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The Treasury
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To the Commission of Inquiry

Financial System Inquiry – Draft Terms of Reference

Governance Institute of Australia (formerly Chartered Secretaries Australia) is the only independent professional association with a sole focus on the practice of governance. We provide the best education and support for practising chartered secretaries, governance advisers and risk managers to drive responsible performance in their organisations.

Our Members are all involved in governance, corporate administration, risk management and compliance with the *Corporations Act 2001* (the Act) with their primary responsibility being the development and implementation of governance and risk management frameworks in public listed and public unlisted companies, private companies, and not-for-profit organisations. Many of our Members work in the financial services industry and all have extensive experience of financial markets.

Governance Institute of Australia welcomes the opportunity to comment on the draft terms of reference for the inquiry into the financial system.

General comments

Given the critical role that the financial system and the financial services industry play in a healthy and functioning economy, it is essential that we ensure that the policy and regulatory settings remain optimal for the future.

Governance Institute is of the view that the draft terms of reference are for the most part sufficiently broad to provide for a review of key issues. For example, although the superannuation sector is not listed as a separate field of inquiry in the terms of reference, the expanding pool of savings through our legislated superannuation scheme and the contribution of that capital to the future requirements of Australians is such that the governance and prudential oversight of this sector must be considered as part of any inquiry into the financial system. We are of the view that the draft terms of reference are sufficiently wide-ranging and comprehensive to provide for such consideration.

Within the timeframe available to comment, we have chosen not to comment on all of the draft terms of reference, but to provide feedback on those where the insights of our Members can add the most value.

Comments on specific draft terms of reference

2.1. balancing competition, innovation and efficiency, with stability and consumer protection

Governance Institute notes that competition of itself is not a panacea and applauds the Inquiry for recognising this simple fact and for acknowledging the need to balance competition with efficiency and stability. The direct fostering of competition by the government is a powerful tool that needs to be managed very carefully. While competition can often produce positive outcomes, experience has shown that it is not always the case. For example, competition can introduce downstream inefficiencies and destabilising effects. It may introduce costs for financial service users or market participants that are greater than any savings attached to the greater levels of competition, that is, there may not be any net benefits for those who are the intended beneficiaries of increased competition.

Another facet of competition to consider is that the greater the extent of intermediation the greater the risk of failures with systemic implications. Governance Institute Members suggest that any review of competition needs to include the substance in and adequacy of the banking system as being more important to the Australian economy than returns to shareholders of individual banks, although a balance between those two elements is the preferred outcome. The Inquiry may also wish to consider the capital adequacy assessment process and the solvency requirements of financial institutions/funds.

We also refer the Inquiry to research undertaken by IndustrySuperAustralia, which conducted a macro-level analysis of whether the facilitation of capital formation by Australia's financial system has become more efficient as the sector has grown. Their research showed that more labour and capital is deployed in finance than in decades past (just as in the US and other financial centres), but that the level of capital formation attributable to finance has grown far less. Their major finding is that the sector has become less efficient in this respect.

We also note that in the developed world, the concept of fairness underpins economic transactions amongst individuals. Indeed, the concept of a fair market is embedded in the regulatory framework. Fairness and a level playing field for participants therefore must be considered as fundamental underpinnings of a healthy financial system.

2. The Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including:

2.2. how financial risk is allocated and systemic risk is managed

a) Allocation of financial risk

Corporate reporting is predicated on disclosure. 'Sunlight is said to be the best of disinfectants; electric light the most efficient policeman,' said Justice Louis Brandeis, US Supreme Court of Justice, in 1933. Justice Brandeis made this comment at a time when fraud and market manipulation led to market turmoil and the Great Depression. It was also made in the context of President Roosevelt's New Deal reform programs that eventually led to the passing of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the US Securities and Exchange Commission (SEC).

James M Landis, the architect of the US securities regulatory system said:

> My fundamental belief is that if the truth is told about these things, then it is up to the parties to decide whether they want to buy them or not. If they want to buy them, and speculate, well, let them go ahead and speculate. I've always felt that the furthest that practical administration could go was to call for a statement of the truth about any enterprise; but that some governmental agency should say you shouldn't buy stock in ABC company — I don't know who can decide a thing like that.

Disclosure is concerned with transparency, that is, letting the truth be available to all. This is the foundation of continuous disclosure. Disclosure is seen as an effective tool for improving investor protection. Some of the responsibility for protecting the investor is shifted to investors themselves. This is the concept of informed self-interest — with good information, the perception of risk in the markets is reduced, as is the cost of capital.

We note that the rise of social media has significantly changed the disclosure landscape in relation to the allocation of financial risk in securities.

Disclosure is also seen to encourage better management of enterprises. Disclosure is seen as addressing the two key problems in agency relationships, where moral hazard and conflicts of interest may arise, which are that:

- the principal is unable to verify (because it difficult and/or expensive to do so) what the agent is actually doing. The two parties may have different interests and asymmetric information (the agent having more information), such that the principal cannot directly ensure that the agent is always acting in the principal's best interests
- the principal and agent may have different attitudes towards risk and because of different risk tolerances, they may each be inclined to take different actions.

However, disclosure is not necessarily a protection in all instances. Allocating financial risk at the consumer level is not identical to allocating financial risk at the investor level. Governance Institute is of the view that disclosure in its many forms needs to be considered, with a view to understanding whether disclosure is the best or only means available of providing protection in the allocation of financial risk.

Governance Institute also notes that consideration needs to be given to funded class actions. Currently the majority of litigation funders are not licensed, nor are the law firms which act as promoters, yet funded class actions are an accepted mechanism in the framework of those seeking retribution from corporations. Other such mechanisms are regulated. This is not simply a matter of disclosure, but of an unregulated industry where the interests of only some parties in the litigation are currently being protected, and where the desire to ensure that ordinary people retain access to the courts has obscured conflicts of interest that need to be addressed in any allocation of financial risk.

Governance Institute Members note that:

- while the funder promises to meet all adverse cost orders which may be made in favour of the defendant, if the funder lacks adequate capital or insurance to meet those costs, the representative member of the class may have an exposure to costs. Funders may manage this by selecting an impecunious representative, knowing the courts are unlikely to grant security for costs. There is a clear incentive for class action promoters to commence actions regardless of whether their risk assessment is that the prospects for success are unlikely and regardless of whether the litigation funder has capital adequacy to meet costs should the action fail
- given that defendants are forced to incur costs, as there is no guarantee of being able to recover costs even if successful, and those costs can be very significant, the current situation is conducive to initiating unmeritorious class actions in the hope of forcing a settlement (so-called ‘blackmail suits’). The significant costs are, of course, ultimately borne by shareholders (for example, management’s time is diverted from the business to defending the litigation; legal advice is costly; media scrutiny of the proceedings can have an adverse effect on the share price and reputation of the company)
- representations made by promoters and law firms, including in the period before proceedings are initiated (and therefore not subject to court supervision) in promoting the litigation may be misleading or deceptive, both in terms of their effect on the members of the class and the proposed defendant and its business

- there is no doubt that a conflict of interest situation exists in funded litigation — the promoter and/or law firm actively seeks out and creates an action to further its business, not the interests of the plaintiffs (although these may be incidentally served). Without adequate conflicts management arrangements, litigation funders whose interests conflict with those of their clients are more likely to take advantage of those clients in a way that may harm the clients.[1]

b) Systemic risk
As demonstrated by the global financial crisis and its impacts, when private interests and decisions pose risks to the health of the world economy, there is a strong and legitimate case for some form of public response to reduce and contain those risks.

Governance Institute is of the view that the scope of what might constitute systemic risk has not been defined in the draft terms of reference, as this could exclude consideration of matters germane to this inquiry. Our Members are of the view that systemic risk involves the extent of interconnectedness between organisations and entities in the financial system, with particular reference to how a potential failure can be identified before it happens; what processes are in place for a regulator to take action in the face of a possible failure rather than waiting for the failure to occur; what processes are in place to quarantine a failure if it occurs etc. We are of the view that the terms of reference need to outline the types of systemic risks the Inquiry intends to examine as this will have a bearing on any inquiry and on responses from the public.

We also refer the Inquiry to research being undertaken by the Organization for Economic Co-operation and Development (OECD) on systemic risks in the financial system globally, which is relevant to any consideration of systemic risk domestically.

c) Short-termism
The issue of short-termism in relation to financial markets and achieving long-term investment outcomes for Australians through superannuation is recognised by many as a serious problem. How to tackle it securely and effectively is, however, unresolved. Statutory clarification of the fiduciary duty of the trustees/boards of superannuation funds would certainly assist. Proponents of a broader view of the fiduciary duty, which not only permits but requires long-term risks and opportunities to be appropriately and demonstrably catered for in investment strategies, are pursuing ways to endorse that view, including via litigation and statutory clarification, as this would provide trustees with the confidence to improve the long-term outlook for their members' equity investments to better match it to the long-term liability of the fund to its members, many of whom are still early in their working careers and will not retire for decades.

The provision of a safe harbour provision in the Corporations Act, to provide directors and officers with the capacity to make forward-looking statements to investors as appropriate, would also assist. This goes to the capacity of directors, currently constrained, to make forward-

[1] IMF (Australia) Ltd, 'Policy Issues in Litigation Funding', Supreme and Federal Court Judges Conference, Hobart, January 2009 explain the type of conflicts of interest that may arise in the case of a funded class action as follows: 'Conflicts of interest may arise between the funder and the funded litigant which may lead to the litigant's legitimate interest being subordinated to those of the funder or being ignored altogether (for example the funder forces an early and cheap settlement on the litigant in order to improve the funder's cash flow or the litigant refuses to accept a reasonable settlement offer when the funder believes that it would be prudent to do so)....The tripartite relationship between funder, client and lawyer has the potential to create numerous conflicts. This may be of particular significance in multi-party proceedings, where claimants could be more vulnerable to both the funder taking control of the proceedings and to lawyers who fail to sufficiently protect and promote the claimants' interests above their own. This includes the lawyer giving advice on the benefits and risks of the funding proposal — which might be seen to be an ethically perilous undertaking if the lawyer is financially dependent on the funder for the litigation to proceed. Further, not only does the lawyer face potential conflicts between the funder's and the client's' interests, there is also a potential conflict between duties owed to different clients if the lawyer is retained by the funder and not directly by the litigants.

looking statements. This in turn hinders the capacity of directors to speak to long-term objectives and prospects, as well as the risks attached to achieving those objectives.

Indeed, short-termism in financial markets is itself a systemic risk that requires consideration. Any consideration of this matter also needs to take account of developments in technology, which have seen the increase in high frequency trading and low latency markets. These developments give rise to questions of whether we wish to facilitate a market based on investment acumen for the long term, or one in which access to the best technology for short-term gain rather than investment acumen decides outcomes.

2.3. assessing the consequences of financial regulation, including its impact on compliance costs, flexibility, innovation and financial services trade

Regulation is necessary to ensure that the interests of business, shareholders, the community and consumers are protected. For any regulation to be effective, it requires a high level of confidence among both business and the wider community that the need for any new regulation is real, and

- any new proposals will be effective in meeting the objectives and addressing the targeted shortcomings in the operation of the market
- without imposing costs that outweigh their expected benefits.

Nor is it desirable for any proposed new regulation to have a distorting or negative effect on the existing regulatory regime in place at the time.

There has been a sharp increase over some years in the amount of legislative and regulatory requirements to which business is subject, much of this relating to financial regulation. As an example, in the corporate law and governance arena, each piece of new financial regulation focused on disclosure is intended to provide greater transparency to shareholders. However, the legislation has been introduced in piecemeal fashion, to address particular issues, and there has been little or no consideration given to the impact on the quality of disclosure overall. As a result, in many areas, disclosure intended to provide greater transparency to shareholders can be now largely impenetrable to them.

Put simply, adding another layer of legislation or regulation does not always produce the desired regulatory outcomes. The addition of each new individual element to the regulatory landscape needs to be evaluated for its impact on the regulatory ‘whole’ or ‘sum of the parts’.

Another issue that has arisen with the greatly increased amount of financial regulation that has been introduced in recent years is the unintended consequences that arise from the practical implications attached to drafting. We believe that this is due, at least in part, to insufficient stakeholder consultation early in the process, and shortened timelines for responding to exposure drafts. Accordingly, we believe that consultation with relevant stakeholders much earlier in the development of legislative proposals would be beneficial, in particular to avoid the problem of subsequently having to ‘fix’ legislation time and time again.

Governance Institute therefore urges the inquiry to review how improved processes can be introduced to avoid the introduction of unnecessary regulation and to enhance the quality, efficiency and effectiveness of new regulation.

We note that the Department of Treasury itself, in its internal review of 2012, has noted its need to better engage with industry and take advantage of the practical assistance that stakeholder groups can bring to the process of developing regulatory frameworks. Stakeholders will have a variety of recommendations to make on how the process of regulation can be improved, including

- stakeholder consultation in the form of roundtables and briefings to take place prior to the release of discussion, options or consultation papers or exposure drafts by the government departments
- the formation of Taskforces, for example, in securities regulation it would be comprised of shareholder representatives, companies and investor bodies, to act as an advisory group to the Department of Treasury on relevant proposed legislative approaches; and in superannuation it would comprise members, superannuation entities and fund managers
- the formation of relevant expert Law Drafting Advisory Groups which would review proposed drafting before it is issued publicly
- the introduction of sunset clauses and review dates every three years for key regulation, and
- the introduction of staged reform.

2.5. the role, objectives, funding and performance of financial regulators

An issue for consideration is the number of financial regulators operating in Australia and the interaction of their requirements for compliance, including financial reporting and disclosure. Currently, those financial institutions that are also companies will have compliance obligations to:

- Australian Prudential Regulatory Authority (APRA)
- Australian Securities and Investments Commission (ASIC).

Those financial institutions which are also listed entities will also have compliance obligations to Australian Securities Exchange (ASX). While ASX is not by statute a regulator, but a market operator, its listing rules operate as a contract between the exchange and a listed entity and cover a range of compliance obligations, including continuous disclosure.

Governance Institute is a strong supporter of disclosure and supports it as a foundation stone of our regulatory framework. However, there is considerable overlap between the compliance, reporting and disclosure obligations owed to the three regulators identified above. This is costly and inefficient. We would suggest that greater clarity as to the role of each regulator is required, particularly with regard to the regulatory requirements imposed on entities.

At present:

- ASIC is responsible to protect the providers of capital, who take risks as part of the potential to gain a reward. ASIC is concerned with capital raising and supervision of a fair and equitable market for capital allocation. ASIC's purview covers transparency and competition.
- APRA is responsible to protect depositors, who do not take risks but expect to retain their deposits. APRA is therefore concerned with capital adequacy, rather than the protection of those investing in financial institutions. APRA is also concerned with the protection of members of superannuation entities, and is also concerned with the adequacy of insurance reserves.

Governance Institute is of the view that a key question is whether the boundaries are clear between the regulatory functions, given the increasing overlap of compliance obligations imposed on entities within the financial system. For example, if APRA regulates financial conglomerates, its regulatory intervention would potentially have an impact not just on one company but on all companies within the group. The boundaries of regulatory oversight would not necessarily be clear in such circumstances.

Any such review would also need to canvass duplication of legislative frameworks. For example, there is considerable overlap between the legislation governing consumer protection under the ASIC Act and the Corporations Act.

The review should also take into account the current Senate Committee inquiry into the performance of ASIC, as many of the submissions to that inquiry will cover issues of role, objectives and funding.

3. The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the financial system, including:

3.5. corporate governance structures across the financial system and how they affect stakeholder interests

The corporate governance arrangements of listed entities are well understood and transparent. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (the Principles and Recommendations) have played a vital role in improving corporate governance in Australian listed companies since the release of the first edition in 2003. Their history is one of practical statements on governance which have brought meaningful change to governance practice.

However, there is not the same level of transparency as to corporate governance arrangements in managed investment schemes (MISs) or superannuation entities.

Importantly, introducing further complex legislation is unlikely to achieve the change to practice and behaviour that lies at the heart of improving corporate governance. As we have seen in the United States, which introduced black-letter law in response to corporate failures, compliance teams within entities may increase in size, but cultural change is not effected.

Governance Institute points to the success of the Principles and Recommendations as a means of effecting meaningful change in corporate governance practice. The model they provide should be considered in any review of corporate governance in other areas of the financial system. The key to the success of the guidelines being adopted by and influencing behaviour in listed entities is that the Principles and Recommendations are based on the 'if not, why not' approach. This model recognises that governance cannot be a 'one-size-fits-all' approach and that 'if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it —- a flexibility tempered by the requirement to explain why'.[2]

3.4. changing organisational structures in the financial sector

The corporate structure has a long and successful history. As noted above, corporate governance is transparent and highly regarded in the listed company arena. Governance Institute suggests that the corporate model is a model that should be examined for its applicability in other areas of the financial system, particularly where more complex organisational structures that pose difficulties in relation to transparency exist.

5. The Inquiry will take account of the regulation of the general operation of companies through corporations law to the extent these impinge on the efficiency and effective allocation of capital within the financial system.

Any consideration of the operation of companies cannot be undertaken with reference to the corporations law alone. Consideration must also be given to the role of ASX, and the operation of the ASX Corporate Governance Council's Principles and Recommendations.

We note further that while the current system of capital allocation and capital raising has proved of economic benefit to the Australian economy, there are significant debates occurring both within Australia and globally concerning:

- the role and responsibilities of the corporation – questions are being asked as to the extent of responsibility that should be imposed on companies for their impacts on the environment, the communities in which they operate and the economic wellbeing of

[2] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd edition, with 2010 amendments, p 5

future generations. These questions canvass the extent to which private interests should be rendered subservient to societal obligation

- the responsibilities of those granted limited liability and the role of shareholder primacy in corporations law. The history of the concept of limited liability is based on an expectation that economic activity undertaken by private individuals transacting among themselves will lead to a common good. These questions canvass the extent to which private rights are linked to public duties, and the implications of any change to the current model for the allocation of capital.

Given these significant debates, and the importance of the regulatory framework for the operations of companies – and in turn the financial markets – Governance Institute strongly recommends that any changes that might be considered to the corporations law would need to be the subject of a separate and serious public consultation and not be annexed to this inquiry.

Recommendation of inclusion of additional term of reference

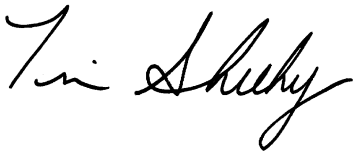
While Governance Institute is of the view that the terms of reference are broad and comprehensive, we strongly recommend the inclusion of an additional term of reference, to the effect that if a matter or issue arises during the course of the inquiry that is relevant to the objectives of the inquiry, that the inquiry is free to pursue it. This will ensure that the inquiry is not constrained by its terms of reference should a relevant and important matter arise not currently contemplated by the terms of reference.

Conclusion

The timeframe allocated to the consultation on the inquiry into the financial system is such that Governance Institute of Australia can only provide a broad outline of some of the issues that we would hope to see canvassed in the inquiry into the financial system.

Our Members would be very happy to provide a more detailed submission.

Yours sincerely



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