?", rather than "Should I do this?".

3.2 Breach reporting requirement

The AICD notes that the legal framework in relation to breach reporting has been widely criticised as deficient. For example, the ASIC Enforcement Review Final Report (December 2017) identified a number of issues in the self-reporting regime that applies to AFS licensees[9], while the results of ASIC Report 594 (September 2018) confirmed the need for change. This is concerning given the breach reporting regime is intended to facilitate effective regulation of the financial services sector by promoting timely detection of non-compliant behaviours.

The AICD notes ASIC's view that there are three barriers to enforcement action, namely:

- the test as to whether a breach is significant, and therefore is legally required to be reported, is subjective rather than objective;

[7] See 'ASIC Calls out inadequate breach reporting in financial services', Sally Linwood, AICD Membership Update, 27 September 2018, https://aicd.companydirectors.com.au/membership/membership-update/asic-calls-out-inadequate-breach-reporting-financial-services.
[8] AICD submission on reforms to strengthen penalties for corporate and financial sector misconduct, 23 October 2018, http://aicd.companydirectors.com.au/advocacy/policy/reforms-to-strengthen-penalties-for-corporate-and-financial-sector-misconduct.
[9] See ASIC Enforcement Review Taskforce Report, December 2017, 3-14.

- the 10-business day period for reporting only begins once an institution has determined that there is a breach and that it is significant. Institutions can delay making those decisions without breaching the law; and
- failures to report can only be prosecuted on a criminal basis with the associated high standard of proof. At the same time, the existing penalty is relatively modest.[10]

The AICD supports law reform to address these issues. In particular, we consider it is critical that the legal requirements are framed in such a way as to prevent entities from delaying a breach report by relying on unreasonably protracted internal investigations into potential breaches.

3.3 Criminal liability for breaching a fault-based Commonwealth law arising from a failure of corporate culture

It is worth noting that companies may already be criminally liable for breaching a fault-based Commonwealth law arising from a failure of corporate culture, on the basis that the fault element will be attributed to a company if the company 'expressly, tacitly or impliedly authorised or permitted' the commission of the offence[11]. This can be found where it is proven that a culture of non-compliance existed or a culture of compliance was absent[12].

The Criminal Code defines corporate culture as meaning 'an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities takes place'[13].

Where a company has committed a fault-based offence, a person can also be held liable as an accessory in circumstances where (among other things) there was a failure of corporate culture. A person will be criminally liable if the person intended that their conduct would aid, abet, counsel or procure the commission of the offence[14].

4. Question 38: When a financial services entity identifies that it has a culture that does not adequately value compliance, what should it do? What role, if any, can financial services laws and regulators play in shaping the culture of financial services entities? What role should they play?

We agree with the Commissioner's observation in the Interim Report that good culture and proper governance cannot be implemented by passing a law, and that while culture and governance are affected by rules, systems and practices, in the end they depend upon people applying the right standards and doing their jobs properly.

We also agree with the two principles outlined in Treasury's submission to the Royal Commission on key policy issues – firstly, that the responsibility for a firm's culture ought to rest with the firm, rather than government; and secondly, that it is desirable to rely on competitive forces to address problems with firms' cultures where possible[15].

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[10] 'ASIC review finds unacceptable delays by financial institutions in reporting, addressing and remediating significant breaches', ASIC Media Release 18-284, 25 September 2018, https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-284mr-asic-review-finds-unacceptable-delays-by-financial-institutions-in-reporting-addressing-and-remediating-significant-breaches/.
[11] Criminal Code, Schedule, s 12.3(1).
[12] Criminal Code, Schedule, ss 12.3(2)(c) and (d).
[13] Criminal Code, Schedule, s 12.3(6).
[14] Criminal Code, Schedule, s 11.2.
[15] Treasury submission on key policy issues, Royal Commission Background Paper 24, 8.

That said, we would suggest, as noted in section 3 above, that more proactive enforcement of existing laws by regulators would encourage entities to strengthen compliance cultures.

Identifying that an organisation does not adequately value compliance is the first step in remedying it.

Then it becomes critical that the issues are addressed and not overlooked – although we do agree with comments in the Interim Report that cultural change may not be easy and may take time. This is particularly the case in large, complex organisations that operate across different business lines and localities.

At an individual level, it is important that penalties are imposed for inappropriate, unethical or unlawful behaviour through disciplinary action and/or remuneration outcomes (including non-payment of bonuses and the application of malus or clawback powers, as appropriate), and that senior managers are held accountable for unacceptable conduct within their teams. More broadly, boards and senior management should carefully consider what message will be sent throughout the organisation if staff involved in persistent breaches of the law or misconduct remain in their positions.

There will also need to be reflection on whether there is a need to improve engagement with the regulator, including in relation to timeframes for doing so, and the approach taken (for example, involving senior business representatives rather than only legal or compliance staff).

At an organisational level, core components of corporate culture – including remuneration frameworks and general governance processes and frameworks – should be closely reviewed and updated by boards and senior management. This includes company values and codes of conduct and risk management and accountability frameworks. More detailed observations will be made in our submission in response to the Interim Report.

We agree with the ASIC Report 594 suggestion that an investment in IT systems and processes may also assist in identifying systemic issues, and would encourage the necessary resources be allocated as a matter of priority.

While the implementation of cultural change will primarily be the responsibility of the CEO, the board has an active and ongoing oversight role. In particular, the board has a role in "setting the tone from the top" in establishing behavioural standards within the organisation.[16] This includes requiring the CEO (and other members of the senior leadership team as appropriate) to report to the board on:

- the way in which system and processes are supporting the implementation of cultural change;
- plans to address the deficiencies that have been identified in the lived culture, and what metrics will be used to track changes; and
- ongoing insights from external sources, such as customer and regulator feedback, and internal sources, such as employee surveys.

[16] See M Muth and B Selden, *Setting the Tone from the Top: How director conversations shape culture*, August 2018, AICD.

5.	Question 39: Are there any recommendations in the "ASIC Enforcement Review Taskforce Report", published by the Australian Government in December 2017, that should be supplemented or modified?

The AICD broadly supports the recommendations in the ASIC Enforcement Review Taskforce Report.

In particular, we note that we:

- agree that breach reporting requirements need to be strengthened. It is critical that entities are not able to unreasonably delay making a breach report because of protracted internal investigations;
- support the availability of disgorgement remedies in civil penalty proceedings brought by ASIC under the Corporations, Credit and ASIC Acts;
- agree that appropriate banning powers play an important role in protecting financial investors and consumers, and in supporting the integrity of the financial sector. However, given the severe consequences that a ban can have on a recipient's professional reputation and livelihood, we believe that an administrative ban is only appropriate when necessary to protect investors or consumers, proportionate to the misconduct, and subject to procedural fairness and a right of appeal[17];
- support increases to maximum civil penalty amounts in ASIC-administered legislation; and
- support increases to maximum imprisonment terms and financial penalties terms for offences involving dishonesty or deliberate misconduct, noting the Court oversight involved.

However, we have concerns about the extension of the infringement notice regime for the reasons outlined in section 1 above.

[17] AICD submission to Treasury on ASIC Enforcement Review position paper titled 'ASIC's power to ban senior officials in the financial sector'. http://aicd.companydirectors.com.au/advocacy/policy/submission-on-asics-power-to-ban-senior-officials-in-the-financial-sector, 23 October 2017.