

# FINANCIAL SYSTEMS INQUIRY

## Submissions in response to Interim Report

### Response to policy options specified on page 3-48 in relation to Corporate Governance

This submission is in two parts:

1. Submission in response to request for views; and
2. Commentary.

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#### 1. Submission

##### 1.1 Role of Boards

**Prudential requirements on boards should be reviewed to ensure that they do not draw boards into operational matters.**

**Regulators should continue to clarify their requirements on the role of boards so as to ensure that those requirements properly recognise the respective responsibilities of the board on the one hand and management on the other.**

The benefit of this is that it will result in a proper identification and delineation of the responsibilities of the board consistently with the overriding principles which apply to a board in relation to its role and responsibilities. It will clarify for the board the standards with which it must comply in discharging its responsibilities in relation to the relevant requirement and will result in a more effective and compliant regulatory regime.

This will result in a reduction in the costs incurred by the entities to which the relevant boards relate and should not result in materially greater costs being incurred by a relevant regulator over and above those required in the proper discharge of its statutory functions. If properly implemented this should not result in any material trade-off such as a reduction in the integrity of the relevant prudential requirement nor in its implementation.

##### 1.2 Directors' Duties

**As a matter of policy there should be no material differentiation between the duties of directors of banks, insurers and trustees of superannuation funds (or other issuers of financial products such as responsible entities of registered managed investment schemes).**

The duties of the directors of each of the above entities should be based upon a common set of core principles, namely:

- (a) a duty to act honestly;
- (b) a duty to act in the best interests of the relevant entity, and for a purpose which is consistent with the objectives of that entity;
- (c) a duty to exercise an appropriate standard of care, skill and diligence in the discharge of their responsibilities;
- (d) if the entity owes a special duty to a particular group of stakeholders (for example, it is a trustee and owes duties to fund members or unit holders), a duty to take

reasonable care and use due diligence so that the entity performs its duty and prioritises its duty to stakeholders over the interests of the entity. Properly characterised, this is a manifestation of the duty referred to in paragraph (c) above.

- (e) a duty to avoid a conflict of interest between the entity, or in the case of the trustee/responsible entity, its members as a whole, and themselves or another entity or person; and
- (f) a duty not to obtain a personal advantage from the holding or performance of that role except to the extent specifically permitted.

The benefit of this is that it will ensure a consistency of duties owed by directors of entities and the trustees of superannuation funds in the best interests of those to whom that duty is owed, irrespective of the legal form which that entity might take. This will result in a reduction in the compliance costs incurred by the entities to which the relevant boards or trustees relate and a consistency of duty should also result in a reduction of the costs of the relevant regulators in supervising those boards and trustees. This should not result in any material trade off because it should not result in any reduction in the relevant person's legal responsibilities.

**The directors' primary duties should be to the relevant entity. In discharging their duties to the entity the directors should be free, but not obliged, to take into account the interests of a broad group of stakeholders.**

**If necessary, where specific policy considerations so require, the interests of specified stakeholders may be recognised pursuant to a specific regulatory provision designed to protect the interest of those stakeholders, for example as presently occurs in relation to creditors. In those cases where policy considerations are such that a specific regulatory provision is required, the obligation to comply with that provision should be imposed on the entity and not the directors. The directors' obligations should be limited to using reasonable care and exercising due diligence so that the company complies with its obligations under that requirement. The directors' obligation in relation to that matter should be expressed as a duty which they owe to the entity and not to those particular stakeholders whose interests are sought to be protected.**

The benefit of this proposal is that it will provide clear guidance to the directors as to the person to whom their duties primarily lie whilst at the same time encouraging boards to have regard to the interests of a wide range of stakeholders as is considered appropriate having regard to the circumstances of the entity. It should facilitate the discharge by the directors of their relevant duties and should therefore result in a reduction in costs incurred by the entity in ensuring compliance. It should not result in any increased costs to the relevant regulators. Whilst on one view it may be said that the absence of a duty owed to a wide range of stakeholders may result in a trade off so far as those stakeholders are concerned, any such trade off will be counterbalanced by the greater deal of certainty which is provided to the directors in relation to the discharge of their duties without in any way precluding their having regard to the interests of the wider group of stakeholders as considered appropriate.

## 2. **Commentary**

In these submissions and commentary we address the relevant policy issues applicable to the matters in respect of which further submissions are sought.

### 2.1 **Role of Boards and Management**

The paragraph on page 3-45 immediately under the heading "The role of boards and management" in our view accurately reflects the relative responsibilities of the board on the one hand and management on the other. It reflects an appropriate policy objective and an appropriate outcome to achieve good corporate governance. Further we agree that whilst there may be a public policy case, as the paragraph recognises, for differential regulation of financial institutions, that of itself does not support or require some separate delineation of the respective responsibilities of the board and management.

Furthermore, there is no policy imperative which requires that this fundamental delineation of responsibilities should differentiate between financial institutions by reason of the legal form which a particular financial institution or its products might take.

We endorse the concern to which the Interim Report refers at the top of page 3-46, reflected in submissions, that requirements specifically imposed by APRA impose an excessive level of managerial ownership by the board which is inconsistent with the basic principles identified at the outset of this section of the Interim Report. We agree that this may diminish the capacity of the board to deal with its other important responsibilities.

We understand that financial institutions who deal with these matters on a day to day basis will be better placed than we are to identify other examples as requested.

## 2.2 **Regulatory Guidance**

We support the proposition that regulators such as APRA and ASIC should be encouraged to provide detailed explanations of their expectations in relation to particular regulatory requirements. This will facilitate the ability of the regulated entities, their boards and management so that compliance with the terms of that regulatory requirement will be to the standard expected by the relevant regulator.

The detailed explanations which the regulator should be encouraged to provide should be designed to simplify and ease the relevant regulatory requirements and not to impose new or additional requirements.

It is essential that the relevant regulator's expectations in relation to a regulatory requirement be built into the body of the regulatory requirement itself.

We have provided further information in relation to this matter in a confidential submission.

## 2.3 **Directors' Duties**

There are no policy imperatives as a consequence of which there should be a difference between the duties of directors of banks, insurers or the trustees of a superannuation fund. The duties of each of them should be based upon a common set of core principles such as those identified above. This is not necessarily an exhaustive list and there may be other core principles which could be included. As a matter of policy the interests of those to whom the relevant duties are owed should be aligned irrespective of the nature or form of the entity through which their interests are held.

Whilst a specific regulatory regime may be appropriate to protect the interests of a particular set of stakeholders, for example, the interests of creditors, as currently occurs, there is no policy imperative such that the interests of other stakeholders should require there to be a specific duty to such stakeholders imposed on the directors of an entity. The interests of those stakeholders can be appropriately addressed through specific regulation of the entity (not the directors) designed to meet the specific policy requirements which are applicable to their interests.

Any proposition that directors should owe "duties" to a broad range of stakeholders has the potential to create material conflicts in the discharge of the directors' duties.

A specific regulation may require that the entity have regard to the interests of a particular group of stakeholders. As a matter of policy, that is not objectionable provided that the relevant regulation appropriately recognises that the relevant duty is owed by the company and that the directors' responsibility is to take reasonable care and exercise due diligence so that the company discharges that duty.

An example of such a requirement is section 48 of the Life Insurance Act (LIA). Subsection (1) imposes a duty to the owners of policies referable to a statutory fund of the company and subsection (6) makes it clear that a director who breaches the duty is liable to pay the

company the amount of a loss to a statutory fund arising from an act or omission by the company arising from the breach. Subsections (2) and (3) make it clear that the directors' duty is a duty to take reasonable care, and use due diligence, to see that in the investment, administration and management of the assets of a statutory fund, the life company complies with the relevant Part of the Act and gives priority to the interests of owners and prospective owners of policies referable to the fund - that is, to see that the company complies with its duty to policyholders under s 32 of that Act. Further, the directors have a duty to take reasonable care, and use due diligence, so that the life company gives priority to the interests of owners and prospective owners of those policies over the interests of shareholders. Note that each of the directors' duties is a duty to take the specified steps so that the life company acts as required. We understand that the policy initiative underlying this flows from the fact that a life company is required to establish a statutory fund or funds and that policies must be referable to such a fund and be satisfied from the assets of the fund.

In our submission ss 48(2) and (3) are a good model for the description of a duty to take reasonable care, and use due diligence, so that a company performs any special obligations to stakeholders, but ss (1) and (6) go too far in imposing a duty owed directly to those stakeholders.

In the current environment boards recognise that it is in the interests of the company to whom their duties primarily are owed to ensure that proper attention is given to a wide group of stakeholders such as employees and independent contractors, health and safety for their employees and the broader community and economic and environmental sustainability.

However in the discharge of their duties to the relevant entity, the directors should be permitted, but not obliged, to have regard to the interests of a wide group of stakeholders, such as those referred to above.

This issue was addressed in corporate law reform in the UK in 2006 in the Companies Act which, firstly, restated the general principle that the duties specified in the relevant provisions are owed by a director of a company to the company, and secondly, provided, most relevantly in this context, that a director of a company must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- (a) the likely consequences of any decision in the long term;
- (b) the interests of the company's employees;
- (c) the need to foster the company's business relationships with suppliers, customers and others;
- (d) the impact of the company's operations on the community and the environment;
- (e) the desirability of the company maintaining a reputation for high standards of business contact; and
- (f) the need to act fairly as between the members of the company.

Again, it should be noted that the duty is to act in the way most likely to promote the success of the company for the benefit of its members as a whole, having regard to a series of matters including the interests of broader stakeholders. This law does not impose a duty to act in the interests of the stakeholders. Note that this provision is subject to any specific provisions relating to the interests of creditors.

There has been considerable debate as to whether the UK provisions do more than enact the previously accepted principle that the directors have a duty to act in the best interests of the company, and that the best interests of the company will, as indicated above, include a consideration of the interests of a wide range of stakeholders.

This confirms our submission that the directors' duty should remain a duty owed to the company, on the basis that in discharging that duty, the directors may have regard to the interests of a wide range of stakeholders.

We would be happy to discuss this further with you.

26 August 2014

**Brigitte Markovic, Partner**

**Karen Evans-Cullen, Partner**

**David Ephraums, Partner**

**Rod Halstead, Director -  
Strategic Corporate/M&A**