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25 October 2018

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

Dear Commissioner Hayne

The Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission)

Thank you for the opportunity to provide a submission to the Royal Commission in relation to the policy questions set out in the interim report of 28 September 2018 (**Interim Report**).

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.

The AICD has expressed its deep concern with the conduct revealed during the hearings held to date by the Royal Commission. Much of it runs contrary to the community's legitimate expectations of corporate behaviour. We acknowledge your conclusion that the conduct that is at the heart of the Commission's work is inextricably connected with personal or institutional gain; deficiencies in governance and risk management; and corporate culture.

We agree that additional regulation is not the answer, and that the critical questions to be explored in the Commission are why this conduct occurred, and what can be done to avoid it happening again.

We also recognise that the Royal Commission itself is driving change within both entities and regulators, through bringing conduct to light and interrogating cultural and governance practices. This is a positive outcome and these improvements must continue well after the Royal Commission has concluded.

Given the focus of the AICD, we have concentrated our response on those questions posed in Chapter 10 of the Interim Report that relate to broad governance issues. Our responses to these questions are set out in **Annexure A** to this submission.

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

AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

ANNEXURE A

1.	What should either or both of banks or regulators be doing to meet the danger of conduct risk?

1.1 Importance of corporate culture, and the role of the board

There are a number of factors that contribute to the prudent management of conduct risk including corporate culture, company governance frameworks, as well as remuneration structures. Our observations on each of these facets are outlined below.

In the view of the AICD, fostering and maintaining a sound corporate culture is pivotal to managing conduct risk. A sound corporate culture depends on strong leadership, and it is the role of a board to 'set the tone from the top' in establishing behavioural standards[1].

It is also critical that the CEO and senior management model appropriate behaviour, including by clearly communicating what the organisation truly values, and holding themselves and other employees to account when unacceptable conduct occurs.

While management of culture is primarily the responsibility of the CEO, it is the role of the board to provide ongoing and effective cultural stewardship and oversight[2]. As part of this role, it is important that directors take steps to understand and assess the culture of their organisation – including whether there are any gaps between 'espoused' culture, and 'lived' culture (i.e., what happens in the business in practice). These steps may include:

- establishing appropriate board committee structures to support the full board in considering issues of culture (including risk culture) in an appropriate level of detail, and asking the right questions of management;
- gaining greater visibility into employee, customer and other stakeholder engagement, e.g. through independent survey mechanisms and site visits; and
- ongoing testing and challenge of management, including requesting additional information as needed that will help reveal the cultural dimensions of the organisation (such as employee or customer surveys, customer complaints and related data, disciplinary or misconduct records, legal or regulatory breaches or other relevant metrics); and
- asking challenging questions of management in relation to the narrative around organisational culture and the tools used to measure and assess culture.

Strong oversight of non-financial risks at a board level is critical. The CBA Prudential Inquiry Final Report released by APRA in May 2018 (**APRA Report on CBA**) is an important case study into governance, accountability and culture, including management of non-financial risk. The recommendations echo with the AICD's governance education curriculum, and the AICD has agreed that the Report is 'required reading' for directors[3].

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

[2] The AICD firmly believes that the separation between the board and management is important and should not be eroded. We note that the 2014 Financial System Inquiry observed that 'good corporate governance across all industries involves clear and distinct duties performed by the board and senior management' and that 'substantial regulator focus on boards has confused the delineation between the role of the board and that of management'. These observations continue to be relevant.

[3] The CBA APRA Report: "Required reading" for all directors', http://aicd.companydirectors.com.au/membership/the-boardroom-report/volume-16-issue-5/apra-cba-report, 10 May 2018

Ongoing board renewal in accordance with succession plans, including promotion of cognitive diversity, can also assist by reducing the risk of 'groupthink' and prompting fresh questioning around organisational culture.

Boards also have an important role to play in setting the governance policies and frameworks that drive behaviour throughout the organisation, including responsibility for setting the remuneration of the CEO and other key management personnel, and oversight of remuneration policy more broadly (see sections 1.2 and 2 below for further discussion).

1.2 General governance frameworks

Both governance systems and processes, as well as human resources and people policies, play an important role in shaping culture, and should be closely reviewed in light of the Interim Report. In particular, consideration should be given as to whether:

- the board holds a visible leadership position and is setting the 'tone from the top' on corporate culture, in both messaging and action;
- company values and codes of conduct are properly implemented, monitored and enforced across the organisation, and built into HR processes as appropriate;
- remuneration frameworks and performance management and reward and recognition programmes align with desired culture and drive the 'right' behaviours (see section 2 below);
- risk management and accountability frameworks are sound, well understood and complied with throughout an organisation;
- decision rights are clear and principle-based. In the face of unlawful conduct, commercial judgement and discretion should be subordinated to legal obligations;
- internal audit and risk teams have sufficient standing within the business;
- formal whistleblowing policies are in place, well-understood, and acted upon;
- the expectation is clear that "bad news" will travel quickly and be appropriately visible and considered by senior management and the board; and
- board reporting processes are robust (including in relation to whether they strike a balance between summary and detailed reporting on non-financial risk areas, and the extent to which they are capable of bringing instances of misconduct to the board's attention and elevating the 'customer voice' to the board[4]).

Some of the evidence presented at the Royal Commission related to adverse outcomes experienced by vulnerable members of the community. It is important that financial services entities reflect on this, and that governance structures set the highest standards of transparency, accountability and ethical behaviour. In particular, entities should re-examine whether they have appropriate practices and policies to identify vulnerable customers and mitigate against the risk of poor conduct towards them[5].

The AICD has previously advocated for stronger whistleblower protection laws and linked robust corporate whistleblowing frameworks to good governance. Indeed, strong whistleblowing policies can be a final line of defence for companies against misconduct. The AICD welcomes the government's commitment to reform Australia's whistleblowing laws to

[4] See APRA Report on CBA.

[5] In response to the Royal Commission into Institutional Responses to Child Sexual Abuse, in September 2018, the AICD launched a new educational course, *Governing to Protect Vulnerable People*, that covers topics including: the board's responsibility in governing to protect vulnerable people; and cultural and ethical dimensions contributing to the wellbeing of vulnerable people, and how to adopt a safe culture.

broaden and strengthen their coverage, and would encourage the passage of the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill* 2017 as a matter of priority[6].

Finally, it is important that there are consequences for inappropriate, unethical or unlawful behaviour. Entities may wish to 'audit' their approach to dealing with misconduct and develop a plan to address any issues identified. For example, how often have formal disciplinary processes been instigated? How often has there been 'clawback' or withholding of remuneration based on poor legal, compliance, risk or customer outcomes (and would remuneration agreements allow it in the range of circumstances where it may be appropriate)? How often has there been an assessment of whether there may be systemic issues following identification of an instance or instances of misconduct?

1.3 Impact of BEAR

While it may be impossible to eliminate conduct risk at an individual level, the recent introduction of the Banking Executive Accountability Regime (**BEAR**) could have a significant impact in developing greater clarity regarding individual accountability in the banking sector.

According to the Explanatory Memorandum to the *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill* 2017, the objective of the BEAR is to put in place a strengthened responsibility and accountability framework for the most senior and influential directors and executives of ADIs and their subsidiaries.

In particular, we note that the 'accountability maps' and statements required under the BEAR are intended to provide a clear allocation of responsibilities throughout the ADI group to ensure that there is accountability for all parts of the group's business, and the requirement to defer a certain portion of an accountable person's variable remuneration is intended to incentivise them not to engage in behaviours inconsistent with BEAR obligations[7]. The BEAR regime also gives new powers to APRA to investigate potential breaches, and to disqualify accountable persons for breach.

The recent hearing of the House of Representatives' Standing Committee on Economics in relation to the review of the four major banks would suggest that bank CEOs believe that the BEAR is improving accountability processes[8].

We note that the BEAR only became operative for the major ADIs on 1 July 2018, and will not come into effect for smaller ADIs until 1 July 2019 (i.e., much of the conduct that has come to light during the hearings held by the Commission pre-dates the implementation of the BEAR).

1.4 Role of the regulators

The AICD supports proactive enforcement of existing laws to achieve deterrence but strongly agrees that, ultimately, entities are responsible for their own conduct. Equally, we would agree with the Interim Report's observation that "breaches of existing law are not prevented by passing some new law that says "Do not do that", and that ultimately the five

[6] AICD submission to the Senate Standing Committee on Economics' inquiry into the Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2017, http://aicd.companydirectors.com.au/advocacy/policy/treasury-laws-amendment-enhancing-whistleblower-protections-bill-2017, 28 February 2018.
[7] Explanatory Memorandum to the *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill* 2017, 10-11.
[8] Standing Committee on Economics, Review of Australia's four major banks, 11 October 2018.

simple principles identified - "Obey the law; do not mislead or deceive; be fair; provide services that are fit for purpose; deliver services with reasonable care and skill; when acting for another, act in the best interests of that other"- are critical ones for individuals and entities to reflect upon. While not excusing any of the misconduct highlighted by the Royal Commission, we would also agree that the complexity of financial services laws has contributed to a mindset of "Can I do this?", rather than "Should I do this?".

With respect to the role of the regulators, if they are to intensify surveillance and enforcement practices, it is important that resourcing is commensurately increased. It is critical that both ASIC and APRA have appropriate financial and personnel resources to fulfil their mandates (see sections 5-7 below for further discussion).

The APRA Report on CBA has led to significant introspection amongst not just APRA-regulated entities, but listed entities more broadly. It has prompted entities, and boards in particular, to critically examine their governance frameworks and to make improvements where necessary. This is a positive outcome and should be encouraged. We note that ASIC's new 'close and continuous monitoring' program 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[9].

We also suggest that the respective roles of ASIC and APRA with respect to conduct regulation be clarified, noting that enforcing standards of behaviour and individual misconduct has not previously been in APRA's remit given its focus on protecting financial system stability[10].

2.	Should any customer facing employee be paid variable remuneration? If the answer is either no, or some should not, what follows about incentive remuneration for managers or more senior executives? Should other changes be made to remuneration practices of banks?

The AICD acknowledges that remuneration structures have contributed to the conduct that has come to light during the hearings held by the Royal Commission, and that in many cases they have (unintentionally or otherwise) incentivised conduct that is adverse to customer and community interests.

The AICD supports consideration of the important issues highlighted in the Interim Report, including options to simplify remuneration structures and ensure that they do not undermine employees' intrinsic motivations to 'do the right thing'. However, we believe that variable remuneration, when designed appropriately and properly implemented, has the capacity to effectively drive performance in accordance with company strategy. For example, variable remuneration, such as via share schemes, can help to align company, employee and shareholder interests towards long-term value creation, while providing a measure of recognition for high performance.

[9] 'ASIC's strategic focus and key priorities over the next year: Improving conduct and restoring trust', A speech by John Price, Commissioner, Australian Securities and Investments Commission at the Risk Management Association Annual Chief Risk Officer Conference 2018, 4 September 2018; 'Turnbull Government Expands ASIC's armoury', joint media release by The Hon Scott Morrison MP, Treasurer, and The Hon Kelly O'Dwyer, Minister for Revenue and Financial Services, 7 August 2018, http://kmo.ministers.treasury.gov.au/media-release/092-2018/.

[10] See AICD Submission to the Royal Commission on Round 5 Closing Submissions, 21 September 2018.

We also believe that a principles-based approach to remuneration (as opposed to a prescriptive approach) remains appropriate. Variable remuneration is common throughout the Australian economy - not just in financial services - with each company and industry needing to develop their own mechanisms to mitigate against the risk that pay frameworks will drive undesirable behaviour and/or poor customer or risk outcomes.

We also note that the BEAR framework requires entities to comply with certain remuneration requirements, including deferring a portion of the remuneration of Accountable Persons for a period of up to four years. The portion of deferred remuneration is significant – for large ADIs, 60% of variable remuneration (or 40% of total remuneration) for CEOs, and 40% of variable remuneration for other executives (or 20% of total remuneration). In addition, APRA's October 2018 information paper on implementation of the BEAR outlines the regulator's expectation that ADIs will establish 'performance based incentive structures for accountable persons and other key personnel that align remuneration outcomes with good risk management and the long-term soundness of their institution'.

Irrespective of any policy reform in this area, companies should review their remuneration frameworks closely for alignment to their desired culture. As part of this, companies should consider whether staff are properly rewarded for 'doing the right thing' (for example, identifying a breach of the law). This also involves reviewing the appropriateness of the performance metrics used (including non-financial metrics), robust assessment that considers both what has been achieved and how it has been achieved, and holding individuals to account through remuneration outcomes (including through withholding bonuses and the application of effective malus or clawback clauses).

Indeed, if well-structured and enforced, variable remuneration could help to drive improved customer and risk outcomes in the financial services sector, by rewarding "good" behaviour and conversely penalising "poor" behaviour.

It is also important to recognise that remuneration is not the only organisational lever to influence culture – rather, remuneration policy sits within a broader cultural ecosystem that includes other people-oriented processes (starting from recruitment and including ongoing professional development, performance management, and reward and recognition programmes), as well as ethical frameworks and risk controls.

In the context of executive remuneration, any changes will require shareholder and proxy adviser support. This can be difficult for boards to manage, given the levers available to shareholders in the Corporations Act, including the 'two strikes' rule, and strong views from some shareholders and proxy advisers on how executive remuneration should be structured (including a strong preference for financial rather than non-financial targets)[11].

If an entity determines that remuneration structures should change (including because they do not sufficiently align with desired culture), the market reality is that it is very difficult to implement change without investor and proxy adviser support. We believe that further dialogue and debate on these issues is important in driving cultural change.

[11] For example, the Treasury submission to the Royal Commission on key policy issues noted that the 2016 strike in relation to the CBA remuneration report was 'arguably in part because the remuneration framework was too highly weighted to non-financial measures (i.e. shareholders were reportedly unhappy with the 'soft', non-financial targets CBA had included in its performance standards)': Treasury submission to the Royal Commission on key policy issues, Background Paper 24, 13 July 2018.

3.	Is the BEAR regime relevant to the intersection between remuneration and culture more generally than its application to particular senior executives? Should the BEAR be altered or extended in application?

The AICD notes that the BEAR regime has been in effect for large ADIs since 1 July 2018 (and will not come into effect until 1 July 2019 for smaller ADIs), and that the legislation provides for a three year review timeframe.

The AICD understands the goals of the BEAR regime and agrees that an effective responsibility and accountability framework for directors and senior executives in ADIs is important[12]. In this regard, we acknowledge the policy rationale behind potentially extending the BEAR regime to other financial services entities.

However, we suggest that it would be prudent to assess the impact of the legislation on the sector (for example, after it has been in operation for twelve months) before considering expanding it further, including to enable 'lessons learned' to be taken into account.

We would have concerns about extending the regime downstream in an ADI. While deferral of remuneration may be appropriate at more junior levels, extending other accountability requirements may have unintended consequences, including potentially undermining BEAR's aim to strengthen accountability in the sector by creating overlapping lines of accountability and areas of responsibility. It is critical that senior managers ultimately take responsibility for outcomes within their respective teams.

4.	Should there be annual reviews of the regulators' performance against their mandates?

The AICD has previously supported periodic independent assessment of the performance of the regulators[13]. In light of the evidence heard at the Royal Commission, and limited enforcement outcomes, it is understandable why there may be a desire to conduct such reviews annually. However moving to annual reviews could create unintended consequences given there is a risk that, over time, the process will become routine and mechanical, rather than a probing accountability exercise. Instead, periodic reviews may be preferable, or alternatively, require each annual review to have a specific theme/focus.

While mechanisms such as Senate Estimates and Parliamentary Joint Committee hearings provide parliamentary oversight of regulators, they cannot be a substitute for a comprehensive independent review. Indeed, on one view, the complex accountability system that currently applies to the regulators can serve to create further work and distraction without achieving the objectives of a transparent and effective accountability regime.

In this respect, we note that the 2014 Financial System Inquiry Final Report stated that:

> '*The main problem with the current arrangements is Government lacks a regular mechanism to assess the overall performance of its financial regulators. Parliament has mechanisms to do this, including review of annual reports. However, parliamentary scrutiny tends to be episodic and focus on particular issues or*

[12] AICD submission to the Senate Economics Legislation Committee inquiry on the *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017,* http://aicd.companydirectors.com.au/advocacy/policy/banking-executive-accountability-regime-bill*, 2 November 2017.*

[13] AICD Submission to the Royal Commission on Round 5 Closing Submissions, 21 September 2018.

decisions. The complexity of regulator mandates presents a challenge to effective monitoring, especially as Parliament is not supported in this role through regular independent assessments of annual reports'[14].

We also suggest that more regular reviews of the Government's Statement of Expectations (**SOEs**) in relation to both ASIC and ARPA may assist. We note that the Government issued revised SOEs to both ASIC (in April 2018) and APRA (in June 2018). Prior to this, SOEs were issued in 2014 and 2007 (see section 6 below for further discussion).

More frequent reviews of SOEs could help to address any disconnect between purpose and performance highlighted by regulator performance reviews and ensure that regulators' mandates are well understood and articulated. In managing finite resources, it is critical that ASIC has a clear understanding of the Government's expectations – expectations that themselves should be shaped by legitimate community expectations (see sections 5 and 6 below for further discussion).

5. Is ASIC's remit too large?

ASIC's remit is extensive, and has grown considerably over time[15]. We note that ASIC administers 12 pieces of legislation (or relevant parts thereof), as well as relevant regulations[16]. ASIC not only enforces laws, it also, amongst other things, publishes a wide range of guidance material and engages in education and policy development, licenses financial services entities and manages relief applications.

ASIC is also subject to a complex accountability framework (see above) which can consume valuable resources.

When reflecting on why, as observed in the Interim Report, ASIC has been unable to effectively deter misconduct in the financial services sector, it is important to acknowledge the structural limitations facing ASIC. In particular, we recognise that it is required to balance ever increasing demands within a limited budget. Despite ASIC's increasing workload, the resources initially allocated to the agency in the annual Commonwealth Budgets have remained relatively steady over the last five financial years[17].

Further, we understand that it can be complex to access the relatively limited funding ($27m annually, adjusted for the efficiency dividend and changes in wage and price indices) available from the Enforcement Special Account (**ESA**), thereby undermining ASIC's ability to act promptly in enforcing the law[18]. This may also partly explain why, according to ASIC

[14] The Financial System Inquiry Final Report, 7 December 2014.
[15] Fit for the future: A capability review of the Australian Securities and Investments Commission: A Report to Government, December 2015: 'ASIC's mandate is extensive, and is not fully replicated by any other conduct regulator globally. It broadly covers financial markets, financial services and corporate regulation; business and company registration; and credit and insolvency practitioners. ASIC's mandate is broad, having grown considerably over the last two decades, generally in response to major reform processes and reviews. The Wallis Inquiry recommended having investor and consumer protection within the one agency, especially given the growing linkages between different financial products and services. In addition, other policy reforms have led to the expansion of ASIC's mandate for example, the move of consumer credit from a fragmented, state-based regulatory system to ASIC as a single national regulator'.
[16] ASIC 2016/2017 Annual Report, 14.
[17] Indeed, according to the 2017 ASIC Annual Report, the regulator received approximately $392m in Government funding, and collected approximately $998m in fees and charges (which flow through to consolidated revenue, after expenses).
[18] We note that there is little publicly available information regarding the Enforcement Special Account including the criteria that need to be fulfilled in order to access funding – see PGPA Act Determination (Enforcement Special Account 2016) – Establishment, and associated Explanatory Statement.

Annual Reports, there have been unspent ESA appropriations of $62m in FY15, $44m in FY16, and $33m in FY17 respectively.

Therefore, it may be preferable to increase ASIC's baseline funding rather than relying on out-of-budget cycle injections of funding for specific, temporary projects (such as the additional $70m allocated to ASIC in August 2018 – see section 6.5 below).

If ASIC's remit remains as extensive as it currently is, it is critical that ASIC has appropriate resourcing – from both a financial and personnel perspective – to support it (see section 6 below for further discussion).

6.	Are ASIC's enforcement practices satisfactory? If not, how should they be changed? Should ASIC's enforcement priorities change? In particular, if there is a reasonable prospect of proving contravention, should ASIC institute proceedings unless it determines that it is in the public interest not to do so?

6.1 Strong and proactive enforcement needed

The AICD agrees that the evidence presented during the hearings held by the Royal Commission demonstrates that ASIC's enforcement practices have not been sufficient to achieve deterrence.

We also acknowledge the findings contained in the 2015 ASIC Capability Review Final Report, which highlighted a number of areas for improvement including noting that there is a perception that ASIC's selection of cases for litigation can be risk averse (tending to prefer cases with a higher probability of success, rather than selecting cases that have strong merits, and also allow ASIC to test the bounds of the law)[19].

The AICD supports strong and proactive enforcement by regulators, and believes that the regulators play an important part in Australia's overall corporate governance framework. We agree that strategically important litigation can be important (both to clarify the law and as a means to achieve deterrence), and have previously acknowledged the important role of courts in the proper functioning of the corporate regulatory system[20]. What may be appropriate in an individual case (e.g. negotiated outcomes) may have adverse system consequences if replicated more broadly.

Overall, to engender community confidence and achieve deterrence, the regulator must pursue, and be seen to be pursuing, an appropriate mix of civil and criminal proceedings[21]. The regulated community must not be able to assume that any breach of the law can be negotiated away, or that the regulator will be reticent to take legal proceedings.

[19] Fit for the future: A capability review of the Australian Securities and Investments Commission: A Report to Government, December 2015, 99.
[20] 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.
[21] For a further perspective on use of civil and criminal actions to regulate the markets, see SEC Chair Mary Jo White, 'All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets', https://www.sec.gov/news/speech/2014-spch033114mjw, 31 March 2014: 'There are, of course, no more powerful tools than a criminal conviction and the prospect—and reality—of imprisonment. When they are added to the wider range of actions the SEC brings and the unique remedies available to us, law enforcement can best fulfil its collective obligation to investigate, charge, and address the full range of securities law violations. And my message today is that a robust combination of criminal and regulatory enforcement of the securities laws is not only appropriate, but also critical to deterring securities violators, punishing misconduct, and protecting investors.'

6.2 Importance of regulator discretion

That said, the AICD is of the view that the regulator should exercise discretion as to enforcement mechanisms, and that it is appropriate that it has a number of tools in its regulatory toolkit.

While it is important to achieve general and specific deterrence, a uniform approach risks making regulatory action a blunt instrument, and fails to recognise that competing priorities or special circumstances may exist on a case-by case basis. Further, it would be an adverse outcome if a strict approach to enforcement discouraged active co-operation and self-reporting by regulated entities.

Given the breadth of ASIC's remit, and its budgetary and other constraints, the AICD recognises that negotiated outcomes have a number of potential advantages. In particular, the AICD is of the view that enforceable undertakings can be an effective regulatory tool on the basis that they can:

- achieve a significantly more efficient outcome, including in relation to customer remediation or compensation;
- result in improved compliance systems and processes; and
- be a far more cost-effective alternative to litigation.

Accordingly, the AICD would not support a rebuttable presumption that civil or criminal proceedings should be ASIC's default regulatory response.

A corollary to the availability of discretion is that the regulator will need to exercise careful judgment in determining which of its regulatory tools to use. We also recognise that, as noted in section 6.1 above, any exercise of discretion should take into account system-wide considerations as well as entity specific considerations – i.e., what is the overall message that a regulator's approach to enforcement sends to the market?

Regular performance reviews could assist in highlighting any deficiencies in ASIC's approach to exercising such discretion.

6.3 Government accountability

At a political level, the AICD believes it is important that ASIC's role is well understood, and Government's expectations of the regulator clearly articulated.

The objects outlined in the *ASIC Act 2001* (**ASIC Act**) are the starting point for formulating ASIC's role and setting expectations as to its conduct. We note that section 1(2) of the ASIC Act provides that in performing its functions and exercising its powers, ASIC must strive to:

a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and
b) promote the confident and informed participation of investors and consumers in the financial system; and
d) administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; and
e) receive, process and store, efficiently and quickly, the information given to ASIC under the laws that confer functions and powers on it; and

f) ensure that information is available as soon as practicable for access by the public; and
g) take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it.

Taken together, these requirements would appear to place a greater focus on promoting corporate performance in a way that will create stable environments for business (without imposing significant cost) than on enforcement and consumer outcomes. In light of the evidence heard by the Royal Commission, it is legitimate to question whether this formulation remains appropriate.

We also note that the relevant Minister has the power to give a direction in writing to ASIC or APRA about policies and priorities[22]. Recognising that these powers of direction are rarely used, the report on the 2003/2004 Review of the Corporate Governance of Statutory Authorities and Office Holders (**Uhrig Review**) recommended that:

- Ministers should issue SOEs to their portfolio bodies to clearly articulate the Government's expectations of each body; and
- the body should respond to the Minister in a Statement of Intent (SOI) which outlines how it proposes to meet the Minister's expectations[23].

In Uhrig's view, this would ensure that 'individuals responsible for the performance of statutory authorities clearly understand the expectations of government including the outcomes for which they would be held accountable'[24]. Uhrig's report contemplated that SOEs and SOIs should be subject to review on an annual basis, or more regularly where appropriate.

The Government has recently released a revised SOE in relation to ASIC in April 2018 that places a much greater emphasis on enforcement. Prior to this, the SOE was revised in 2014 and 2007. Notably, the words 'enforcement' and 'consumers' were each only used once in the 2014 version. Concerns have been expressed in the past in relation to both the substance of SOEs, and the irregularity of review timeframes[25]. We would share similar

[22] Australian Securities and Investments Commission Act 2001 (Cth) s 12(1); Australian Prudential Regulation Authority Act 1998 (Cth) s 12(1).
[23] John Uhrig, Review of the Corporate Governance of Statutory Authorities and Office Holders (Commonwealth of Australia, 2003), 38.
[24] John Uhrig, Review of the Corporate Governance of Statutory Authorities and Office Holders (Commonwealth of Australia, 2003), 60.
[25] For example, The Financial System Inquiry Final Report, 7 December 2014 recommended that government provide clearer guidance to regulators in statements of expectation, including setting out a statement of the strategic direction that government expects regulators to take. Further, the 2015 ASIC Capability Review Final Report observed that there has been infrequent updates to the SOE (with the latest version being released in 2014, and the previous version having been released in 2007) and that this can result in possible misalignment between current economic and market realities and stated Government priorities (Fit for the future: A capability review of the Australian Securities and Investments Commission: A Report to Government, December 2015, 49). We also note that Joanna Bird (then Associate Professor at the University of Sydney) has written in 2011 (prior to the issue of revised SOEs in 2014) that "Given their vague and platitudinous content, they [SOEs] are certainly unlikely to provide any concrete guidance on the government's expectations or on how the regulators intend to give effect to the government's expectations. Uhrig stated that the SOE and SOI should be reviewed at least annually and more regularly if circumstances, such as the appointment of a new Minister or head of department, required. A measure of the lack of relevance of these SOEs and SOIs is the fact that they have not been updated since their original issue in spite of a change in government and a number of changes in Minister: Bird, Joanna --- "Regulating the Regulators: Accountability of Australian Regulators" [2011] MelbULawRw 27; (2011) 35(3) Melbourne University Law Review 739.

concerns, and emphasise the need for regular reviews to ensure SOEs align with legitimate community expectations of regulators.

6.4 Shifts already underway

We acknowledge that ASIC is shifting its approach, with a number of new appointments (including Deputy Chair, Daniel Crennan QC), the announcement of a Corporate Governance Taskforce and a plan to embed representatives into the four major banks and AMP, accompanied by additional Government funding. Further, ASIC's recently released corporate plan for the next four years highlights a number of focus areas for FY18/19 including: poor culture and professionalism; and culture, governance and incentives that can harm markets.

In particular, we welcome the decision by ASIC's Chair James Shipton to re-focus ASIC's strategic direction on proactive enforcement[26].

That said, if ASIC is to meaningfully shift its approach to enforcement, it will need sufficiently deep litigation experience and expertise (in-house) (see below).

6.5 Importance of adequate resourcing

While we acknowledge that all regulatory funding is necessarily finite, it is critical that it is not so limited as to constrain ASIC in carrying out its enforcement priorities. If a greater number of civil and criminal proceedings are to be brought in order to achieve deterrence and align with community expectations, ASIC must be resourced accordingly.

While the Government announced new funding for ASIC in August 2018, the $26.2 million allocated to the ESA to accelerate ASIC's enforcement activities and enhance its capacity to pursue actions for serious misconduct against well-funded litigants is only temporary (two financial years) and does not represent a permanent increase in its baseline funding.

Proper resourcing also extends to capacity and expertise. ASIC must have enough sufficiently skilled staff to confidently and effectively pursue civil and criminal proceedings. Similarly, the Commonwealth Director of Public Prosecutions should consider whether it also has the appropriate personnel to pursue criminal cases referred to them by ASIC.

The new industry funding model may assist with these issues, as will the exclusion of ASIC employees from the *Public Service Act 1999* which will allow more market competitive salaries to be offered to skilled staff[27].

6.6 ASIC governance

Effective internal governance frameworks support effective accountability.

We note that the 2015 ASIC Capability Review Final Report commented on ASIC's governance arrangements (in particular, Commissioners having both an executive (management) and non-executive (governance) role). While it acknowledged the model's strengths (including close alignment between operational and strategic decision-making), it

[26] 'Turnbull Government Expands ASIC's armoury', joint media release by The Hon Scott Morrison MP, Treasurer, and The Hon Kelly O'Dwyer, Minister for Revenue and Financial Services, 7 August 2018, http://kmo.ministers.treasury.gov.au/media-release/092-2018/.
[27] Treasury Laws Amendment (Enhancing ASIC's Capabilities) Act 2018.

also noted that it results in a number of key challenges and tensions including potential erosion of the strength of internal accountability and lack of bandwidth for Commissioners to focus on strategic issues and external engagement[28].

The AICD has previously advocated for a change in ASIC's governance structure to improve accountability and culture, and suggested that having a board with a majority of non-executive directors will provide greater oversight, objectivity, independent thinking and external perspectives to ASIC[29].

From an international perspective, there are a number of examples of regulators with board structures in place, including the Financial Conduct Authority and the Financial Reporting Council in the UK, and the Financial Markets Authority in New Zealand.

The challenge will be finding individuals with the requisite knowledge and experience to provide effective oversight, at the same time as avoiding any material conflicts of interest arising from other board positions.

6.7 Reporting and transparency

Enhancements to reporting practices may assist in improving accountability and transparency. In this regard, we note the suggestions made in the 2015 ASIC Capability Review Final Report in relation to consolidation of performance reporting and enhancing the use of performance narrative[30], and ASIC's commitment to ensure communications clearly explain ASIC's role and all the regulatory tools it will use to carry out its mandate (including explaining ASIC's proactive surveillance and enforcement to influence behaviour across an industry)[31].

As part of this, it would assist if there was greater clarity around ASIC's enforcement priorities and how it intends to approach particular types of matters (including, for example, through illustrative case studies). This could be reflected in ASIC's annual report or corporate plan, as well as an update to Information Sheet 151: *ASIC's approach to enforcement* (September 2013). It may also assist for ASIC to indicate annually the proportion of its annual budget allocated to enforcement.

7.	Are APRA's regulatory practices satisfactory? If not, how should they be changed? Does the conduct identified and criticised in the report call for reconsideration of APRA's prudential standards on governance? Having examined the governance, culture and accountability within the CBA group, what steps (if any) can APRA take in relation to those issues in other financial services entities?

[28] Fit for the future: A capability review of the Australian Securities and Investments Commission: A Report to Government, December 2015, 6.
[29] See also Joanna Bird, "Regulating the Regulators: Accountability of Australian Regulators" [2011] MelbULawRw 27; (2011) 35(3) Melbourne University Law Review 739: [on public company boards] '…there is an argument that this is one way to ensure accountability without undermining independence and expertise. The non-executive directors can ensure that the regulator is aware of and responsive to the needs of the ultimate stakeholders (i.e. the public) just as a key role of non-executive directors in a public company is to ensure accountability to members of the company. However, the presence of non-executive directors on the board of a regulator does not undermine the independence of the regulator. In other words, the use of a public company-type board is the holy grail of accountability mechanisms for regulators — a mechanism that ensures accountability without undermining independence or expertise'.
[30] Fit for the future: A capability review of the Australian Securities and Investments Commission: A Report to Government, December 2015, 59.
[31] ASIC Capability Review – ASIC's implementation plan.

The AICD acknowledges APRA's prudential focus, and its core objective of promoting financial system stability, means that its regulatory scope is necessarily limited.

In relation to the APRA review into the CBA group, we note that APRA's Chair, Wayne Byres, has called on all regulated institutions to conduct a self-assessment 'to gauge whether similar issues [to that identified with CBA] might exist in their institutions' and said APRA supervisors will expect institutions to demonstrate how they have considered the issues raised in the report[32].

It may assist if the outcome of these reviews (or a de-identified thematic summary) as well as APRA's intended next steps, are made public, both in the interest of transparency and accountability and as a way of sharing learnings across corporate Australia more broadly. The APRA Report on CBA is a valuable case study in terms of matters of governance, culture and accountability, as well as APRA expectations.

In terms of APRA's Prudential Standards, the AICD believes that ordinarily it is not appropriate to prescribe governance practices. We have previously expressed the view that it is almost always preferable to adopt an approach which is flexible and principles-based, similar to the ASX Corporate Governance Council Principles and Recommendations, so that boards can adapt governance practices to suit their organisation's circumstances and operating systems rather than adopting a 'tick the box' approach. For completeness, we note that we have stated that we see merit in a more prescriptive approach to some aspects of superannuation governance, given the unique nature of that sector[33].

Going forward, ongoing targeted monitoring and surveillance may assist, combined with greater levels of co-operation and co-ordination (including sharing of information) between APRA and ASIC.

With respect to the operation of the 'twin peaks' model of regulation, we also suggest that it is important that the respective mandates of ASIC and APRA are clear, particularly in relation to who bears responsibility for conduct regulation[34].

All that said, it must be acknowledged that APRA's enforcement role is deliberately limited, given that ASIC remains the conduct regulator and that both regulators have differing mandates.

[32] APRA media release, "APRA releases CBA Prudential Inquiry Final Report and accepts Enforceable Undertaking from CBA", 1 May 2018, https://www.apra.gov.au/media-centre/media-releases/apra-releases-cba-prudential-inquiry-final-report-accepts-eu.
[33] AICD Submission to the Royal Commission on Round 5 Closing Submissions, 21 September 2018.
[34] AICD Submission to the Royal Commission on Round 5 Closing Submissions, 21 September 2018.