SUBMISSION TO THE TREASURY, *CONSULTATION PAPER: REVIEW OF NOT-FOR-PROFIT GOVERNANCE ARRANGEMENTS*

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INTRODUCTION

The University of Melbourne Law School's Not-for-Profit Project is a three-year research project funded by the Australian Research Council which began in 2010. This project will be the first comprehensive Australian analysis of the legal definition, taxation, and regulation of not-for-profit (NFP) organisations. Further information on the project and its members is attached to this submission as Appendix A.

We welcome this opportunity to contribute to the Treasury's work. We have previously contributed submissions on other aspects of the Treasury's agenda of NFP reform, which are available on our website http://tax.law.unimelb.edu.au/notforprofit.

We note at the outset that our Project has not focused on NFP governance, although the issue of governance is an important element of the regulatory framework. Our submission is limited, therefore, primarily to a consideration of the legal issues raised, the interaction with the regulatory framework, and our awareness of overseas legal regimes.

Although we acknowledge the crucial importance of NFP governance and have sympathy with the general thrust of the policy intent, this submission expresses deep reservations about the feasibility and desirability of the present proposals. In particular, we foresee considerable practical difficulties caused by the compressed timing of the proposals, the absence of a federal co-operative scheme of regulation, and the detail of the present proposals. We begin by outlining those concerns.

Further, we are not convinced that the ACNC Bill should include governance requirements, at least upon commencement, and question some of the underlying premises of this proposal. Third, we also consider that there are some conceptual issues with the understanding of governance in the Consultation Paper. Finally, we briefly comment on some of the questions in the Consultation Paper.

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RECOMMENDATIONS

While we therefore welcome a review of the governance of NFPs, we suggest that this is a 'second-stage' reform that should be developed through collaboration with the sector, after the ACNC has been established, and in consultation with the States and Territories. We note that there are legislative precedents for separating governance duties from legislation establishing a regulator.[1] Greater time will also enable proper consideration of the many innovations overseas that have recently occurred and the results of the pending reviews of fundraising legislation and companies limited by guarantee. It would also enable consideration of the types of governance requirements that are most appropriate to different types and sizes of NFP entities.

However, in recognition of Treasury's expressed policy intent, we have also considered other possible options. One obvious option would involve including the duties in the *Corporations Act 2001* (Cth) in the ACNC Bill, which in large part replicate existing fiduciary duties, as 'core' principles. However, as we discuss below, we foresee considerable difficulty with that approach.

Another option would be to merely refer to the existing fiduciary duties under general law and the existing duties under other relevant legislation. As with the first option, we consider there will be real difficulties (including constitutional difficulties) in empowering the ACNC to enforce such duties upon commencement, and prior to any arrangements being made with States and Territories. Under this option, the ACNC's enforcement powers could be 'switched on' at a later date in respect of classes of entities at a time when the ACNC is ready to enforce governance, and once it has gained full regulatory jurisdiction over those entities. This would allow for a 'staged' approach to enforcement and enable appropriate negotiations with existing regulators and the sector in general.

We note, however, that there may be limited utility in including in such a provision powers under State or Territory legislation, given that the inevitable complexity of any inter-governmental arrangements will need to be given effect in further legislative amendments. Such an approach, however, could be helpful in relation to (for example) the duties under existing Commonwealth legislation, including the *Corporations Act* and the *Corporations (Aboriginal and Torres Strait Islander) Act 2006* (Cth) (CATSI Act).

We have also seen (in draft form) a third option suggested by Alice Macdougall of Freehills, which suggests that instead of including duties there could be a statement of high-level

[1] For example, the Australian Securities and Investments Commission is established under the *Australian Securities and Investments Commission Act 2001* (Cth). However, the duties it enforces are under the *Corporations Act 2001* (Cth). Similarly, the Australian Prudential Regulation Authority is established under the *Australian Prudential Regulation Authority Act 1998* (Cth). However, it enforces duties under other legislation including the *Banking Act 1959* (Cth) and the *Insurance Act 1973* (Cth).

principles and a requirement to report on the same basis as the Australian Securities Exchange currently requires in relation to its governance principles, namely that the entity report compliance or explain why it does not comply. The matters that it must report on would be developed in consultation with the sector and be listed in Regulations. Such an option aligns more closely with the key reporting and disclosure function of the ACNC upon commencement and, provided the list was developed in consultation with the sector and was accompanied by suitable guidance such as model policies, may be of practical use in improving governance in the sector.

DIFFICULTIES WITH THE CURRENT PROPOSALS

Although there is merit in identifying core governance principles for NFPs, we consider that there are considerable difficulties with the present proposals because of three problems: timing, the absence of federal co-operation, and the detail of the present proposals.

TIMING

We appreciate that the sector has already made clear its concern about the length of the consultation period. Nevertheless, we emphasise that a consultation period of this length, given the scope of the Consultation Paper and the current diversity of legal regimes, is far too short. Further, such consultation precedes parallel reforms in fundraising and in relation to companies limited by guarantee, which will have direct impact upon this review. Finally, we note that if the intention is to develop principles specific to NFPs, a much longer consultation period is necessary. For example, we contrast the years of development of the Scottish Charitable Incorporated Organisation[2] (and the English version which has still not yet been implemented)[3] as well as the recent Canadian Not-for-Profit Corporations legislation.[4]

We understand it is desired to have the principles in place before the ACNC commences. Nevertheless, we do not see a real need for urgency. First, most of the 'core' principles already exist in law, albeit in different legal regimes. The principles are set out in mature legislative schemes with existing regulators. The real problem is under-enforcement, not the absence of law. This should be improved by the collection of information by the ACNC and its capacities to investigate the affairs of entities.

Second, there is no evidence of a governance crisis in NFPs that necessitates immediate action. Third, the establishment of the ACNC will provide a more appropriate forum for policy development in consultation with the sector concerning governance. Fourth, it seems

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[2] *Charities and Trustee Investment (Scotland) Act 2005* (Scotland) asp 10 Ch 7.

[3] See generally Charity Commission of England and Wales, *Charitable Incorporated Organisations* (April 2010) <http://www.charity-commission.gov.uk/Start_up_a_charity/Do_I_need_to_register/CIOs/default.aspx>. Model constitutions were released but regulations have not yet been introduced.

[4] *Canada Not-for-Profit Corporations Act 2009* (Canada).

appropriate for the ACNC to focus its early efforts on other regulatory priorities. The ACNC will have enough work to do without promising to enforce compliance with governance principles across all NFP entities—a promise that is bound to be misleading in the early years.

Finally, the confusion that will be engendered by changing governance requirements at the same time as establishing a new regulatory scheme will be, in our view, counterproductive.

FEDERAL CO-OPERATION

The Paper signally fails to address the question of how this proposed regime will co-exist with parallel existing legislation, with the exception of stating that the governance rules would be removed in relation to ASIC (see [43]). Indeed, we understand that there is still no settled position in relation to other federal regulators, such as the Office of the Registrar of Indigenous Corporations, and its relationship with the ACNC.

Presumably, at least at the outset, incorporated associations and other entities will be required to comply with requirements in two regimes, with different regulators. There is, of course, potential that these regimes may be in conflict, but even where they are in harmony there is a risk of conflicting guidance by regulators, being penalised twice for the same conduct, and at the very least, an increased regulatory burden as the result of a need to ensure compliance with both regimes.

We also see major legal and political problems in proceeding with this aspect of the reform prior to proper negotiations with the States or Territories. The legal issues include the constitutional question of how the regulator could enforce such duties in respect of State and Territory legislation, and in respect of entities over which it does not have constitutional jurisdiction. (The constitutional issues are addressed more fully in our submission on the ACNC Bill.) This is particularly so given the detail of some of the proposals, as discussed below. Further, there are legal issues concerning diverging requirements and the consequences of duplication.

The political problems include the difficulty of negotiating in good faith with State or Territory governments when, for most intents and purposes, the proposals in the Consultation Paper practically override existing State or Territory legislation and regulatory powers.

DETAIL AND SCOPE OF PROPOSALS

The Paper seems to indicate, at various points, that this duplication and increased burden is minimised by the intention to commit to 'high-level' principles only. Yet these statements are countered by the detail and scope of the proposals envisaged by the Paper, which appears to contemplate a fairly comprehensive governance regime including, for example, model rules, remuneration disclosure, and insurance requirements. The detail and scope

suggested in the Paper raises additional problems of complexity and duplication in a very limited time frame.

In light of these considerable difficulties, we consider that the detailed proposals in the Consultation Paper are not desirable or even feasible at this stage, and should not be included in the ACNC Bill.

THE NEED FOR GOVERNANCE REQUIREMENTS IN THE ACNC BILL

We also question some of the premises that apparently justify the inclusion of governance requirements in the ACNC Bill. At various points in the Paper, it appears to be implied that:

- Consistent governance principles should apply across all NFP entities ([36]);
- Such governance rules must be developed specifically for NFPs ([38]-[39]).
- A single regulatory scheme requires core governance rules (at [44]); and
- The ACNC is the appropriate regulator ([44]).

We question each of these propositions in turn.

CONSISTENCY

First, as a matter of principle, the diversity of NFPs may mean that a diversity of governance frameworks will be appropriate. For example, particular issues of governance may arise where: there are many individual members who primarily subscribe as a show of support but do not wish to take an active part; the organisation is service rather than member-oriented; or where the organisation may be dominated by a particular donor or by a small group of related persons. The not-for-profit mission is only one of the major factors to be considered in developing governance principles.

Second, the entity type will not necessarily be irrelevant to the governance considerations. For example, the relationship between trust and trustee is quite different from that envisaged in the incorporated associations model. There are a variety of duties on a trustee that do not apply in corporations or incorporated associations. The Aboriginal and Islander corporation is clearly designed to meet particular needs that were not met by the standard corporations model. NFPs that are established by statute may raise special considerations because of their relationship with government or churches.

In particular, we note that the incorporated associations legislation was expressly designed as a low-cost, simple alternative to that provided under the *Corporations Act*. The differences in these legal regimes, therefore, are intentional rather than inadvertent. In particular, as commentators have noted, the associations legislation maximises the "private

sovereignty" of such associations, namely their capacity to determine their own rules.[5] The associations model has been popular, in contrast with the limited attractiveness of the model of the company limited by guarantee. We are therefore concerned that the current proposals will have the effect of undermining the purpose of associations legislation, and will impose instead requirements that are developed with larger entities in mind.

Third, a key issue is the level of abstraction at which consistency is envisaged. While there may be a case for consistency at a high level of abstraction, this is not apparently what is envisaged by the Paper. Rather, it appears that the Paper contemplates what would effectively be a centralised replacement for existing mature legislative schemes.

Fourth, there is a question of constitutional principle, in the sense that the desire for (national) consistency must sit alongside a commitment to federalism. In a federal context, there ought to be some tolerance of diversity and respect for the States' legislative powers. This is particularly important in the NFP context, which is dominated by incorporated associations. For these associations, there is no real benefit in federal regulation, and there is benefit in a State-based regime that enables decision-making to be made at the level closest to the association. For those organisations for whom national consistency is important, the option of a company limited by guarantee exists. The question here is whether there is a genuine need for consistency in this context.

DEVELOPED SPECIFICALLY FOR NFPS

One of the criticisms of the existing legal framework is that the regulation is developed for companies rather than for NFPs. While we agree that this is a difficulty in respect of companies limited by guarantee, this proposal is both unlikely and unnecessary to resolve that difficulty.

First, the Government has already proposed a review of legislation in respect of companies limited by guarantee. Since this type of company structure is largely concerned with NFP entities, it appears that this review is the best place to develop principles specific to NFPs. In contrast, the incorporated associations structure is already designed specifically for NFP entities, as are statutes specific to particular corporations.

Second, there are a number of elements of the proposed governance principles that are not specific to NFPs generally. For example, as we discuss below, there is already significant commonality between legal entities in respect of the core duties. Indeed, if anything, it seems likely that the standards in the *Corporations Act* would probably be imposed in any set of governance principles, given that its general framework in relation to duties has

[5] Keith Fletcher, 'Developing Appropriate Organisational Structures for Non-profit Organisations' in Keith Fletcher, A S Sievers, and Myles McGregor-Lowndes (eds), *Legal Issues for Non-Profit Associations* (LBC Information Services, 1996) 1-21.

already been adopted in the CATSI Act and in the proposed amendments to the Victorian incorporated associations legislation.

Third, the timing and the tenor of the proposals do not suggest a genuinely collaborative partnership with the sector in identifying principles that are peculiarly appropriate to that sector. If anything, the proposals tend to suggest increasing the governance requirements above and beyond that in existing entity legislation, which is only likely to increase the regulatory burden, despite the contrary policy intent.

The need for core governance principles in a regulatory regime

We do not agree that such principles are inherently necessary parts of a regulatory regime. We point, for example, to the regulatory regimes of England and Wales, and Northern Ireland, which are founded rather on concepts of 'misconduct' or 'mismanagement'. They do not include most of the matters that are canvassed in the Consultation Paper. As already noted, other Commonwealth legislation establishes regulators and imposes duties in associated legislation.

We also note that most of these governance principles already exist in entity legislation such as the *Corporations Act* and the State incorporated associations legislation. This legislation is well-developed and mature, and there are existing regulators responsible for enforcement. Although ultimately it may be desirable to streamline this regulatory duplication, we consider that this need not be done immediately upon commencement. Indeed, as we discuss below, we foresee many practical difficulties in doing so.

The ACNC is the appropriate regulator

We are also not convinced that the ACNC is necessarily the appropriate regulator to enforce such duties, at least initially. At its inception, the ACNC will have significant work that will make investigating breaches of governance principles a fairly low priority. Further, the ACNC is initially unlikely to have significant enforcement capability or experience, in contrast to existing regulators.

As a practical matter, we consider that it may be more feasible, at least in the early stages, for the ACNC to have capacity to refer matters that arise under its powers to ASIC or other regulators for enforcement of governance principles under entity legislation.

We also note that there may be constitutional difficulties in the ACNC enforcing such governance principles in relation to entities outside its constitutional jurisdiction. These constitutional difficulties were discussed in our submission on the ACNC Bill. Given the current uncertainty surrounding the breadth of the corporations power, this could be a significant gap in its enforcement powers. In this respect, we also suggest it is more practical (as well as more consonant with the principles of federalism) for the ACNC to be empowered to request a State or Territory regulator to investigate where necessary any breaches of governance principles.

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GOVERNANCE

We also consider that there are several conceptual difficulties with the understanding of governance expressed in the Paper. The Paper implicitly adopts a traditional view of governance that fails to reflect contemporary understandings of governance in the NFP sector. The difficulties of this approach include: an over-emphasis on legal and compliance-based forms of governance; an implicit 'top-down' approach to governance; and a failure to clearly distinguish between the role of law in governance, and governance issues more broadly.

Much of current research on governance relies on the insight that legal requirements are only one aspect of governance, and that the focus should be on internalising good governance through practice and reflective learning. Organisations are therefore encouraged to reflect on their goals and stakeholders, to consider and discuss governance issues and develop appropriate policies, and to engage in peer review, accreditation and evaluation schemes as ways of improving governance.[6]

This move away from a legal or compliance-based view of governance recognises the following limitations of legal requirements: their focus on 'minimum' standards; their imposition by external authorities; their failure to reflect the diversity of contexts and stakeholder relationships in which NFPs are engaged; their failure to internalise governance as part of the culture of an organisation; the tendency to respond to such requirements as 'tick boxes' or as punishments; and their reliance on adequate enforcement.

Another difficulty with the Paper is that it fails to recognise that better governance can assist, but cannot ultimately guarantee, the effectiveness or efficiency of an organisation. This is true of both the NFP and the private sector. In the end, both sectors involve risk, and in some cases the risk-taking behaviour is one that ought to be encouraged—such as taking new approaches to social problems, promoting cutting-edge art, or undertaking activities that are not commercially profitable.

As we have noted, there is a flourishing field of research into governance of NFPs. Although this has not been a focus of our research, this research provides some useful insights into the differences between governance of NFPs and for-profit entities.

WHY ARE NFPS DIFFERENT?

It is critical, at the outset, to recognise what makes NFPs different in terms of governance. The most important difference is that the NFPs are mission-based, and as a result their loyalty is to the mission, rather than the interests of a particular constituency. In contrast,

[6] Alnoor Ebrahim, *The Many Faces of Nonprofit Accountability* (Working Knowledge Paper, Harvard Business School, 11 March 2010) <http://hbswk.hbs.edu/item/6387.html>.

despite increasing recognition of other stakeholders, for-profit corporations have a clearer task: that of preferring the interests of their shareholders.

The mission-based nature of the NFP has several implications for its governance. First, a mission is subject to contesting interpretations and is likely to need to adapt to changing times and circumstances. For example, a mission of assisting Indigenous people may well change in nature because of changing attitudes and beliefs about what is in the 'best interests' of Indigenous people.

The inherently elastic nature of a mission makes it difficult to prescribe adherence to a mission, because it requires adjudication between competing interpretations of that mission, and because it might endanger the flexibility and responsiveness of the entity.

Second—and here the research is especially abundant—the NFP is accountable to multiple stakeholders, whose priorities and interests may not align with the mission itself. These stakeholders include regulators; donors and funders; clients; volunteers; staff; collaborators; unions; citizens and community groups affected by the mission.[7] There are three 'dimensions' to these multiple accountability relationships: 'upwards' accountability to donors, foundations and governments, often focused on finances; 'downwards' accountability to clients; and 'horizontal' accountability to the mission itself and staff.[8] The structure of accountability relationships varies greatly between NFPs, including, characteristically, by type of organisation. For example, members can exercise control in member-oriented organisations to ensure that the organisation serves their needs, while service-oriented organisations focus heavily on upward accountability at the expense of 'downward' accountability where clients typically have little choice about the services.[9]

Third, the mission-based nature of the NFP complicates the process of accountability. There are four general categories of matters which NFPs are expected to be accountable for: finances, governance, performance, and mission.[10] In each of these spheres, the mission-based context creates difficulties. In relation to finances, there is no readily apparent comparison between profits and expenditure; rather, expenditure must be judged against performance (delivery of 'results') and progress towards achieving their mission. The NFP that spends less money is not necessarily the most successful one; a balance must be struck between preserving property and achieving the mission.

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[7] *Road to Accountability* Charity Central - Your Guide through Charity Law <http://www.charitycentral.ca/node/711>.

[8] Ebrahim, *The Many Faces of Nonprofit Accountability*, above n 6, 4.

[9] Ibid 5–6.

[10] Ibid 7.

In relation to governance (as noted above) the duties of acting in the organisation's interests and in furtherance of its mission is complicated by the elastic nature of the mission itself.

The key difficulties lie in the spheres of 'performance' and 'mission'. While the field of performance measurement and evaluations have flourished, critical issues remain about how to define outputs, especially in the context of less measurable or more long-term objectives, and whether a focus on measurable outcomes undervalues other aspects such as relationship-building or less measurable goals in relation to political or social change.

More recently, the focus has been on evaluating progress towards the 'mission', which takes a more self-critical, iterative approach. However, this leads back to the original problems of mission—its capacity for engendering competing interpretations, and the need for the mission to evolve over time. Further, accounting for one's mission is very difficult where the mission is broad or its aims difficult to measure, other than in the most general of terms.

Another critical difference is that NFPs frequently operate in a context where resources are short and reliance on honorary directors or members and volunteers is critical. There is, as has been noted elsewhere, a tension between the desire to improve the management and governance of NFPs, and on the other hand the natural disincentives to volunteer in a context where the duties and liabilities are equal to, and (as the Paper envisages) even higher than, for-profit boards.

Professor McGregor-Lowndes, commenting in the wake of a case that established the personal liability of an honorary director of an NFP, suggested that knowledge of legal liability tended to have three effects: it either encouraged a person to "flee" from governing NFPs, it encouraged the purchase of expensive directors' and officers' insurance, or it resulted in a person simply ignoring it and trusting to the fact that such matters happened to other people.[11] Such effects are likely consequences of the increased governance requirements envisaged in the Paper. We are aware that many NFPs already find it difficult to attract board members, and the proposed measures will only create further disincentives.

General Comments on the Consultation Paper

As we have stated, we are not convinced of the necessity or desirability of these governance proposals, particularly at this stage of the reform process. In our view, most if not all of the measures in the Paper are better left to be developed in partnership with the sector, once the ACNC is established. We are particularly concerned that the tenor of the Paper suggests

[11] Myles McGregor-Lowndes, 'Effectively Managing Risks and Liabilities of Non-profit Associations' in Keith Fletcher, Angela Sievers, and Myles McGregor-Lowndes (eds), *Legal Issues for Non-Profit Associations* (LBC Information Services, 1996) 52-73.

a high level of regulation which contradicts both the desire to reduce red tape and the proportionate regulatory approach proposed for the ACNC.

For the sake of completeness, we have provided brief comments here to the questions in the Paper, with the exception of the issue of the duties of responsible individuals which warrants more detailed consideration.

DUTIES OF RESPONSIBLE INDIVIDUALS

The general law imposes upon certain relationships fiduciary obligations. The obligations imposed on fiduciaries include: the duty to act with reasonable care, skill and diligence; the duty to act in good faith in the best interests of the organisation;[12] and the duty to put the principal's interests ahead of their own.

We set out, in Appendix B, the applicable duties in respect of different types of NFP entities. As noted there, these obligations apply not only to directors of companies, but also to committee members of incorporated associations and (in principle) to unincorporated associations.[13] Those fiduciary obligations are also the basis of the statutory duties in the *Corporations Act*, which are replicated in the CATSI Act, and in the amendments to the Victorian incorporated associations legislation which are due to come into force this year. There are also some statutory duties in incorporated associations legislation that are based on similar principles. However, the nature and extent of the obligations varies depending on the context, and the obligations are more strictly applied in relation to trustees, who are considered to be the quintessential form of fiduciary.

These fiduciary duties therefore form the 'core' minimum governance principles applicable to NFPs. If, as appears to be desired, 'core' duties are to be included in the ACNC Bill, these are the appropriate duties. While there may be benefit in spelling out such duties in the legislation, given in particular their somewhat unsettled legal status in relation to associations, we note that there are some subtle difficulties in doing so. As already noted, the scope of the duties vary according to the nature of the relationship. Further, the language used in the *Corporations Act*, while broadly based on these principles, may differ in subtle ways from the duties under general law. The language in relation to conflict of interest in associations legislation also differs substantively from that under the *Corporations Act.* Finally, trustees remain subject to higher duties that are not readily amenable to 'core' principles.

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[12] Under general law, this has several aspects: 1) directors must exercise their powers in the interests of the company, and must not misuse or abuse their power; 2) they must avoid conflict between their personal interests and those of the company; 3) they should not take advantage of their position to make secret profits; 4) they should not misappropriate the company's assets for themselves and 5) they must exercise an independent judgment in relation to proposals put before the board: *Chew v R* (1991) 5 ACSR 473, 499.

[13] See the discussion by Angela Sievers, *Associations and Clubs Law: In Australia and New Zealand* (Federation Press, 3rd ed, 2010).

One solution may be to state in the legislation the general law duties applicable to all responsible individuals, followed by a statement that the general law imposes additional duties upon trustees. This might be followed by a statement setting out the statutory duties applicable to different entities. This would clarify the nature of the duties owed and provide the 'core' rules suggested by the Paper, while not changing the substantive law and respecting existing legislation.

The tenor of the Paper suggests, however, that the governance provisions should include greater detail than these general duties. It seems to suggest, for example, that the legislation should specify whom the responsible individuals should consider in exercising their duties, and different standards of care for different categories of people. We note that the general duties allow a holistic consideration of the standard of a 'reasonable' person in that position, and consider that this flexibility should be retained rather than vainly attempting to prescribe the content of such duties in advance.

We make the following brief responses in relation to the specific consultation questions.

1. Should it be clear in the legislation who responsible individuals must consider when exercising their duties, and to whom they owe duties to?

The primary duty must always be to the entity itself.[14] Given the diversity of stakeholder relationships among NFPs, we do not consider it feasible or desirable to list the range of stakeholders which must be considered. We consider that this level of detail is better left to guidance than in the legislation. Any legislative statement will be so general that it will not in practice be of any assistance. We also note that we have not found any comparable legislative precedent.

2. Who do the responsible individuals of NFPs need to consider when exercising their duties? Donors? Beneficiaries? The public? The entity, or mission and purpose of the entity?

As stated above, the overriding duty is to the purposes of the entity. However, there needs to be some flexibility in construing the purposes, given that changing contexts and approaches may necessitate changes in approach. In the case of trusts, there is an overriding duty to observe the trust, which is a stricter standard than that applying to associations or corporations.

The types of stakeholders and the priority of stakeholders will depend upon the nature of the entity, including its purposes, its membership or client-based structure, and its funding structure. As discussed above, the stakeholders may include: regulators; donors and funders; clients; volunteers; staff; collaborators; unions; citizens and community groups

[14] In relation to a trust, there is a duty is to carry out the purposes of the trust, but the trustee does not 'owe' a duty to the trust itself.

affected by the mission. Some structures may be reasonably straightforward, such as member-based associations, while others may be complex and require consideration even of future beneficiaries (such as the environment). Further, the typical weaknesses in accountability do not relate to the funders of NFPs (whether donors, grant-makers or governments). Rather, the difficulty is in ensuring 'downward' accountability and in ensuring loyalty to mission.

As noted above, we do not consider that it will be helpful to require consideration of stakeholders in the legislation as this would need to be so general as to be practically useless.

3. What should the duties of responsible individuals be, and what core duties should be outlined in the ACNC legislation?

This is discussed above.

4. What should be the minimum standard of care required to comply with any duties? Should the standard of care be higher for paid employees than volunteers? For professionals than lay persons?

As discussed above, we do not consider it helpful to prescribe particular standards of duties and prefer to rely on the holistic examination of circumstances that would include, for example, any special skill or office the person held.

5. Should responsible individuals be required to hold particular qualifications or have particular experience or skills (tiered depending on size of the NFP entity or amount of funding it administers)?

No. We do not see why responsible individuals of NFPs should be held to a higher standard than in existing corporations legislation, which do not require any particular skills to be a director. Requiring particular qualifications will have practical ramifications for NFPs who already find it difficult to recruit board members, particularly since most of these positions are not remunerated.

6. Should these minimum standards be only applied to a portion of the responsible individuals of a registered entity?

The core duties should apply to all individuals in the position of a committee or board member, director or trustee. We note that the definition of 'responsible individual' in the ACNC Bill also includes the content of the definition of 'officer', and that the duties applicable to officers may vary from that of directors or trustees. In our submission on the Bill, we suggested clarification of that definition.

7. Are there any issues with standardising the duties required of responsible individuals across all entity structures and sectors registered with the ACNC?

Yes. As discussed above, some entity types, especially trusts, impose greater or higher duties. Further, including duties beyond these core general duties will result in a greater compliance burden and create further disincentives to participate in the governance of

NFPs. Finally, as already discussed, there are constitutional issues, federal principles, and practical difficulties in centralizing the governance regime in the ACNC.

8. Are there any other responsible individuals' obligations or considerations or other issues (for example, should there be requirements on volunteers?) that need to be covered which are specific to NFPs?

We do not consider that there should be additional requirements on volunteers who are not "responsible individuals". This would be counterproductive to legislative changes that have been made to encourage volunteering.

9. Are there higher risk NFP cases where a higher standard of care should be applied or where higher minimum standards should b applied?

Again, the level of risk is a factor that can be considered in the general duty. The ACNC should provide guidance on risk management, and use risk assessment to guide its regulatory approach. However, we consider that the issue of risk is not an appropriate one for legislation.

10. Is there a preference for the core duties to be based on the Corporations Act, CATSI Act, the office holder requirements applying to incorporated associations, the requirements applying to trustees of charitable trusts, or another model?

This is discussed above.

DISCLOSURE REQUIREMENTS

This section of the Paper is somewhat confusing. It refers to disclosure of financial information, internal governance rules, remuneration, and conflicts of interest. These are all quite discrete topics involving different considerations which are discussed below.

The disclosure of financial information is, as the Paper notes, under consideration in parallel consultations concerning the reporting framework. We therefore do not deal with this here.

11. What information should registered entities be required to disclose to ensure good governance procedures are in place?

The discussion of disclosure of good governance procedures is somewhat opaque. We note that the ACNC Bill, as presently framed, would require that a copy of the internal governance rules be included on the register. We do not consider that further disclosure is necessary, and are unsure what further disclosure is contemplated in this question.

12. Should the remuneration (if any) of responsible individuals b required to b disclosed?

This is a complex issue that requires greater consideration. In our view, there is a danger in isolating remuneration of responsible individuals for disclosure, but there may be a good case for encouraging disclosure of remuneration within the broader context of a larger organisation's annual return.

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There are several difficulties with isolated information on remuneration. First, remuneration figures on their own can be misleading to the public. Remuneration is based on market demand and supply, and differs significantly depending on the sector involved. For example, CEOs of hospitals and educational institutions are likely to earn significantly more than in other parts of the sector. Without understanding this contextual background, it is difficult for the public to understand if the remuneration paid is 'reasonable'. We note that, in the analogous context of administrative overheads of charities, the public generally expect administrative overheads to be as close to zero as possible, although this is clearly unreasonable.

Second, an over-emphasis on remuneration may in fact be inefficient. Focusing on remuneration is likely to discourage investment in human capital. Payment of reasonable wages to a top-performing executive may be a wise business decision, but the isolation of remuneration in disclosure requirements may distort such decision-making.

Third, an over-emphasis on remuneration communicates a certain hostility or suspicion of the sector. It tends to suggest a concern that responsible individuals are overpaid. However, in truth many 'responsible individuals' (especially those on governing boards) are unpaid. Under the CATSI Act, for example, directors cannot be paid unless the constitution permits, and then they are paid only what members approve. Apart from specific exceptions, trustees are generally not allowed to be remunerated. In general, the norms of the sector are that employees will work for a 'discount' to the market rate.

Fourth, there are issues of privacy and parity in respect of remuneration. In general, remuneration is a confidential matter and there must be a good justification for departing from this general principle. In the private sector, public disclosure of directors' remuneration is not required except for listed companies.

Fifth, we note that a possible consequence of enhanced disclosure may be to actually increase the level of compensation paid. In its recent report on executive remuneration in the corporate sector, the Productivity Commission noted that:

Some participants argued that public disclosure of individuals' pay triggered a pay spiral, as companies and executives sought to 'position' themselves in the market, with no one wishing to be seen as hiring or being a 'below average' executive. This is sometimes characterised as the 'Lake Wobegon' effect — a mythical place from US public radio where '… all the children are above average'.[15]

Although the Productivity Commission concluded there was no clear evidence of this, it did note that

[15] Productivity Commission, *Executive Remuneration in Australia* (2010) XX <http://www.pc.gov.au/projects/inquiry/executive-remuneration/report> at 19 January 2012.

Nonetheless, by improving access to market comparator information for both executives and boards, public disclosure is likely to have led to more rapid flow-on effects where, for example, one company in an industry disturbs relativities by paying an overseas appointee a significantly higher level of remuneration.[16]

We note, however, that a possible regulatory interest that may justify disclosure is to assist the regulator in ensuring that there is no breach of the prohibition against distribution of profit. Disclosure to the regulator, in our view, is less problematic than disclosure to the public.

However, the difficulties lie with isolating remuneration as a misleading indicator of possible abuse. We suggest instead that both functions are better fulfilled in the context of annual financial reporting, which would also take into account the differing sizes of NFP entities which correspond to the risk of excessive compensation.

In this regard, we note that the Charity Commissions' Statement of Recommended Practice (SORP) in accounting requires, among other financial information, disclosure of trustee remuneration as a material related party transaction. The total staff costs are also required to be shown.[17] The SORP must be followed by charities that are required to be audited (namely, large charities only). However, this is in the overall context of an annual report that also includes information on governance, objectives and activities, and other matters as well as financial costs, and this context assists in interpreting these details.

In relation to the interests of members, we note that the *Corporations Act 2001* (Cth) and the CATSI Act have provisions that entitle members to approve directors' remuneration and to require disclosure of remuneration and expenses upon request. We have no difficulty with these principles. We do not see it as necessary to apply similar rules to all NFP entities.

13. Are the suggested criteria in relation to conflicts of interest appropriate? If not, why not?

We consider that there is no need to require NFP entities to adopt a conflict of interest policy. Most of the criteria suggested in the Consultation Paper are already legal requirements for NFP entities.

The general law imposes fiduciary obligations upon committee members of unincorporated[18] and incorporated associations[19] as well as directors of companies and trustees.[20] As described above, such a relationship imposes a duty of loyalty, which includes a duty to avoid a position of conflict of interest. This general duty encompasses both the first suggested criteria (a responsible individual should avoid any conflict arising between

[16] Ibid XX.

[17] Ibid 33–34.

[18] Sievers, *Associations and Clubs Law*, above n 13, 17.

[19] Ibid 146–147.

[20] Gino Dal Pont, *Equity and Trusts: Commentary and Materials* (Lawbook Co, 3rd ed ed, 2004) 94–95.

their personal interests (or the interests of any other related person or body) and their duties to the entity) and the fourth suggested criteria (the personal interests of a responsible individual member, and those of associated individuals, must not be allowed to take precedence over those of the entity generally).

In addition, some of the incorporated associations legislation already include provisions, similar to those in the *Corporations Act* and the CATSI Act, prohibiting misuse of position or information (thereby covering suggested criteria two and three). These aspects are also addressed by the general law, upon which the duties in the *Corporations Act* are based. Further, all the incorporated associations legislation already regulates disclosure of interests, although it is narrower in scope than under the *Corporations Act*. In general, with the exception of the pending Victorian amendments, the legislation requires disclosure of pecuniary interests in contracts or proposed contracts (rather than a 'material personal interest') and, upon disclosure, enables participation in discussion but precludes voting on the matter. Although this differs in scope from the duty in the *Corporations Act,* we consider it undesirable to have two co-existing legislative standards for disclosure for the same entity, particularly when the practical differences are not great.

While, as a matter of principle, it is desirable for organisations to adopt a conflict of interest policy, we consider that this should not be imposed but rather encouraged as a matter of good practice by the ACNC.

14. Are specific conflict of interest requirements required for entities where the beneficiaries and responsible individuals may be related (for example, a NFP entity set up by a native title group)?

We note that the CATSI legislation deals specifically with the issue of common native title interests in the context of native title legislation. As we do not see a need for further regulation of conflict of interest, we suggest that this is an issue also best considered by the organisation itself.

15. Should ACNC governance obligations stipulate the types of conflict of interest that responsible individuals in NFPs should disclose and manage? Or should it be based on the Corporations Act understanding of 'material personal interest'?

See above.

RISK MANAGEMENT

16. Given that NFPs control funds from the public, what additional risk management requirements should be required of NFPs?

We question the premise of this question. Not all NFP entities 'control funds from the public'. In our view, risk management is essentially a matter of good practice rather than a matter for prescriptive regulation.

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We note, however, that the Charity Commission's SORP requires inclusion of a statement confirming that the trustees have reviewed the major risks to which the charity is exposed and that systems or procedures have been established to manage that risk.[21] In the context of an annual report, this may be a useful inclusion. We emphasise, however, that the SORP does not apply to smaller entities, and consider that this is appropriate.

17. Should particular requirements (for example, an investment strategy) be mandated, or broad requirements for NFPs to ensure they have adequate procedures in place?

Again, we consider that this need not be dealt with by legislation. Rather, as already discussed, we would prefer that these elements be considered within the broader context of an equivalent to the SORP, developed by the ACNC in collaboration with the sector. We note that the UK's SORP does include a requirement to detail the investment performance achieved against the objectives set.[22]

18. Is it appropriate to mandate minimum insurance requirements to cover NFP entities in the event of unforeseen circumstances?

In relation to insurance, we note that NSW and Queensland have repealed earlier requirements to take out public liability insurance. This was repealed in NSW in 2002 and by Queensland in 2007. In Queensland, the management committee is required to consider whether public liability insurance is necessary and must advise members of the decision. However, the committee must take out public liability insurance in respect of land it owns, leases or has in trust.[23]

The repeal of the NSW requirement was explained as follows:

> *The Department of Fair Trading instigated the change in response to an increasing number of concerns voiced by associations regarding their public liability insurance policies. They were finding that insurers were refusing to insure new associations, renew existing policies or were dramatically increasing their premiums. For many associations, which the Department considered were at an almost non-existent risk of physical injury, for example, book, knitting and quilting clubs, the obligation to effect public liability insurance was becoming too onerous.*[24]

Given the experience of these States and Territories with mandatory public liability insurance requirements, we consider that such a requirement ought not to be included. Instead, appropriate guidance should be given by the ACNC.

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[21] *Chew v R* (1991) 5 ACSR 473, [45].

[22] Ibid [53].

[23] *Associations Incorporation Act 1981* (Qld) ss 70, 70A.

[24] Anne Farr and Marie-louise Symons, *Public Liability Insurance and Incorporated Associations in NSW* (30 September 2002) Arts Law Centre of Australia <http://www.artslaw.com.au/articles/entry/public-liability-insurance-and-incorporated-associations-in-nsw/>.

19. Should responsible individuals generally be required to have indemnity insurance?

No. The need for insurance must be weighed against the risks in the particular context of an organisation. Such insurance can be expensive and may be unnecessary, and give misleading comfort to responsible individuals.

INTERNAL REVIEW

20. What internal review procedures should b mandated?

Again, we see no reason for legislative requirements imposing stricter governance requirements than for corporations. While processes of internal review may enhance governance, we consider that this is rather a matter for appropriate guidance rather than prescription.

GOVERNING RULES

21. What are the core minimum requirements that registered entities should be required to include in their governing rules?

Incorporated associations legislation (excepting Tasmania) already requires fundamental matters to be regulated. Generally, these include: the name and objects of the association, qualifications for membership, subscriptions or other fees payable by members, the source and control of association's funds, the constitution and powers of the committee or other governing body and its procedures; matters relating to meetings; amendment of rules; accounting and audit; formal matters such as the custody and use of the common seal and the association's books; disciplinary action against members; and winding up and the distribution of any surplus property.[25]

The CATSI Act sets out the 'internal governance requirements' in s 66.1. These include a constitution, internal dispute resolution, and the matters covered by the replaceable rules. These are set out in a list in s 57.5 and cover 89 issues relating (inter alia) to membership, meetings, and officers. In addition, of course, the *Corporations Act* also sets out a raft of internal governance rules in the form of replaceable rules.

Given that these legislative requirements have been developed specifically for these entities, and will continue to exist upon commencement, we see no reason to identify a 'core' list common to both of these entities. We also note that such requirements cannot apply to trusts. Rather, if it is thought necessary, the issue should be considered in the context of the foreshadowed review of legislation governing companies limited by guarantee.

22. Should the ACNC have role in mandating requirements of the governing rules, to protect the mission of the entity and the interests of the public?

[25] Sievers, *Associations and Clubs Law*, above n 13, 135–136.

As we have discussed above, we are not sure how such a role would be compatible with the existing parallel legal regimes which already mandate certain requirements. Such a role may be desirable once a co-operative arrangement with the States or Territories has been established. However, we reiterate our concern that the review of governance principles should be in partnership with the sector and respect the fundamental need for entities to choose their own internal governance, unless clearly justified by public policy.

23. Who should be able to enforce the rules?

As discussed above, we consider there are both legal and practical problems in conferring the primary responsibility for enforcing the duties on the ACNC, particularly in the absence of any worked-out co-operative arrangement with States or Territories. We do recommend, however, that in the interim the ACNC should ensure co-operation with existing regulators in enforcing breaches under relevant legislation.

24. Should the ACNC have role in the enforcement and alteration of governing rules, such as o wind-up or deregistration?

See above for the role of ACNC in enforcement. We do not think the ACNC should have any role in altering governing rules upon winding up or on deregistration.

25. Should model rules be used?

As noted above, the issue of model rules should not be broached while there are existing parallel legal regimes.

MEMBERS

26. What governance rules should be mandated relating to an entity's relationship with its members?

Entity legislation and model rules already prescribe rules relating to members in some detail. We do not consider additional rules are necessary or desirable, especially at this stage.

27. Do any of the requirements for relationships with members need to apply to non-membership based entities?

No. Such requirements are founded on an entirely different governance structure.

28. Is it appropriate to have compulsory meeting requirements for all (membership-based) entities registered with the ACNC?

No, because the existing rules should continue to apply.

OTHER

29. Are there any types of NFPs where specific governance arrangements or additional support would assist to achieve in better governance outcomes for NFPs?

There will be types of NFPs that would benefit from additional support and guidance, but we consider that this is a matter best left to the regulator at a later stage and does not need addressing at this point.

30. How can we ensure that these standardised principles-based governance requirements being administered by the one-stop shop regulator will lead to a reduction in red tape for NFPs?

As is clear from our comments, we are concerned that the present proposals will only lead to an increase in red tape while parallel entity legislation is in place.

31. What principles should be included in legislation or regulations, or covered by guidance materials to be produced by the ACNC?

In general, our approach has been that most of the measures or suggestions here should be left to guidance rather than legislation. If enforcement of governance duties is required (which we suggest is not necessary), then some legislative reference to the duties imposed by general law and statute may assist.

32. Are there any particular governance requirements which would be useful for Indigenous NFP entities?

We note that governance of Indigenous groups has clearly been considered in the framework of the CATSI Act. We consider that this is a matter best left for the ACNC at a later stage.

CONCLUSION

Although we support the Treasury's desire to enhance the governance of NFPs, we have considerable concerns about the nature of these proposals. We hope that Treasury will consider these comments carefully and thank it for the opportunity to comment on this Paper.

As always, please feel free to contact us directly if there are any questions or further information is required.

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