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GOVERNANCE IN THE AUSTRALIAN ASSET-MANAGEMENT INDUSTRY

SETTING THE STANDARD: FUND MANAGERS LIFT THEIR GAME

In July 2018, the Financial Services Council (FSC) will implement a new code, Principles of Internal Governance and Asset Stewardship, to help improve transparency and accountability among Australian fund managers.

The code—the first of its kind in Australia—is a significant initiative by the FSC and its investment-industry members to maintain world-class governance and, in the post-financial-crisis environment, strengthen the foundations of public trust in the industry.

At the FSC Leaders Summit held shortly after the code was announced in July 2017, an industry panel discussed the background to the code, its design and objectives, and its likely impact on the industry. This article provides edited highlights of their discussion.

The panel consisted of David Dixon, Chief Investment Officer—Equities, Colonial First State Global Asset Management; Aisling Freiheit, Managing Director, Wellington Management; Jen Driscoll, Chief Executive Officer—Australia, AllianceBernstein (Chair); Kevin Lewis, Chief Compliance Officer, ASX Compliance; and Josef Pilger, Global Pension and Retirement Leader, Ernst & Young.

Jen Driscoll: It's clear that there's an overwhelming view that our industry needs to evolve in terms of culture and governance, and respondents see plenty of scope for their own organisations to improve, too.

On that note, I'll start with you, David, as you were a contributor to the establishment of the code. Can you give us some insights into how the process began and evolved and the extent to which it was influenced by similar codes in other jurisdictions?



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The panel (left to right): David Dixon, Aisling Freiheit, Jen Driscoll, Kevin Lewis and Josef Pilger

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David Dixon: I think every one of the FSC's investment-industry members agreed we needed to come up with a standard, particularly given there were standards in other jurisdictions. The key driver of the code, as set out in the document itself, is to encourage high standards of governance and stewardship.

It's also intended to provide better transparency and information for stakeholders and clients and to raise the standing of Australia in financial services globally. We've talked a lot about trust and the loss of trust, particularly since the global financial crisis, and clearly there are challenges there.

The fact that the FSC code has been initiated by the members is a point of difference with some overseas codes which have been introduced by regulators, as in Europe and Japan, for example. During the process, we consulted with other interested parties such as the Australian Institute of Company Directors, asset owners, and the Australian Securities and Investments Commission.

Typically, the codes overseas focus on stewardship, whereas ours is also about internal governance. We see that as a positive. By internal governance, I mean explicitly calling out how asset managers manage their conflicts of interest, their remuneration and incentives structures, how they spend clients' money on brokerage and commissions, how they carry out execution, trade allocation, personal account trading. There's a whole raft of things that are explicitly called out, but they're not limited to what's in the code itself. They're really about principles for internal governance and asset stewardship.

Where our code resembles many others is that it doesn't take a prescriptive approach but is more principles-based. A tick-the-box approach often doesn't achieve the desired outcomes, while a principles-based approach offers members greater flexibility in accommodating their investment styles and approaches.

Jen Driscoll: Aisling, what do you think will be the greatest area of impact for the asset-management business? Will there be a lot for us to adapt to?

Aisling Freiheit: I think it's going to increase awareness of how different managers are meeting their responsibilities, and I think it will take the industry closer to governance best practice in the key areas mentioned by David. Some managers are going to be more comfortable with that than others.

In my role, I focus solely on the institutional side, where I believe Australia has a pretty mature and professional market. For this reason, I'm surprised that internal governance was such a high priority for FSC members, as I would think that's an area where, on the institutional side, we have quite good coverage.

I would have thought the area where we could have more impact is that of asset stewardship, but I do think that increasing transparency is a step in the right direction. Public trust is something our industry is clearly lacking these days and transparency helps counter that, in my view. Bank bashing is sport du jour, and fund managers, rightly or wrongly, get painted with the same brush. I think it's important to build trust in the system and this initiative helps to do that.

It's clear also that millennials are much, much more concerned about how fund managers are thinking about stewardship, their engagement with companies, and what it means for environmental, social and governance (ESG) issues. So, at the margin I'd say that some fund managers will have a harder time with transparency than others, but that we're in a pretty good position regarding internal governance.



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–AISLING FREIHEIT

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Jen Driscoll: Josef, could you share your views on some of the trends that you think are influencing our industry and our markets, both locally and abroad, and how that ties back to the importance of the new standard?

Josef Pilger: Firstly, I think that launching and implementing the code puts us back where we belong in terms of global best practice. We talk a lot about trust and confidence; what we don't talk about much is scrutiny. We've never been under the limelight to such an extent as we have since the financial crisis. Every stakeholder—whether it's retail, institutional or government—is looking closely at us.

And when you think about why we're in this position, it's essentially because of what we are selling, which is hope and trust. Some of us would say that they're all about investment outcomes, but those are just numbers on a spreadsheet or screen. Since the financial crisis, we've seen returns come down from double-digit levels that we all thought were the norm, and the effect has been to fundamentally upset expectations.

I don't think we've done a good job of communicating that it's very, very hard to create markets that go only up, and that markets will always come down at some point.

My second point concerns fees, and I can recommend the UK Financial Conduct Authority study on the asset market that came out in June. It notes, for example, on average, that actively and passively managed retail funds have not outperformed their own benchmarks after fees.¹ In situations where our product, our promise, has utterly not delivered, we still get paid.

I think that created an enormous amount of reflection as to whether our business model is adequate and whether we need to think about how we get paid and, more broadly, how we do our business.

My third point is that, around the world, we're seeing people having much more control over their lives through personal electronic devices, and when you see how millennials are doing this, I think the trend can only intensify. It means that we are shifting from a seller society, from a seller business, to a buyer's business. And in that sense, we're becoming much, much more truly customer-centric.

When I personally look at some of my clients around the world, there are many trillions of dollars that they are going to think about insourcing, to have more control. And that, to me, is just the peak of the iceberg of customer centricity.

One final point: I'm personally glad that the code hasn't come from the regulators and that the industry took the initiative because, at some point, pressure for the code would have come from the customers, retail or institutional. Providing we stay ahead of such expectations, I think we will be able to retain our position.

Jen Driscoll: Kevin, could you share your thoughts on what you think the regulators mean when they refer to culture? Can we truly measure it and the extent to which it's aligned with client outcomes?

Kevin Lewis: I'd start off by noting that, while governance and culture are linked, one doesn't inexorably lead to the other. It's hard, I think, to have good culture without good governance, but you can have good governance and still have poor culture.

If we look at our major banks, for example, they all adopt and follow all the ASX Corporate Governance Council's principles and recommendations. From a standpoint of the regulator



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—KEVIN LEWIS

¹ Asset Management Market Study, Financial Conduct Authority (UK), *Asset Management Market Study: Final Report* (June 2017); page 4, paragraph 1.11

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of the market, we'd say they have a good corporate governance process in place, but clearly they've had some cultural issues in parts of their business.

I have to say I tend to squirm a little bit when I hear suggestions that we should be legislating for culture and making directors personally responsible for culture.

Culture can be many things. It can describe many attributes of an organisation. Is your organisation hierarchical or open? Is it siloed or collaborative? Do you embrace diversity or do you value commonality or uniformity? These are all aspects of culture.

I think that when regulators talk about culture, they're talking about one very narrow aspect of it. They're talking about a culture of compliance and responsible risk-taking. When you define culture in those terms, from my perspective, I think there are probably four key drivers to good culture.

The first one inevitably is tone from the top. The second one is remuneration practices, noting that, if you reward people for the amount of products they sell, it probably shouldn't surprise you that they will perhaps engage in questionable selling practices to earn more remuneration.

The third factor is management oversight and accountability, which are often overlooked. If you're managing a financial planning team and one of them is knocking the lights out and writing five times as much business as the next best person, as a manager you need to ask yourself why. Are they really that good, or are they doing something they shouldn't be doing?

Finally, and this is important: transparent and proportionate disciplinary action for poor behaviour. We've seen many scandals which have given rise to issues of trust where senior managers' heads have not been among those put on stakes. The people down at the bottom may have been sacked for misbehaviour, but the people who managed and supervised them, have they been?

I personally think that more needs to be done in those areas but that it needs to be industry-led.

Jen Driscoll: We're seeing an increasingly complementary focus on not just the financial aspects of governance but the nonfinancial aspects, too—such as engaging with company management, the conduct of boards, ESG and so on. How important are these nonfinancial aspects, and have they evolved simply in response to the financial crisis or have they always been embedded in the way we assess companies?

David Dixon: I think there's no doubt that the importance of these elements has lifted dramatically, and rightly so. Perhaps this has happened partly in response to the financial crisis, but don't forget that the question of ESG was progressed through the United Nations' Principles for Responsible Investment (UN PRI) before the crisis happened. Many organisations in Australia signed up to UN PRI well before the crisis, so they had been applying both financial and nonfinancial factors to governance for quite some time.

Aisling Freiheit: I'm just going to add that we regard engagement with company management as part of our fiduciary responsibility. ESG issues are strategic issues that have a long-term impact on financial performance and, like any other fund manager, we invest a lot of time in understanding them and how companies think about them. It's part of being an informed and active manager and part of our investment process.



“ASSET MANAGERS HAVE A CLEAR RESPONSIBILITY TO INFORM AND...SUCH AN OBLIGATION SHOULD BE EMBEDDED IN MANDATES.”

—DAVID DIXON

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The short-term link between these issues and the financial impact is not obvious, but I think the long-term link is becoming more evident. There's a bit of a conundrum here with asset owners, however. Trustees in Australia have a sole purpose test, and that should make them think long term, but sometimes they don't.

David Dixon: Asset owners who are members of the FSC and insource and manage are required to comply with the code, but those who outsource all their functions are only encouraged to comply. As part of the voluntary process, trustees need to explain to their members what's going on. Asset managers also have a clear responsibility to inform, and I think, from an asset owner's point of view, that such an obligation should be embedded in mandates and that fund managers should be put on notice that it's critical.

Jen Driscoll: Yes, and I think it's great that non-FSC members are being encouraged to sign up to the code, as it's incumbent on the whole industry to employ it in a way that creates a stronger sense of transparency and trust across the industry.

Kevin, the stewardship code adopts the ASX 'If not, why not?' approach to disclosure and I'm just curious about why the ASX adopted that model. What are the advantages or disadvantages of the approach, and how well do you think that will translate into the funds-management industry?

Kevin Lewis: If you look at all the ASX-listed companies, they range from some of the biggest miners and financial-services organisations in the world, with market caps in the many tens of billions of dollars, all the way down to some pretty small junior explorers based in Western Australia. To impose an inflexible 'one-size-fits-all' model on them wouldn't have been appropriate, so that's why we started from the premise of 'If not, why not?'

The ASX approach is based on the UK Corporate Governance Code, which describes certain practices, gives organisations the opportunity to say whether they adopt those practices and, if they don't, requires them to explain why they don't. It's designed to ensure that companies disclose meaningful information about their governance practices so that investors and others can have an effective dialogue with the board and management about their governance practices.

I think the 'If not, why not?' framework has served the ASX very well, and I hope that, as part of the stewardship code, it serves the financial-services industry just as well, by getting the relevant information out into the public domain so that your customers can have a meaningful dialogue with you about your internal governance processes.

Josef Pilger: Just one final point. To me, the code is a great starting point, an aspiration. In itself it will do nothing. Its success will depend on its implementation and on people doing the right thing. If I look at other markets, it has taken the UK probably 10 years, give or take, to drive real fundamental change. We shouldn't expect the world to shift overnight; it will take some time.



**“THE CODE’S SUCCESS
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–JOSEF PILGER



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