ASIC

Australian Securities & Investments Commission

Conduct in the spotlight: Views from ASIC

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CHECK AGAINST DELIVERY

Introduction

Thank you for having me at your conference.

Today I would like to talk to you about a number of focus areas for ASIC:

- I will discuss ASIC's Corporate Plan, and some of the key risks it discusses, including how culture and incentives can drive risks in the financial system.
- I will discuss some target areas of focus for ASIC, including remuneration structures, conflicts of interest, breach reporting, whistleblowing and cyber security.
- I will discuss in more detail ASIC's focus on culture, and the practical things that leaders can do to promote a healthier culture in their organisation.

ASIC's Corporate Plan

In August, we released our Corporate Plan for 2016–17, which outlines key challenges and risks ASIC has identified. In 2016–17, we are continuing to focus on the risks from poor gatekeeper culture driving poor conduct, particularly within the financial advice, credit, insurance, superannuation and managed funds sectors.

Gatekeepers play a crucial role in the overall health of the financial system. Their conduct influences the level of trust and confidence that investors and consumers can have in the financial system.

A key theme that underpins our view for each sector is the importance of organisational culture and collective industry norms and practices on behaviour and conduct, of both the firms we regulate and the individuals who work within those firms. A positive culture, driving good conduct, is central to investor and consumer trust and confidence, market integrity, and growth.

We continue to see poor culture and incentive structures driving misconduct, and resulting in poor investor and consumer outcomes. We see these issues across our regulated population.

What is ASIC doing to address these issues?

So, what is ASIC doing to address these issues?

We have said in our Corporate Plan that we will be focusing on a number of specific target areas in relation to gatekeeper culture driving poor conduct, and I will touch on five of these briefly now.

Remuneration structures

The first key target area is remuneration structures.

ASIC has been saying for some time that one of the issues driving poor conduct in the financial services sector is the incentive structures many firms currently use. We think incentives play a key role in driving conduct for two reasons:

- first, they affect an organisation’s culture because they impact on the priorities of staff
- second, they act as a motivator and reinforcer of conduct.

We are undertaking a number of projects of 2016–17 that will look at remuneration structures.

We are conducting an industry-wide review looking into mortgage broker remuneration. This review is being undertaken at the request of Minister Kelly O’Dwyer, as part of the Government’s response to the Financial System Inquiry. In particular, ASIC was requested to review the mortgage broking market to determine the effect of current remuneration structures on the quality of consumer outcomes. The Government has requested that the review be completed by the end of 2016, and that the results be made public

We are also looking at commission structures in the motor vehicle finance sector and, in particular, the role of flex commissions. We have been concerned about flex commissions because of the poor consumer outcomes created by this type of remuneration structure, and the disproportionate impact on vulnerable and less sophisticated consumers.

Importantly, flex commissions do not facilitate risk-based interest rate pricing. This is not about ASIC preventing lenders from charging higher interest rates to consumers who are riskier from a credit perspective. Instead, flex commissions enable car dealers to charge higher interest rates because they can, and to receive higher commissions for higher rates. We have seen examples of loan contracts with interest rates more than 800 basis points above the base rate.

Conflicts of interest

A second, and very much related, key target area for ASIC is conflicts of interest. ASIC has been concerned about conflicts of interest in the financial services sector for some time, because poor management of conflicts of interest – by corporates, market infrastructure providers, market intermediaries, accountants, auditors and insolvency practitioners – can threaten market integrity.

To address this we are undertaking a number of projects in 2016–17, including two which I will mention briefly.

First, in relation to markets, ASIC recently published Report 486 *Sell-side research and corporate advisory: Confidential information and conflicts* (REP 486). In doing the groundwork for this report we found a number of inconsistent practices in how conflicts are managed, including a lack of research independence and inadequate separation of research and corporate advisory activities.

An example of the type of poor practice we observed included client bids being scaled back in well-supported capital raising transactions to allow for staff participation.

Secondly, we are also looking closely at conflicts of interest in relation to financial advice. The financial advice industry still faces challenges in providing good quality financial advice. For example, the continued vertical integration between product designers and distributors has the potential to exacerbate conflicts of interest and deliver poor outcomes for consumers.

To address this, we are undertaking a project that will investigate conflicted advice at the big five financial advice firms. This project will review the impact of conflicts of interest on the quality of advice in large, vertically integrated businesses (such as banks).

Breach reporting to ASIC

A third key target area in 2016–17 is timeliness of breach reporting to ASIC.

ASIC has found that a licensee’s system for identifying, escalating, and reporting breaches to ASIC is an important indicator of their culture.

ASIC understands that breaches will occur in your business, and we have provided guidance to AFS licensees about how to comply with breach reporting obligations in our

Regulatory Guide 78 *Breach reporting by AFS licensees* (RG 78). AFS licensees must report significant breaches to ASIC as soon as practicable, and in any case within 10 business days after becoming aware of a breach.

Breach reports are an important source of intelligence information for ASIC to understand current conduct in the market. Given the importance of the breach reporting regime, ASIC is seeking to better understand how AFS licensees, and the big banks in particular, comply with their breach reporting obligations.

That is why we have announced in our 2016–17 Corporate Plan that ASIC is commencing a cross-team project to review how AFS licensees discharge their breach reporting obligations. It is likely that many of you will be asked to respond to our inquiries in this regard, and I take this opportunity to provide some further context to this project.

Inadequate or late reporting to ASIC will suggest to us that the licensee has broader compliance and cultural issues. We treat this as a red flag for closer scrutiny. For example, where the risk or audit team raises an issue with the board or senior management, how is the issue dealt with?

So, an example of what ASIC might look for during our surveillance work is how responsive senior management or the board are when a compliance team elevates an issue – is the issue taken seriously and dealt with, or is it ignored?

We think that licensees with internal systems allowing them to identify, address, and report breaches to ASIC quickly will very often also be licensees with a good compliance culture.

For this, ASIC appreciates the efforts of the Institute of Internal Auditors, and you as its members, in seeking to better understand and promote compliance with breach reporting obligations. As many of you may be aware, the Institute wrote to ASIC in 2014, seeking further guidance on the timeliness requirement in the breach reporting obligation and our views on compliance methods.

We responded to the particular questions, stressing the importance of internal systems and processes that allow the licensee to respond quickly to ASIC. Our response was shared with the Institute and is on our website, along with RG 78.

We are pleased to report that, from 2014, we can track an increase in the volume of breach reports we received from AFS licensees. We think this a really positive example of ASIC and industry working together to get better outcomes, and we commend the Institute and its members for their contribution to this outcome.

Whistleblower policies

Our fourth area of focus in relation to culture is whistleblower policies in our regulated population.

ASIC sees benefits to businesses where the business has a culture encouraging people to speak up when they see the wrong thing being done, whether that be the wrong strategy, the wrong approach or, more seriously, misconduct and breaches of the law. Businesses can work towards this culture by having strong and effective whistleblower policies and processes.

Companies and AFS licensees need their own people to come forward when their people observe or experience misconduct in the firm. Whistleblowing plays an important role in uncovering misconduct and alerting businesses to changes that are necessary to improve their performance. But, as we can all appreciate, all too often whistleblowers can find themselves risking their jobs or even their careers.

As you may be aware, there are a number of discussions happening at the moment about how the law can better encourage and protect whistleblowers, and how ASIC can better treat the whistleblowers that come to us. These are important debates, and ASIC is contributing to them.

To do this more effectively, ASIC has established an Office of the Whistleblower to be the central point within ASIC to ensure that we record and action the matters that whistleblowers bring to us.

We are grateful for the whistleblowers who have alerted us to misconduct occurring in the corporate and financial services sector. It should be no surprise that ASIC is pursuing a number of enforcement cases because a whistleblower came to us.

This is only part of the story. ASIC is also supporting work to help encourage the business sector as a whole to improve their own systems and processes to better encourage and protect whistleblowers. We appreciate that there are a number of methods to do this, including support, compensation, or rewards. Each will have its benefits and costs, and there will be strategies that better suit a particular business than others.

To further explore these options, ASIC has contributed funding to Griffith University academics to undertake whistleblower research. The project is jointly funded by 16 state, federal and New Zealand ombudsmen and anti-crime commission bodies.

The research seeks to review the experience of whistleblowers and management response to whistleblowing to date, to ascertain what worked well and can be used across organisations to inform future policy.

In 2015, ASIC wrote to 30,000 organisations about this project seeking information and assistance. The survey received many responses, and Griffith University research staff released preliminary analysis of the first phase of data earlier this month. Early indications are that a high number of organisations have formal whistleblower procedures and processes. So this shows that Australian business is taking this issue seriously.

We continue to support the research project as it is an important evidence base from which to consider possible reforms to the legal and practical approaches to supporting whistleblowers personally, and dealing with their information properly.

Cyber security and cyber resilience

Now I will move on to discuss another key issue for ASIC: cyber resilience.

As the digital footprint of companies, consumers and investors expands, it also increases their vulnerability to cyber threats. The total number of cyber security incidents detected in 2015 in Australia increased by 109% over the preceding year, a substantially faster rate than the global average.

We undertake surveillances that target areas posing the greatest risks to investors and consumers and the markets we regulate, including the cyber resilience of licensees that provide critical market services. On cyber resilience, some of the issues we will focus on over the next four years include:

- incorporating cyber threats in our real-time monitoring of Australia's financial markets
- incorporating cyber resilience into our surveillances of entities, particularly those that provide critical services within the Australian financial industry (e.g. market infrastructure providers)
- raising awareness of cyber attacks and the importance of cyber resilience among our regulated populations – for example, by discussing the issue at public forums like this conference.

Cyber threats are no longer an abstract notion, or just an IT issue. There has been significant growth in the number, sophistication and severity of global cyber attacks in the last few years. The impact from a cyber attack can be severe, and could undermine trust and confidence in the resilience of the financial system.

With the risk and sophistication of cyber attacks growing faster than traditional firewall and antivirus technology can keep up, financial services organisations need strategies to prevent, detect and respond to cyber risks.

Because we see cyber risk as a key threat to our strategic priorities, ASIC is seeking to assist our regulated population in their efforts to improve their cyber resilience. As part of this work, we have established a cyber task force to ensure that we take a coordinated approach to stakeholder engagement, education and regulatory action.

Last year, we published our cyber resilience health check report, to help our regulated population improve cyber resilience. In that report, we encourage organisations to use the NIST Framework – the US National Institute of Standards and Technology Framework for Improving Critical Infrastructure Cybersecurity.

We followed that up in March of this year with a report regarding the cyber resilience of the market operators ASX and Chi-X that commented more broadly on examples of emerging good practices in the cyber world. Most recently, with ASX we have written to companies in the ASX 100 index encouraging that they consider completing a voluntary cyber resilience survey.

We acknowledge that complete cyber security can never be achieved; however, a comprehensive and long-term commitment to cyber resilience is essential to retain investor and financial consumer trust and confidence.

Why is ASIC focusing on culture and conduct?

I want to finish by talking in a bit more detail about ASIC's focus on culture:

- First, why does culture matter?
- Second, what roles should the board and senior management play?

Why does culture matter?

So, why does culture matter?

Culture matters because it is a key driver of how people behave within their organisations. From a regulator's perspective, culture matters to ASIC because poor culture can be a driver of poor conduct, and we regulate conduct. We think that by focusing more on culture, we will be able to catch poor conduct earlier and be a more proactive regulator.

What is ASIC's approach to culture and conduct?

Now I'd like to quickly touch on ASIC's approach to culture and conduct.

But before I do that, I'd like to stress that ASIC is not trying to micro-manage the culture of firms or dictate how businesses should be run. As an organisation's culture represents the 'mindset of an organisation', it is ultimately an issue that organisations themselves must address. However, since ASIC is a conduct regulator, we do play an important monitoring role, particularly where poor culture has the capacity to undermine trust and confidence and market integrity.

So, what are we doing about culture?

First, as I discussed earlier in this presentation, we are focusing on culture by targeting areas such as incentives, conflicts, whistleblowing and timeliness of breach reporting to ASIC. Where we identify poor culture, we will make this clear to the firms in which we see it. We think it is important to share this information with directors, given their role in guiding and monitoring the management of their company.

Second, we are continuing to raise awareness about the importance of culture through discussions with our stakeholders, and delivering public messages, including through events like this one.

Last, but not least, we are focusing on promoting good governance practices, including highlighting the importance of internal audit to developing a healthy corporate culture. Strong governance is critical to underpinning many key areas, including an organisation's approach to managing conflicts, remuneration, whistleblowing and breach reporting.

An appropriate corporate governance framework, which includes a strong internal audit focus, is a key cornerstone to a firm culture that is conducive to good behaviour and conduct.

What are the practical things that senior management boards and directors can do to promote a more positive culture within an organisation?

Senior management and the board have different, but complementary roles, in relation to fostering a positive culture within their organisations.

Senior management

Day-to-day responsibility for embedding organisational culture lies with the senior management, particularly the chief executive officer (CEO). The senior management is responsible for creating a culture where everyone has ownership and responsibility for 'doing the right thing'. They should set the values and principles of a firm's culture and ensure these are reflected in the business's strategy, business model, risk appetite, and compliance and governance frameworks.

They also need to ensure the firm's values are incorporated into all of its business practices and are cascaded down and understood throughout the organisation. This is important because, quite often, the message gets lost in the white noise in the middle and is not heard by the frontline. It is important that middle and frontline managers model the firm's values, because this is how new and junior employees learn 'how things are done around here'.

Senior management also needs to consider putting in place mechanisms to help with measuring and monitoring a firm's culture, and I commend the work that the Institute of Internal Auditors is currently doing in relation to this.

Measurement is important because it can help ensure that there is no 'gap' between a firm's desired culture and the actual mindset of the organisation. Many firms are currently looking at creating culture dashboards to help with capturing data on key indicators gathered through employee feedback and surveys, customer complaints, and progress on employee training on culture issues. Internal and external audits can also help with the periodic monitoring of a firm's culture, since they generally touch many parts of the organisation and are exposed to a variety of cultural indicators.

Board

While the senior management drives cultural change within the organisation, the board plays an important role in influencing culture – including providing support to and oversight of senior management.

The UK Financial Reporting Council (FRC) has recently issued a report that provides some useful observations about corporate culture and the role of boards. They have observed that cultural change may take a long time, and boards can provide continuity.

Boards also find it easier to be objective, since they are not immersed in the day-to-day running of the business.

The FRC report also observed that boards should give careful thought to how culture is measured and reported on, and that the best way to assess culture may be different for different businesses, and the outcomes that they seek.

The board plays an important role in setting the ‘tone at the top’ by:

- appointing a CEO and management team that not only align with the desired culture, but more importantly will drive that culture throughout the organisation
- overseeing culture, including holding the CEO and management team to account where they see a misalignment.

Another important consideration is how a board can gain better insights into their company’s culture. For directors who are not involved in the daily operations of a company, overseeing culture can be challenging. But there are a number of levers available to help with this. For example, boards can:

- make culture a regular feature on the board and audit committee agenda. The FRC report I just referred to included analysis that showed many companies now have culture and conduct as a standing item on the agenda for board meetings
- gather insights about team-specific issues and sub-cultures by developing relationships with key employees (e.g. line managers)
- ensure they have a broad perspective of the various competing issues impacting their organisation by engaging periodically with various stakeholder groups.

Conclusion

I’d like to wrap up my presentation by urging you all to think about your organisation’s culture, and reflect on some of the changes you can make to foster a more positive culture towards ‘doing the right thing’, both within your firms and more broadly across the industries in which you work.