Corporate Governance and the Regulation of Conglomerates

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My comments on Bob Baxt's paper will touch upon aspects of the Financial Services Reform Act relevant to duties of directors of financial conglomerates. The FSR Act, or Chapter 7 of the Corporations Act 2001 as it now is, has been the opening topic of this year's Conference, and will appear again in a later session.

By way of leading into corporate governance aspects of this legislation, it is worth repeating Bob Baxt's reminder of the basic legal principle that directors owe their duties, both statutory and common law, to the company and not to particular interest groups which are associated with the company. The stated object of new Chapter 7 (see section 760A) is to promote:

- "Confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services";
- "Fairness, honesty and professionalism by those who provide financial services";
- "Fair, orderly and transparent markets for financial products"; and
- "The reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities".

The term "consumer" is not defined in the Act but the objects of the protection of the legislation would seem to be persons entering into some form of contractual relationship with a financial institution for the provision of a financial product or financial service, for example a contract of deposit, or a contract under which representatives of the institution undertake to provide financial advice (but not a credit contract, which is excluded from the legislation). In other words, the Act is regulating the formation and performance of certain contracts, entered into between a client or customer and its financial institution.

It is sometimes simplistically suggested, particularly in the media, that when a financial institution makes a decision to impose or increase a fee, or abandon or reduce an unprofitable service, that the institution is favouring its shareholders over its customers. The duties of directors of a company are not divisible, and there is no conflict in the minds of directors between the interests of customers and shareholders — their interests coincide. It is of no benefit to customers (particularly depositors) to see an uneconomic service maintained, which becomes unduly costly and unsustainable for the institution in the longer term — cross-subsidies disadvantage other customers. Equally, it is of no long term benefit to the share price to see an institution losing customers to competitors through inadequate or excessively costly services. The task of directors of a financial institution, or the managing director as their delegate, in all decisions pertaining to their company is to balance many factors to determine what is in the best interests of the company as a whole.

In contrast to the duties of directors to make balanced decisions in the furtherance of their company's interests and future sustainability, regulatory bodies have sectionalised statutory responsibilities. In the case of banks and other financial institutions, the Australian Securities and Investment Commission is given a far greater and more intrusive role in the management of financial conglomerates under the FSR legislation than it previously had. As well as ASIC, the Australian Prudential Regulation Authority, the Reserve Bank of Australia, and the Australian Competition and Consumer Commission, in addition to direct involvement from the Treasurer as responsible Minister, and special purpose regulators such as the Privacy Commissioner and AUSTRAC all encroach on the ability of directors to make business decisions. Australia is certainly not currently going through an era of deregulation.

While directors of companies are accountable for the consequences of negligent or wrongful decisions, damaging their companies, regulatory bodies interfering in a company's preferred course of action are not accountable, if their intervention turned out to have unjustifiable adverse consequences for the customers and shareholders of the business.

Hitherto, a bank's authority to carry on banking business was derived solely from the Banking Act and a life insurance company's authority to carry on life insurance business from the Life Insurance Act. The FSR Act will require banks and life insurers, by the end of the two year transitional period, to hold a second licence to carry on their business. Under the Banking Act, section 9, APRA is given power to grant authorities to corporations to carry on banking business in Australia. APRA, may, at any time, by notice in writing, impose conditions or additional conditions on an authority, or vary or revoke conditions imposed on an authority. However, the conditions must relate to "prudential matters".

Prudential matters are defined to mean matters relating to the conduct by the body corporate of any of its affairs in such a way as to keep itself in a sound financial position and not to cause or promote instability in the Australian financial system, and with integrity, prudence and professional skill." APRA may also revoke a banking authority on solvency, prudential or national interest grounds. Under the Life Insurance Act, authorised life insurers and their directors have obligations, specifically, in relation

to the protection of the statutory funds and life companies can have their authorities revoked on similar grounds to banks.

Section 912A of the Corporations Act as amended by The FSR Act sets out general obligations of financial services licensees. Sub-section 912A(1)(a) provides:

> " A financial services licensee must do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly."

A licence may be cancelled or suspended once ASIC has given the licensee opportunity for a hearing, for non compliance with section 912A (section 915C).

Previously, there was an in-built protection for the financial system in that the statutory power to take away or restrict banking authorities was constrained by matters relating, in effect, to the soundness of the financial system or the bank concerned. The financial system was in that way insulated from political or media pressures of the day. This safeguard has now been taken away by the FSR Act.

History shows a run on a bank is triggered by market panic over the future ability of bank to repay its depositors and when a run happens, invariably depositors funds are lost in an ensuing collapse. It is not difficult to imagine these conditions in the market arising where the regulator is persuaded to act, or even to raise the prospect of acting against a bank's licence, in the face of media pressure, fuelled by special interest groups over a current "consumer" issue. In recognition of this systemic risk created by the new FSR Act regime. The former Minister for Financial Services, Joe Hockey, caused the FSR legislation to provide that only the responsible Minister, rather than ASIC had power to revoke or suspend the licence of an approved deposit taking institution under the Banking Act (see section 915I(2)(c)). (As a matter of statutory interpretation, it would be expected that the general powers of the Minister to delegate to ASIC for the purposes of Chapter 7, under section 1101J, could not apply to the express provision in section 915 I(2)(c)). In the case of other APRA regulated bodies, such as insurance companies, there is a mechanism for consultation between ASIC and APRA.

Concerns were expressed by banks and others over the consultation period during which Government sought public submissions and the views of business on the drafting of the FSR Act, on the subjective nature of words such as "fair" and "efficient". There was the expectation in the drafts of the legislation that were circulated during this process, that the term "fair" would be omitted. However, the legislation, as enacted, retained the word "fair" and added new words that express the obligation of a licensee much more strictly than in previous drafts of the Bill. The final Bill as introduced and enacted provided that a financial services licensee <u>must do all things necessary</u> to ensure that the services are provided fairly.

The regime under new Chapter 7 is a derivation, in a much expanded form, of former Part 7.3 of the Corporations Law for the licensing of securities dealers. The wording "efficiently, honestly and fairly" comes from the former provisions, but the words were previously used in a more limited context. Apart from the former sections not applying to the general banking business of banks or general life

business of life insurers, (they were restricted to dealings in securities) former section 784(2) provided that the Commission shall grant a licence to a body corporate if "the Commission has no reason to believe that the applicant will not perform efficiently, honestly and fairly the duties of a holder of a licence of the kind applied for" and former section 826(1)(j) permits revocation for failure to comply with this ground. Former section 784(4) set out considerations for the Commission to take into account in determining these criteria, which basically were matters relating to the good reputation and character of the applicant and its responsible officers. The wording in the current section 912A imposes a much broader and more absolute obligation, and it applies on a continuing basis for a licensee.

As stated above, directors are required to balance different commercial considerations in deciding the manner in which the company can adequately provide its services. There is also the business judgement rule in section 180(2) which gives directors a safe harbour in relation to the duty of care and diligence in forming a judgement which they rationally believe to be in the best interests of the corporation. A company has limited resources and cost restraints, and limits on the ability to cross-subsidise services. Under the FSR regime, ASIC is obliged to form its own subjective view on whether the directors have caused the financial services entity to "do all things necessary", to fulfil the obligations of "efficient" and "fair" provision of financial services. To whom the duty of fairness is owed and what it entails must be regarded as an open question, but a bank's or other institution's financial services licence is under threat and therefore, the whole of its business is in jeopardy, for it failing to live up to the perceptions by the personnel from time to time comprising the regulator on these matters.

Licensing within Financial Services Groups

Financial services conglomerates will need to be licensed for a number of their activities. The current dealer's licence and proper authority regime will be replaced by a financial services licence and cover a greatly expanded range of dealing and financial advisory activities, with the attendant training requirements for relevant employees being put in place. Some entities not previously licensed, such as a custodian subsidiary will need to be licensed and banking and insurance arms will need to obtain their second licence, as outlined above.

Every financial services group will need to decide how to structure its licensing regime. It is possible for one licence covering all activities to be held in the group with other entities being appointed as corporate representatives (see Part 7.6 Division 5). However, from a risk management point of view, it may be preferable to have several licenses covering different functions of the group, particularly as dual licensing is now required for banking and insurance services, as discussed above. At least, it may be prudent for the financial services licence for banking activities to be quarantined from other licenses. These issues are currently being evaluated by banking groups.

Decisions on group licensing structures are likely to be made by financial conglomerates at a group management level, rather than leaving the decision to individual subsidiaries. Bob Baxt mentions, in his paper, the current law, in Australia and New Zealand, permitting directors of subsidiaries to take account of the interests of their holding companies. Conversely, the main board of the holding company does not have day to day management responsibilities of the subsidiaries but, as part of its duties to the company as a whole, needs to have in place group corporate governance procedures for all substantial business carried on through subsidiaries. Historical evidence shows that losses in banking groups have often arisen in the business of subsidiaries, rather than the main business where stricter controls are often in place and the issue of group management responsibility for businesses conducted through wholly owned subsidiaries is an essential part of the corporate governance practices of a financial services conglomerate. Decisions on the structure of the group's licensing under the FSR Act are part of this responsibility.

Product Disclosure Statements

In one significant respect, the direct involvement and liability of directors is reduced under the FSR Act, by reason of the Act moving the disclosure requirements for managed investments from the prospectus regime under Chapter 6D (renumbered following the FSR amendments), to the regime applying to other financial products, under Chapter 7.

As a result, it is no longer envisaged that product issuers would need to undertake a due diligence exercise (note Explanatory Memorandum for FSR Act, clause 14.30), and the due diligence defence to protect directors from personal liability is no longer applicable for managed investment products. Issuers, of course, continue to be under an obligation to have adequate procedures to ensure that the product disclosure statement is accurate and contains all relevant information.