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SUPERANNUATION FUND GOVERNANCE POST-HAYNE: PART TWO

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Legal Briefings

CONDUCT AND CULTURE

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was charged with inquiring into, and reporting on, 'whether any conduct of financial services entities might have amounted to misconduct and whether any conduct, practices, behaviour or business activities by those entities fell below community standards and expectations.'

Not surprisingly therefore, its Final Report contains considerable discussion on the contribution of the 'governance' of the entities under investigation towards the misconduct identified. It also contains a number of recommendations designed to render such misconduct less likely in the future.

This short article is the second of three in a series that considers the Commissioner's recommendations with respect to the governance of trustee companies in the superannuation context. Specifically, it evaluates what the Final Report had to say, and the recommendations made, concerning standards of conduct. Part One considered the topic of Institutional Structure and Part Three considers Community Expectations and the Sole Purpose of Superannuation (Part Three).

A CULTURE OF GREED?

Thirty two years ago, in the film Wall Street, the fictional villain Gordon Gecko addressed the Annual General Meeting of Teldar Paper in the following provocative terms:

> ‘The point is, ladies and gentleman, that greed -- for lack of a better word -- is good. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms -- greed for life, for money, for love, knowledge -- has marked the upward surge of mankind.’

Oliver Stone’s purpose in crafting this address for his anti-hero was at once satiric and shocking. It was also profoundly unsettling. Economists for centuries (but not Adam Smith, despite the claims of some) had extolled the role of self-interest (‘aka greed’). Self-interest, they argued, provides the motive force that drives markets towards greater productivity and greater efficiency. Some, such as Nobel Laureate Milton Friedman have even rehearsed the ‘greed is good’ mantra publicly and on the record. Others, however, such as George Akerlof (also a Noble Laureate and best known for his work entitled “The Market for Lemons”) showed analytically that markets impelled by selfishness can generate socially sub-optimal outcomes.

Mr Hayne is most decidedly of the latter bent. In his Interim Report he noted (at page xix) in response to the question ‘Why did it [the alleged misconduct] happen?’:

> ‘Too often, the answer seems to be greed – the pursuit of short term profit at the expense of basic standards of honesty.’

And later, in respect specifically of financial advice (at pages 73-74):

> ‘Two themes recurred: dishonesty and greed. …No matter whether the motive is called ‘greed’, ‘avarice’ or ‘pursuit of profit’, the conduct ignores basic standards of honesty.’

Greed it seems, is not good, contra Mr Gecko. Journalists lapped it up, thankful that the arcane complexities investigated by the Royal Commission could be distilled to such a compelling summary.

In the Final Report this rhetoric was dialed down somewhat. In place of the more colourful language, the Commissioner reported that:

> ‘[I]n almost every case, the conduct in issue was driven not only by the relevant entity’s pursuit of profit but also by individuals’ pursuit of gain, whether in the form of remuneration for the individual or profit for the individual’s business.’

That de-escalation in the rhetoric is welcome. The vehemence of the language in the Interim Report obscured the nuanced and often subtle issues at play. There is no doubt that some of the conduct investigated by the Royal Commission was reprehensible and deserving of disapproval. Equally, however, there are extensive processes of remediation already being rolled out across multiple client groups across the industry. In that light it is to the Commissioner’s credit that he did not emulate the approach taken by Professor John Kay in the United Kingdom in calling for all relationships in respect of financial services and products to be deemed ‘fiduciary’. That capitulation to populist pressure would require all participants within the production chain to owe a duty to act in the interests of the other. Such a system would be unworkable. The regulatory regime exists to determine in what circumstances, and to what extent, the consumers of different types of financial services and products can expect to transfer the financial impact of their losses to the provider of that service or product. In some cases, as the Commissioner found, customers cannot and ought not be able to have the provider bear the customer's losses. In other cases, losses ought to be shared or borne by the provider.

Beneath the rhetoric however lies an important assumption. The Commissioner concluded that the volume and spread of misconduct he identified could not be not purely the result of a few bad apples. Rather, he concluded. the pattern of misconduct was the product of a set of attitudes, pervasive across the industry, that the Commissioner found to be inconsistent with community expectations.

In their place, the Commissioner sought to re-instate the following six norms of conduct:

1. obey the law;
2. do not mislead or deceive;
3. act fairly;
4. provide services that are fit for purpose;
5. deliver services with reasonable care and skill; and
6. when acting for another, act in the best interests of that other

The banality of these norms is striking. The fact that the Commissioner felt it necessary to articulate them even more so. On its face, they show little respect for the complexity of the structures and processes in which the relevant human actors are embedded, nor the challenges of ascertaining the ‘bigger picture’ in real time and in the face of incomplete information. That may however have been the Commissioner’s point: that simple norms that most people would regard as unexceptionable can get lost in the ‘heat’ of the moment and amidst the complexity of the environment.

THE IMPORTANCE OF ACCOUNTABILITY

The key to correcting the industry's attitudes, according to the Commissioner, is to increase individual and firm accountability across the industry. This clearly underpins the Commissioner's recommendation to extend the Banking Executive Accountability Regime to the superannuation and insurance sectors (Recommendation 6.8), to make industry Codes of Conduct enforceable (Recommendations 1.15 and 1.16) and to make breach of the covenants set out in sections 52 and 52A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**) or the obligations set out in sections 29VN and 29VO of the SIS Act enforceable by action for civil penalty (Recommendation 3.7). (Notably this latter recommendation has already been legislated, notwithstanding uneasiness in some quarters about its relationship to adjacent criminal provisions.)

The focus on individual accountability also underpins the recommendation that APRA build a supervisory program focused on building culture that will mitigate the risk of misconduct, use a risk-based approach to its reviews, assess the cultural drivers of misconduct in entities and encourage entities to give proper attention to sound management of conduct risk and improving entity governance (Recommendation 5.7).

The Commissioner's recommendations, then, span a range of modes, from prophylactic to remedial and from personal to institutional. It is worth recalling however that organisational culture is not something you can simply legislate into existence. As Professor Edgar Schein of MIT's Sloan School of Management in "The Corporate Survival Guide" noted:

> "… you begin to realize that culture is so stable and difficult to change because it represents the accumulated learning of a group – the ways of thinking, feeling and perceiving the world that have made the group successful. For another thing you realize that the important parts of culture are essentially invisible. Culture at this deeper level can be thought of as the shared mental models that the members of the an organisation hold and take for granted, They cannot readily tell you what their culture is, any more than fish, if they could talk, could tell you what water is."

Considering the difficulty in identifying, understanding and changing corporate culture, it is an open question whether these new rules will be enforced with any greater success than those whose lack of enforcement the Commissioner bemoaned in his Interim Report.

There is also a question of whether it is even sensible to conceive of corporate culture in an organisation as diverse as a bank, for instance, as monolithic. It is far more plausible that there are variations in culture between functional groups (risk management vs salesforces vs trading desks for instance), levels (senior management vs line staff) and geography, at the very least. For such an organisation to take a credible approach to culture it will have to recognise that possibility, and possibly to accommodate it to some extent. One would not, for instance, want traders on the trading desk to have the risk aversion of a senior compliance officer, or vice versa. The challenge for organisations will be to identify how to articulate context-relevant strategies in relation to such cultural variegation in ways that are not tokenistic and/or cynical.

THE INFLUENCE OF REMUNERATION AND OTHER 'BENEFITS'

If greed was the root cause of the misconduct identified by the Commissioner, it should be no surprise that remuneration practices would come under his intense focus. (The term remuneration appears no less than 469 times in Volume 1 of the Final Report alone). As was noted in the first article in this series, the Commissioner noted (at 335) that:

> 'remuneration and incentives tell staff what the entity values'

Although this finding has a commonsense ring to it, it ignores evidence presented to the Commission by one of its advisers (Professor Sheedy) that formal remuneration structures have much less impact on whether individuals comply with rules than is commonly believed and that the introduction of 'balanced' scorecards achieves little in this regard. Indeed Professor Schein's "shared mental models that the members of the organisation hold and take for granted", reminds us that money isn't everything. Other factors, such as the organisation's heritage and branding will influence those shared mental models. And individual motivation will vary within organisations. Factors such as the behaviours likely to result in a person's promotion at different levels in the organisation and over a career, as well as the personal interest a person has in being able to provide corporate hospitality to clients and the satisfaction a person may derive from undertaking interesting or prestigious work are all powerful motivators. The idea that a government agency, however well-intentioned, can effectively regulate something as elusive and intangible as corporate culture is not self-evident.

CONCLUSION

Mapping in any rigorous way the way that individual incentives and attitudes relate to corporate conduct (or even misconduct) is fraught with difficulty. However compelling they may be from a rhetorical perspective, the Commissioner's six norms of the conduct are arguably the weakest part of his Report. They over-simplify issues at the heart of financial services regulation. Modern corporations are complex organisms. It is entirely possible that individuals operating ethically and lawfully within their narrow frame of reference could, in combination and at some higher level of organisation, behave collectively in ways that don't meet community expectations. Systems theory tells us that much. Moreover, market capitalism relies for efficiency and innovation on the extraction of economic rent by risk-takers. There will be winners and losers.

That, however, is not to say that the financial services market ought to operate on a dog-eat-dog caveat emptor basis. The regulatory regime exists specifically to temper that extremity. It intervenes to re-distribute financial accountability not on a whim but according to deep principles, including vulnerability and fairness. Exhorting people to 'obey the law' will achieve little – few of the parties whose conduct the Commissioner impugned knowingly broke the law (and those who did deserve to be prosecuted for their actions). Rather, good governance must impose accountability, but it must also recognise the complexity and nuances of an organisation's context, including its obligations to its customers (crucially), its employees and its other stakeholders. And it must do so in real time and in the presence of uncertainty and incomplete information. But most importantly, as author H Jackson Brown Jnr once said of character, 'its what you do when you think no one is looking.'

Click here to read Superannuation Fund Governance Post-Hayne: Part One

Click here to read Superannuation Fund Governance Post-Hayne: Part Three

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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