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Senior Adviser
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The Treasury
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Dear Sir/Madam

Financial System Inquiry

The Australian Institute of Company Directors (AICD) welcomes the opportunity make this further submission with respect to the Government's Financial System Inquiry (Inquiry), this time in response to the recommendations set out under the *Financial System Inquiry Final Report* (Final Report).

The AICD is the nation's leading organisation for directors, dedicated to making a positive impact on society and the economy by promoting professional director education and excellence in corporate governance. We have a significant and diverse membership of more than 35,000 from across a wide range of industries, commerce, government, the professions, private and not-for-profit sectors.

We have limited the comments made in this submission to the following Recommendations in the Final Report:

- Recommendation 13 – Governance of superannuation funds;
- Recommendation 22 – Introduce product intervention power;
- Recommendation 28 – Execution of mandate;
- Recommendation 29 – Strengthening the Australian Securities and Investments Commission's (ASIC's) funding and powers;
- Recommendation 31 – Compliance costs and policy processes; and
- Recommendation 36 – Corporate administration and bankruptcy.

Executive summary

In summary, our comments are as follows:

- The Australian Prudential Regulation Authority's (APRA's) governance regulation for all regulated entities should be revised so that there is greater alignment with the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (Principles and Recommendations), including the "if not, why not" approach taken under the Principles and Recommendations;
- To the extent possible, all APRA-regulated entities (including superannuation funds) should be held to the same standards of governance practices a requirement that boards of superannuation trustee companies have a majority of independent directors on their boards and that the chair be independent;
- To align the governance standards of superannuation funds with those of other financial institutions, the same independence requirements should apply to the boards of superannuation trustee companies;

- A broad description of "independent" should be adopted for directors of superannuation trustee companies, similar to the one that is used for the purposes of Principle 2 under the Principles and Recommendations;
- Unless deficiencies exist with the current director liability regimes for superannuation funds and life insurance companies, we do not believe that new criminal and civil penalties should be introduced;
- Given that superannuation trustee company boards are already required to have appropriate processes in place with respect to conflicts of interests, we do not see that there has been sufficient cause shown for further regulation to be introduced to strengthen these processes;
- We agree with the recommendations to increase and provide more stable funding to ASIC and to APRA so that they are better able to execute their mandates;
- Consideration should be given to how ASIC can better utilise its existing powers before additional or increased powers are called for or given;
- Any proposals to introduce new powers (for example, a product intervention power) must be fully considered and tested before they are brought into law;
- Deregulation – both stemming the growth in new regulation and cutting back existing red-tape – is a crucial part of the Government's economic policy challenge. The current regulatory burden facing companies makes boards overly focused on compliance at the expense of being focused on performance; and
- Irrespective of any further insolvency reform approaches that may have merit, a critical element to addressing the problems created by the insolvent trading regime is for directors to have access to a broad-based defence that extends to the insolvent trading provisions under the Corporations Act.

Recommendation 13 – Governance of superannuation funds

Mandating board independence

As noted in our previous submissions to the Inquiry[1] and also in our submission in response to Treasury's recent superannuation review[2], it is our recommendation that APRA's governance regulation for all regulated entities be revised so that there is greater alignment with the Principles and Recommendations, including the "if not, why not" approach. It is our view that standards of corporate governance should not be mandated, as is currently the case under APRA's prudential standards relating to corporate governance. Mandated standards of corporate governance result in a "one-size-fits-all" approach to regulation which should, in our view, be avoided wherever possible.

The flexibility of the "if not, why not" approach encourages boards to put in place the best corporate governance arrangements for their companies' particular circumstances and can lead to the development of innovative, alternative practices that could produce better outcomes. Companies and their boards are best placed to decide what governance arrangements they should adopt – the regulatory regime for the financial sector should not distort their decisions and business judgments on these matters, but

[1] AICD submission to the Financial System Inquiry with respect to its initial consultation dated 31 March 2014 and AICD submission to the Financial System Inquiry in response to the Interim Report dated 26 August 2014. All of the AICD's submissions referred to in this submission can be located on our website at www.companydirectors.com.au

[2] AICD submission to Treasury in response to its Discussion Paper, *Better regulation and governance, enhanced transparency and improved competition in superannuation* dated 12 February 2014.

rather should allow the regulator to be assured that governance standards are being satisfactorily met. The "if not, why not" regulatory approach allows this. It also has the advantage of creating the impetus for the board to focus on its governance practices and their appropriateness, rather than encouraging a box-ticking approach to governance.

That said, to the extent possible, all APRA-regulated entities (including superannuation funds) should be held to the same standards of governance practices and boards of superannuation trustee companies should have a majority of independent directors on their boards and that the chair be independent.

It is widely accepted that independent directors play an important role in achieving good governance. We note, for example, that:

- the Organisation for Economic Co-operation and Development (OECD) recommends that boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest;[3]
- the ASX Corporate Governance Council recommends that a majority of the board should be independent directors;[4]
- the Australian Council of Superannuation Investors (ACSI) considers that a board should be comprised of a majority of independent non-executive directors who are sufficiently motivated and equipped to fulfill the function of independent scrutiny of the company's activities;[5] and
- the Financial Services Council (FSC) considers that the board of directors of a listed company should be constituted with a majority of individuals who qualify as independent directors.[6]

Additionally, APRA has demonstrated support for the inclusion of independent directors on the boards of organisations in other industries. Paragraph 19 of Prudential Standard CPS 510 provides that the boards of ADIs, general insurers and life companies must have a majority of independent directors at all times.[7]

The AICD considers that independent directors can make a valuable contribution to the boards of superannuation trustee companies. There are a variety of reasons why independent directors are considered important for good governance; however, the significance of any particular reason may vary depending on the type of superannuation entity. The Super System Review of the governance, efficiency, structure and operation of the superannuation system (Super System Review)[8] recognised, for example, that independence from management is important for retail funds, while an "outside perspective" is important for industry funds.[9]

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[3] OECD Principles of Corporate Governance, 2004, Principle VI.E(1), http://www.oecd.org/dataoecd/32/18/31557724.pdf

[4] ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations 3rd ed*, Recommendation 2.1

[5] ACSI Governance Guidelines: A guide for superannuation trustees to monitor listed Australian companies, July 2011, principle 5(d), http://www.acsi.org.au/images/stories/ACSIDocuments/cg_guidelines_2011_final_version_22.06.11.pdf

[6] IFSA (Investment and Financial Services Association Limited) (now FSC) Guidance Note No. 2.00: Corporate Governance: A Guide for Fund Managers and Corporations, June 2009, para 8.2.3, www.ifsa.com.au/downloads/file/IFSAGuidanceNotes/2GN_2_Corporate_Governance_2009.pdf

[7] APRA, Prudential Standard CPS 510: Governance, July 2012, http://www.apra.gov.au/CrossIndustry/Documents/Prudential%20Standard%20CPS%20510%20Governance.pdf

[8] Super System Review chaired by Jeremy Cooper, Final Report, http://www.supersystemreview.gov.au

[9] Super System Review, *op. cit.,* s.4.3

The AICD also considers that there are other important reasons to include independent directors on the boards of superannuation funds that are currently subject to the equal representation requirements in Part 9 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) (or where a board otherwise comprises only employer and member representatives). These reasons include:

- Independent directors can represent and protect the interests of significant groups that are unrepresented under the equal representation model. The Super System Review found that employer and employee representatives are often nominated by third party organisations, such as employer associations and trade unions, which do not necessarily represent the interests of all employers or employees.[10] Similarly, there are other key groups, which are growing in size and are unrepresented under the equal representation model, including retirees, ex-employees and members who have joined funds by exercising fund choice;
- Independent directors can assist employer and member representatives by providing a fresh perspective, as well as bringing different skills and knowledge, particularly where member representatives and employer representatives may have had similar backgrounds, experiences or training;
- Independent directors can bring specialist investment, finance, director or trustee experience, which employer and member representatives may lack;
- Independent directors may be able to reduce the risk of industrial instability, which is inherent in the equal representation model; and
- Unlike many company directors who have long involvement with a company and substantial company-specific knowledge, employer and member representatives may have no real understanding of the superannuation fund, the superannuation entity or the superannuation industry generally. Where this is the case, a failure to appoint independent directors with specialist skills and knowledge may be particularly problematic.

The AICD considers that there should be enough independent directors to genuinely influence and affect the decisions of the board. It is widely accepted that at least a majority of the directors on a board should be independent. The AICD also considers that the Chair of a superannuation trustee company's board should be independent.[11]

Appropriate definition of "independent director" for superannuation funds

In defining the term "independent director", it is important to recognise that the determination of a director's independence involves an assessment of whether the director is, as a matter of practice, in a position to exercise independent judgment as a director. This assessment needs to be able to take into account a number of factors that may impact on the director's ability to exercise independent judgment. For instance, a director appointed as a nominee will not be independent as they will not be in a position to exercise independent judgment as a director.

As noted in our submission to Treasury last year in response to the superannuation review[12], while we agree that there are certain relationships that are likely to be relevant to the board's consideration of a director's independence, the AICD opposes the use of

[10] Super System Review, *op. cit.,* s.4.2
[11] See also: APRA Prudential Standard CPS 510: Governance, para 20; ASX Corporate Governance Council's Corporate Governance Principles and Recommendations 3rd ed, Recommendation 2.2; IFSA Guidance Note No. 2.00, para 8.2.5
[12] AICD submission to Treasury in response to its Discussion Paper, *Better regulation and governance, enhanced transparency and improved competition in superannuation* dated 12 February 2014

indicative factors based on the director's relationship with the company. It is our view that, by listing these relationships for the purposes of defining when a director will be "independent", this can create an unofficial "independence criteria". We note on this point, for example, that there is a trend amongst some proxy advisors and investors to apply an arbitrary definition of independence based on tenure, which sees directors as no longer being independent after being on a board for, say 10 or 12 years. The use of such hardline definitions should be discouraged.

A director's independence cannot be assessed strictly against set criteria, nor can it be based on any one factor. There are a number of factors that may impact on a director's independence, and many of these are captured in Box 2.1 of the Principles and Recommendation. However, a director's independence is ultimately a function of attitude, diligence and mindset. A board can be expected to take into account all relevant interests, positions, associations and relationships that could impact on a director's ability to exercise independent judgment – but the board's assessment should ultimately be made based on whether the director is in fact independent of mind and in practice exercises their judgment in an unfettered and independent manner.

Accordingly, we would recommend that a broad description of "independent" be adopted for directors of superannuation trustee companies, similar to the one that is used for the purposes of Principle 2 under the Principles and Recommendations, namely:

> *"An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment."*

If any examples are to be provided of the types of relationships that might materially interfere with the independent exercise of their judgment (along the lines of Box 2.1 of the Principles and Recommendations and as adapted for Annexure A of the APRA Prudential Standard CPS 510), it should be made clear that the existence of any such relationship is just one consideration to be taken into account. Ultimately, independence is a matter for determination by the board based on whether the director is in fact independent of mind and in practice exercises their judgment in an unfettered and independent manner. Such factors should not, on their own, be considered as factors that preclude a director from being independent.

Again, however, we acknowledge that this has not been the approach taken by APRA. In its Prudential Standard CPS 510, APRA has listed a number of relationships that, if they exist, mean that a director will not be independent for the purposes of the standard. While we do not agree with this approach, if SPS 510 is to be aligned with the requirements of CPS 510 to bring superannuation funds in line with other financial institutions, this more prescriptive definition will also need to apply to superannuation funds.

Penalties for directors of superannuation trustee companies and life insurance companies

Recommendation 13 suggests that the penalties regime for directors of superannuation trustee companies be aligned with those that currently apply to the responsible entities of managed investment schemes. It is argued that this is required as currently "superannuation directors are not subject to criminal or civil penalties in relation to their duty to act in the best interests of members".[13] The Inquiry considers this represents "a significant gap in the current framework".[14] The Inquiry also notes, almost in passing,

[13] Financial System Inquiry Final Report, November 2014 at page 135
[14] Financial System Inquiry Final Report, November 2014 at page 135

that the government should also look at aligning the penalties regime for directors of life insurance companies.

The directors of superannuation trustee companies and life insurance companies must, as all directors must, comply with the duties imposed on directors under the *Corporations Act 2001*. Directors who breach these duties can be subject to civil penalties and may have criminal proceedings brought against them. Directors of superannuation trustee companies also owe duties to the fund's members under section 52(8) of the SIS Act, while directors of life insurance companies owe duties to their policy holders pursuant to section 48 of the *Life Insurance Act 1995*. Both of these duties are expressly stated in the relevant legislation to override the duties that the directors owe to their shareholders (and so take priority to the directors' duties under the Corporations Act to the extent that these are inconsistent). These additional duties place directors in the difficult position of having to resolve any conflicts that may arise between the interests of the company and those of the fund members or policyholders.

While it is true that neither Act imposes civil or criminal liability for breaches of these duties like the penalty regime that applies to managed investment schemes does, they do provide fund members and policyholders who may have incurred loss or damages as the result of director misconduct with the ability to bring an action against the directors to recover that loss (in addition to any action that they may have against the company itself). Where a director has breached their duties under the Corporations Act, this will also carry civil and potentially criminal liability.

The Final Report has not provided any reasoning behind why it believes the introduction of additional civil and criminal penalties for directors of superannuation trustee companies or life insurance companies is required, beyond the fact that they exist for the directors of managed investment schemes. There is no suggestion in the Final Report that the avenues of redress already available to fund members and policyholders in circumstances where a director has breached their duties are in any way deficient. Nor is it suggested that the introduction of civil and criminal penalties would improve outcomes for fund members and policyholders. Unless deficiencies are shown to exist with the current director liability regimes for superannuation trustee companies and life insurance companies, we do not believe that new penalties should be introduced.

Conflicts of interest

Recommendation 13 also suggests that there is a need to strengthen the conflicts of interest requirements that apply to directors of superannuation trustee companies. To achieve this, it has recommended that each director's interests should only be deemed to have been properly disclosed when they have been acknowledged by all other directors.

The SIS Act already requires that superannuation funds publicly disclose their register of relevant duties and interests (which would include the relevant interests of its directors) and also that its conflicts management policy be disclosed.[15] Further, APRA's Prudential Standard SPS 521 requires superannuation funds to have a conflicts management framework in place that is approved by the board. The Inquiry itself notes that these requirements are broadly appropriate. We also note that directors of superannuation trustee companies are also subject to the conflicts of interest requirements under the *Corporations Act*.[16]

In making its recommendation, the Final Report states that "by specifying that each board member must acknowledge when a director adds an interest to the register...

[15] Section 29QB(1)(b) of the SIS Act and regulation 2.38 of the *Superannuation Industry (Supervision) Regulations 1994*.
[16] Sections 191 to 195 of the Corporations Act.

[t]his would focus the attention of the board on director interests and ensure rigorous oversight process".[17] Given the processes that are already required to be in place with respect to conflicts of interests, it is not clear why such further regulation is required, particularly given that the changes suggested in Recommendation 13 would add an additional layer of administrative red tape for boards without any clear benefits to fund members. As such, we do not believe that the further conflicts of interest requirements called for under Recommendation 13 are required.

Recommendations 28 and 29 – Execution of mandate and strengthening ASIC's funding and powers

Funding for ASIC and APRA

We agree with the recommendations of the Final Report to increase and provide more stable funding to ASIC and APRA so that they are better able to execute their mandates.

In our submission to the Senate Inquiry on the performance of the ASIC in 2013[18], we noted that, in our view, any deficiencies in ASIC's performance and effectiveness are more likely to be caused by a lack of adequate funding and resources to allow ASIC to fulfil its role as a corporate regulator. Being well-funded and resourced is essential for a regulator to be able to effectively use its powers and discharge its duties. Relevantly, being adequately resourced allows a regulator to be more pro-active and therefore maximise the chances of ASIC being able to properly enforce existing legislation. The AICD has long called for and supported moves to provide appropriate funding to ASIC and other regulators to meet the increasing demands that they face, and we continue to believe that this is the best way to increase ASIC's performance as a regulator.

This lack of funding is likely, at least in part, to be due to the fact that ASIC's role as a regulator has been increased significantly over time and its resources have been stretched as a result. In addition to increasing the existing funding and resources of ASIC, going forward ASIC's roles should only be added to or extended where there is also a commensurate increase in ASIC's funding and resources.

As noted in our submission to the Senate Inquiry, the following would also assist ASIC to better utilise its resources and properly execute its mandate:

- Improving the quality of the drafting of corporations law (and any other laws to be enforced by ASIC). It is not the job of ASIC, or of any other regulator, to create laws or to interpret vague or poorly drafted laws. Previously, there have been where, as a result of the introduction of vague or poorly-drafted legislation, ASIC has found itself needing to develop and release Regulatory Guides that seek to clarify and/or interpret certain laws that it enforces. If legislation was more carefully drafted, ASIC would not be required to provide such guidance and this would, in turn, free up significant resources within ASIC;
- Increasing ASIC's understanding of business and of the commercial realities in which the companies it regulates operate. ASIC's approach is often overly-technical which can cause the companies dealing with them great frustration. If the commercial knowledge within ASIC was improved, greater consultation between ASIC and the companies it regulates could be achieved. This could, of itself, create greater effectiveness and efficiencies within ASIC;
- Giving greater focus to how ASIC prioritises its investigations and prosecutions. Objectively, it would seem that greater priority is given to high-profile targets that

[17] Final Report at page 136

[18] AICD submission to the Senate inquiry on the performance of the Australian Securities and Investments Commission dated 18 October 2013

have received significant exposure. Our recommendation is for ASIC to apply a more risk-based enforcement strategy to maximise the efficiency and effectiveness of its enforcement efforts.[19] Where resources are insufficient to enable ASIC to monitor and enforce all breaches, priority for enforcement action should be given to those breaches that present the highest risks, not on those that are being given the most attention in the media. This would enable greater enforcement action to be taken against targets that are perhaps smaller but that carry a greater risk of harm; and

- Greater consideration being given to how ASIC undertakes its investigations and enforcement actions and how this can be done in a way that reduces the time and money spent both by ASIC and the other parties involved. For example, the use of unnecessarily broad requests for documents and information, that go beyond what ASIC would reasonably require, places significant financial and time burdens on both the person receiving the request and also for ASIC once the information has been delivered up. Again, this is something that could be addressed by an increase in funding so that ASIC has the time and resources to appropriately scope such requests. Similarly, it would be hoped that a more expeditious approach to enforcement actions, particularly in the discovery stages of litigation, would result from an increase in funding to more effectively and efficiently run litigation.

The above points would also, for the most part, be equally applicable to APRA.

By ensuring that ASIC and APRA have sufficient and stable funding, as well as addressing the issues set out above, the regulators will be better placed to deliver their mandates as well as going some way to reducing the regulatory burden that is placed on those entities that they regulated.

We note that Recommendation 29 has proposed that such funding be provided through the introduction of an industry funding model. This is a point that is worthy of further consideration by the Government and in consultation with all relevant stakeholders.

Strengthening ASIC's powers

While we agree that ASIC requires increased and more stable funding, we do not believe that there is a general need for ASIC be provided with additional or increased powers. As argued in our submission to the Senate inquiry on ASIC's performance[20], it is important that, in response to any real or perceived deficiencies in ASIC's effectiveness and/or performance, the Government does not introduce further regulation (including by increasing ASIC's existing powers) without proper consideration of and consultation on whether existing regulation is sufficient.

Over-regulation impacts negatively not only on organisations but also on the regulators. The introduction of any new regulation requires the regulator to familiarise itself with and gain a firm understanding of the operation of the new regulation. They must also put in place new processes or adapt existing processes to monitor and enforce the new regulation, and also increase its resources or further burden its existing resources to meet the additional workload created by the new regulation. As such, the introduction of any new regulation (even if it is to provide ASIC with additional powers) may impede ASIC's performance, at least initially.

[19] For more information on the application of risk-based enforcement strategies, refer to Part H.3 of the Productivity Commission's report, *Identifying and Evaluating Regulation Reforms* released on 15 December 2011 (http://www.pc.gov.au/__data/assets/pdf_file/0018/114165/regulation-reforms.pdf)

[20] AICD submission to the Senate inquiry on the performance of the Australian Securities and Investments Commission dated 18 October 2013

In our view, it is unlikely that ASIC requires additional powers. ASIC already has broad investigation and enforcement powers in place. For example, there are laws in place that already provide ASIC with extensive powers to investigate suspected breaches of the law (including requiring people to produce books or answer questions at an examination), issue infringement notices in relation to alleged breaches of law, ban people from engaging in credit activities or providing financial services, seek civil penalties from the courts and commence prosecutions. There is therefore unlikely to be a pressing need for additional regulation to be introduced to address any issues that may be identified regarding ASIC's performance. Given, as noted above, that the introduction of new regulation inevitably causes an increase in volume of work for, and resources required by, the regulator, consideration should instead be given to how ASIC can better utilise its existing powers before additional powers are called for or given.

As noted above, any deficiencies in ASIC's performance and effectiveness are, in our view, more likely to be caused by a lack of adequate funding and resources to allow ASIC to fulfil its role as a corporate regulator.

Introduction of product intervention power

Recommendation 22 recommends that ASIC be provided with an additional, proactive product intervention power. While the Final Report notes that the proposed power is expected to be used "infrequently and as a last resort or pre-emptive measure" and is not intended to be used for pre-approval of products, we are of the view that there is a real risk that consumers would nonetheless see the mere fact that ASIC has not exercised this pre-emptive power in relation to a product as an indication that the product has been approved by ASIC and is therefore low-risk. Product reviews will therefore need to be carefully considered by ASIC.

Before introducing a product intervention power in Australia, its effectiveness needs to be extensively researched, explored and tested. This should include looking at how successful similar laws have been in other jurisdictions, for example in the UK and in Europe. We would caution against the introduction of similar powers here unless the experiences in these other jurisdictions provide positive evidence that suggests the power could be effectively administered by a body similar to ASIC, both in terms of its resources and expertise.

The effectiveness of the power in Australia is also likely to be impacted by the fact that ASIC does not have the power to make final, binding orders against the product issuer – such orders would need to be made by the courts. Rather than providing ASIC with additional powers that are designed to avoid the court system, a better approach may be to instead look at ways to improve the overall efficiencies of our current court system, particularly in dealing with corporate issues. This could potentially address a multitude of issues with the current regulatory system without imposing further powers, accountability and administrative burden on ASIC.

Recommendation 31 – Compliance costs and policy processes

In our initial submission to the Inquiry, we called for a reduction of the current compliance burden being faced by boards of companies in the financial sector. It was noted that APRA's requirements in particular, including those relating to governance, are considered to be the most demanding on the boards' time in this sector. We put the case that APRA appears to believe that boards are more involved in the day-to-day operation of a business than actually occurs and that this expectation should be addressed by the inquiry. This creates a significant compliance burden on boards and puts Australia at a competitive disadvantage internationally.

It is our view that the current regulatory burden facing companies, particularly those in the financial system, makes boards overly focused on compliance and does not reflect

the expectations of good corporate governance for the separation of the board and management. This encourages conservative behavior at the board level resulting in a lack of "animal spirits" amongst Australian businesses, as identified by the Governor of the Reserve Bank of Australia in his recent speech.[21]

More generally, in our paper, *Towards Better Regulation*[22], we note that deregulation – both stemming the growth in new regulation and cutting back existing red tape – is a crucial part of the Government's economic policy challenge. The plan of action that was put forward in that paper, which involved three pillars of reform covering the reviewing and cleaning up of existing regulation, getting new regulation right and regulator reform, should be applied to the financial sector.

We also noted in our previous submission to the Financial System Inquiry that it is important that the regulation of governance arrangements for financial institutions is not unnecessarily duplicative and that it is considered in the context of existing regulation, such as the provisions of the Corporations Act which are administered by the ASIC, and the ASX Corporate Governance Council's Principles and Recommendations. As stated above, we recommended that there be a greater alignment between APRA's governance regulation and the Principles and Recommendations, including the "if not, why not" approach taken under those Principles. Standards of corporate governance should not be mandated, as is currently the case under APRA's prudential standards relating to corporate governance and it should be left to the companies and their boards to determine (and disclose) what governance arrangements are most appropriate for their particular circumstances.

Where additional governance regulation is considered for financial institutions, it should only be introduced after a full Regulatory Impact Assessment (RIA) has been undertaken, including engaging with business and undertaking adequate consultation and, as identified in the Final Report, assessing the costs and benefits of the proposed regulation on the community as a whole, and assessing the impacts and compliance costs for business. The importance of the RIA process in the development of efficient and effective regulation is outlined further in the *Towards Better Regulation* paper.

Once regulation is in place, its effectiveness should be subject to an ex post review. The appropriate timing for the review will depend on the significance of the regulation and the circumstances of its formulation, but should typically be within three to five years of the regulation being introduced.[3] It should follow a similar process to the RIA process, proportionate to the nature and significance of the regulation and broad enough to assess the performance of the regulation.

The way that regulation of the financial sector is then carried out by regulators can also add significantly to the regulatory burden. The Productivity Commission has previously noted that, even where new or reformed regulation is appropriate and well designed, poor enforcement practices can risk making the regulation ineffective, or unduly burdensome, or both. Just as there is an imperative for cultural change within financial institutions, cultural change is also needed within the regulators to promote a more balanced approach, and improve the way regulators interact and consult with business in relation to the regulations that they administer.

Recommendation 36 – Corporate administration and bankruptcy

The question of whether a company is solvent under the Corporations Act is extremely complex and time-dependent.

[21] Glen Stevens, Governor of the Reserve Bank of Australia, *Opening Statement to the House of Representatives Standing Committee on Economics*, 20 August 2014

[22] A copy of this paper can be located on our website (http://www.companydirectors.com.au/~/media/Resources/Media/Media%20Releases%20and%20Speeches/2013/Towards%20better%20regulation%20July%202013.ashx)

The AICD is of the view that the primary objective of Australia's insolvency regime should be corporate recovery. The insolvency regime should encourage entrepreneurialism and operate to save businesses that can be saved. In turn, the regime would encourage innovation, economic growth and the preservation of employment.

Australia's insolvency regime must also protect relevant corporate stakeholders including employees, suppliers, customers, creditors and shareholders. Unfortunately we are concerned that aspects of the current regime sometimes prevent the best stakeholder outcomes from being achieved.

It is the view of the AICD that the current insolvency regime in Australia, which is arguably one of the strictest in the world:

- not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;
- discourages directors from taking sensible risks when considering other kinds of informal corporate reconstructions or "work-outs" to deal with a company's financial problems;
- provides an incentive for creditors, especially secured creditors, to act in their own self-interest and arrange for the disposal of key assets and the termination of continuing contractual arrangements as soon as possible;
- can lead to financially viable companies suffering the consequences of external administration, including ceasing to be a "going concern", suffering the loss of value and goodwill and incurring the expense of engaging administrators or receivers when it may have been possible under a less prescriptive legislative regime for the company to restructure itself and secure its financial standing; and
- can lead to losses by shareholders, creditors, employees and, in many cases, may have downstream impacts on the broader community through the loss of the value of their investments, retirement savings and jobs.[23]

Irrespective of any further insolvency reform approaches that may have merit, we consider that a critical element to addressing the problems created by the insolvent trading regime is for directors to have access to a broad-based defence that extends to the insolvent trading provisions under the Corporations Act. The defence proposed in our paper, *The Honest and Reasonable Director Defence: A Proposal for Reform*[24], is intended to create an environment that is conducive to strong yet responsible corporate decision making and performance by supporting directors who act honestly. We see this as being a crucial step, in conjunction with other measures, to boosting Australia's productivity and competitiveness and will address many of the personal liability concerns facing Australia's directors, including with respect to insolvency. While this is relevant to all sectors, this is of particular importance to the Australian financial system.

[23] AICD paper *The Honest and Reasonable Director Defence: A Proposal for Reform* (2014) at page 11. This paper can also be located on our website (http://www.companydirectors.com.au/~/media/Resources/Director%20Resource%20Centre/Policy%20on%20director%20issues/2014/The%20Honest%20%20Reasonable%20Director%20Defence%20A%20Proposal%20for%20Reform_August%202014_F.ashx

[24] Note 25.

We also refer you to our recent submission to the Productivity Commission in response to its discussion paper *Business Set-Up, Transfer and Closure*[25] in which we provided further comments specifically relating to aspects of Australia's insolvency regime.

We hope that our comments will be of assistance to the Inquiry. AICD would be happy to provide assistance and commentary on the further development of any of the initiatives discussed in this submission. Please do not hesitate to contact Senior Policy Advisor, Gemma Morgan on (02) 8248 2724 if you would like to discuss.

Yours sincerely

JOHN BROGDEN
Managing Director & Chief Executive Officer

[25] AICD submission to the Productivity Commission dated 17 February 2015