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COMMENTARY

The Changing Role of Australian Boards in Oversight of Corporate Culture

The Australian Securities and Investments Commission's ("ASIC") recent crackdown on corporate culture, particularly focused on banks, has been fuelling much debate about the role of boards in the oversight of culture within an organisation. Some have accused ASIC of attempting to be the "culture police" and expecting directors to step into the shoes of management. Others, including ASIC, insist that this is not the case at all.

In our view, at the core of this debate is a need to clarify the role of Australian boards in overseeing and monitoring the culture of an organisation because a poor culture can significantly increase the risk of poor conduct and ultimately lead to the destruction of shareholder value, and adversely affect employees, customers and suppliers.

ASIC Chairman Greg Medcraft has made clear that ASIC will now incorporate culture into its risk-based surveillance reviews. Simply put, culture is the values, incentives, policies and practices that a company adopts.

Why is ASIC so focused on culture? In Mr Medcraft's words: "Culture matters to ASIC because it is a key driver of conduct".

"Time and time again, we have seen firms blaming it on a few bad apples … rather than taking responsibility by looking more closely at their organisation and implementing the necessary changes to address the root cause of the problem".

In light of ASIC's declared crackdown on corporate culture, Australian boards (particularly those in the financial services sector) need to ensure their governance systems are effective to withstand both regulator and potential judicial scrutiny.

This raises the question: To what standard will a court and/or ASIC hold directors to account when it comes to breaches of law that it believes flow from a board's failure to engage in proper oversight of corporate culture? And, what steps can boards take to mitigate this cultural risk?

Directors of Australian companies are legally exposed in a personal capacity because they owe a duty of care and diligence, under both general law and the Corporations Act. This duty requires that directors take all reasonable steps to place themselves in a position to guide and monitor the management of the company.

In the 2011 Federal Court judgment arising out ASIC's action against the directors of Centro property group, the court provided some guidance on the meaning of "all reasonable steps" in the context of the duty of care and diligence.

"The standard of 'all reasonable steps' is determined objectively by reference to the particular circumstances of the case. It requires, at a minimum, that directors take a diligent and intelligent interest in the information either available to them or which they might appropriately demand from the executives or other employees and agents of the company", Justice Middleton said.

"A director must become familiar with the fundamentals of the business in which the corporation in engaged. A director is under a continuing obligation to keep informed about the activities of the corporation. Directorial management requires a general monitoring of corporate affairs and policies".

While the Centro case was largely concerned with the duties of directors in reviewing and approving the company's financial reports, Australian courts and regulators are likely to apply the same principles with respect to the duties of directors to oversee company culture and conduct more generally.

As a starting point, Australian boards need to identify their key governance and business principles and effectively communicate these principles to stakeholders. These are the values that will set the tone for and underpin the company's culture, and which will be reflected in its strategy, business model, policies, incentive structures and risk appetite. Some of these principles will be specific to the type of business and industry involved. For example, for an airline or mining company, a specific guiding principle would be a commitment to physical safety. For a bank, it might be promoting investor trust and confidence and ensuring data privacy.

In terms of monitoring corporate culture, Australian boards need to have an effective, probative and independent system to receive timely and relevant information about the company's affairs in a systematic, rather than reactive, way.

As part of this process, directors are expected to have an inquiring mind and put processes in place to manage conflicts of interest that may arise. At times, this may require the board to engage external advisers to conduct an independent review.

In circumstances in which it is alleged that a company or one or more of its employees has engaged in unlawful conduct, courts and regulators are likely to look at whether the misconduct arises out of a systemic governance failure within the organisation. This can expose directors to a risk of being accused of breaching their directors' duties. In this regard, courts and regulators are likely to look critically at how boards have objectively tested the company's adherence to its own governance principles, policies and practices to deter the risk of that kind of misconduct occurring in the first place. In particular, ASIC has indicated it will be looking to see if there is any disconnect between firm policy and how that policy is actually applied in real time, including at a board level.

Where the board was on notice of the misconduct, the courts and ASIC will want to ascertain that the board has taken genuine and reasonable steps to ensure that firm policy has been followed and that those responsible (whether directly or indirectly) have been held accountable for their actions. It is likely that particular attention will be paid to ensuring that incentive structures and consequence management policies are consistent with this end.

Going forward, it is likely that further lessons for Australian boards will emerge as ASIC's current enforcement activities are played out in courts and elsewhere. However, it is clear that ASIC is resolved to press on in its crackdown on corporate culture. In this environment, boards can no longer afford to be complacent about culture by, in the words of Mr Medcraft, blaming poor behaviour on "a few bad apples".

Lawyer Contacts

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