ASIC

Australian Securities & Investments Commission

ASIC — friend or foe of business

An address by David Knott, Chairman, Australian Securities and Investments Commission to the Australian Institute of Company Directors, Perth, 9 July 2003

It is a great pleasure to be back in Perth talking again with the AICD. A good deal of water has passed under the bridge since I last spoke here 14 months ago.

I share the concern of others that too much of the news about corporate Australia over that period has been bad. While we have had our problems, there is a tendency to take things out of context and to forget how much progress has been made since the 1980s in making our investment markets fairer and more transparent.

Indeed, I can track that process back to the formation of the National Companies and Securities Commission (the old NCSC) in 1980 and its inaugural Chairman Leigh Masel.

He was the first person I heard talk about the need to make our markets fairer and more transparent to retail investors. Remember this was long before the days of privatisation and demutualisation, which subsequently revolutionised retail participation in equities, But even then he foresaw the need for our markets to be opened to direct investment as the population aged; and he knew that this could not happen for so long as the market was the preserve of the privileged few.

Looking back, many of us will have forgotten how bad things were. The lack of transparency; the trading in selectively disclosed information; market abuse, including insider trading; and anti-competitive market practices and regulation that precluded any real prospect of fair dealing for the direct retail investor.

I was a relatively young lawyer at the time and was very much influenced by Leigh Masel's commitment. It is one that I have attempted to emulate by promoting improved disclosure to investors, higher standards of investment advice and the punishment of abusive market practices. Unless we have a market that is trusted by ordinary Australians the whole framework of our national savings and retirements policy is imperilled. Let me explain that.

Governments all around the world are faced with changing demographics that make it increasingly difficult for them to provide broad-based post-retirement income support. More and more, our people will be expected to manage their own financial futures. Whether through compulsory savings schemes like superannuation (in which over $500 billion is already invested, projected to exceed $1700 billion by 2020), or through individually structured investments, successive generations will necessarily engage as participants in our equities and other traded markets.

They have a right to expect that those markets are not stacked against them. They have a right to expect access to price sensitive information on like terms to institutions. They have a right to expect that conflicts of interest confronting market intermediaries and advisers will be managed fairly; and they have a right to expect that someone is looking out for their interests. ASIC is one agency attempting to do so.

One way we have gone about that task has been to encourage greater consciousness by listed companies of their continuous disclosure obligations. I want to make it clear that ASIC respects legitimate claims for confidentiality of commercial negotiations and the continued operation of the ASX carve outs. However, we have campaigned for a more open culture of disclosure by listed companies and a less legalistic approach to the listing rules. I think Boards are beginning to accept that disclosure can be managed in this spirit while at the same time preserving confidentiality when it is essential to shareholder interests. Instead of asking 'do we have to disclose this information?' Boards should be asking 'is there any good reason <u>not</u> to disclose this information?'

ASIC's approach to disclosure has been under the spotlight recently in the context of AMP's offer to its shareholders. Our view was that retail shareholders should be given the opportunity to participate in AMP's capital rasing as an adjunct to the institutional placement. We took steps to ensure that shareholders were given all available information and obtained an assurance from AMP that nothing material was left undisclosed.

In those circumstances the retail shareholders were able to make a choice. They could accept the same investment risk as the institutions (albeit at a potentially discounted subscription price) or they could decline. It was not ASIC's role to deprive them of the choice. Instead, we published a succinct statement of AMP's demerger status quo (derived from discussions with AMP and the prudential regulators) together with AMP's assurance that all material information then available had been disclosed.

The repetitive assertion by one prominent commentator that ASIC should have frozen the retail participation until AMP's demerger details were finalised is completely misconceived. Even if ASIC had the power to interfere in that way with contractual rights agreed between a company and its underwriters, could such intervention be justified, except in circumstances where known information was being withheld? Do we want the regulator dictating the timing of corporate fundraisings based upon its own assessment of risk? More fundamentally, do we want to deny retail shareholders a limited participation in placements under the same investment risk parameters as offered to institutions?

The fact that most retail shareholders decided to decline the offer is irrelevant to these questions of principle. There are many reasons why they may have decided to not accept the same investment risk as the institutions. But at least they had the choice. And while uncertainties regarding the demerger meant that the level of available information was not ideal, at least they could exercise that choice understanding that fact and knowing that the institutions had not accessed additional information to inform their own investment decision.

More recently we have been confronted by the collapse of the Stanwell magnesium project, with serious consequences to holders of AMC securities. In this case the criticism, (from the same commentator, which may tell you something) is that ASIC did not do enough to protect investors. Those of you who remember the float of AMC will recall that it was beset by controversy from the outset, partly because of project uncertainty and partly because of the project's political sponsorship. For these reasons ASIC took a keen interest in the level and nature of risk disclosure to investors. In my experience, it is difficult to recall a prospectus that more prominently and explicitly set out the investment risks inherent in the float. Nine pages of risk analysis started with the warning that:

> 'An investment in the (securities) involves a high degree of risk'.

The first risks analysed were those related to Stanwell , and included comments such as:

> 'There can be no assurance that construction will be completed and the Stanwell Plant commissioned on time and within the capital cost estimated'.

The prospectus explicitly stated that failure to complete and operate the Stanwell Project as planned would negatively affect AMC's main business activity and adversely affect its results and the value of its securities.

It is difficult to imagine what more ASIC could have required AMC to disclose about the risks of this venture. All investors in that float had the risks clearly and prominently explained to them. They had a choice to accept or decline those risks.

The question of whether AMC has subsequently complied with its continuous disclosure requirements is a separate matter now being investigated by us. Nothing I have said today relates to that aspect of their disclosure. But I have used AMP and AMC to remind you that ASIC does not see itself as an arbiter of acceptable investment risk. Our task is to optimise investment risk disclosure and to leave investment risk decisions to investors.

Our approach to this issue is consistent with the operations of a market economy where information disclosure is promoted but investment risk decision making remains with shareholders. That policy has enjoyed bipartisan political support in Australia for many decades. While there is always room for rational discussion about individual cases, we should be extremely wary of recalibrating policy towards increased regulatory intervention.

Let me return to the NCSC. I'm sure that many of you will remember its second Chairman, Henry Bosch (who remains active in AICD affairs). Like me, Henry held office at a time when the cyclical impact of market excess was all too apparent. As a man who was devoted to deregulation and the elimination of red tape, Henry was confronted by ugly realities of market abuse and the dilemma of managing such contradictions. He too, seized upon a simple but elusive truth that had a lasting influence upon me. It is simply this – that regulation without enforcement will fail.

Laws that are not enforced are neither respected nor observed. As a result, offensive practices and excesses compound until, like the infamous pyramid schemes, they collapse for want of a sound formation. Governments and regulators then intervene with even more laws, expanding compliance cost and assuaging the electoral cry for blood. And on it goes and goes. If you want to see this theory in practice take a look at most Asian countries where over-regulation and under-enforcement are common features of the regulatory landscape.

On a shoestring budget – and employing strategies that I couldn't even think about today – Henry Bosch started to address this problem in Australia. As I recall it, certain Carlton Football Club personalities featured prominently in his enforcement focus. What a legacy he left me!

This seems like an appropriate point to spend a few minutes considering Australia's latest bout of corporate failures and ASIC's response to them.

That response is broadly divided into two categories: enforcement and policy.

Although we have been active in both areas, we placed an early strategic priority on our enforcement role. It was inevitable that corporate failures here and in the US would revive a great debate on corporate governance. It was also inevitable that in the media and in public forums we would be bombarded by every possible opinion on what should be done. On an issue as nebulous as good governance, everyone is an expert.

We decided not to play that game.

Our view was that we could do more to influence corporate behaviour through one successful court case than through 10 volumes of speeches.

We were also influenced by our view about the regulator's proper role in the policy area. Unlike our counterparts in the USA and the UK, we do not have a rule-making power under which we can impose new regulatory requirements. That fact is very often overlooked by critics who point to actions taken by overseas regulators and ask why ASIC is not doing something similar.

In this country, the responsibility for policy lies with Government, and in an area as important as this, it is quite proper that Government should determine what, if any, new legislation is required. ASIC's role is to advise the Government and to be one of the many parties that submits policy propositions for consideration.

We also believe that in the area of governance, only part of the framework should be legislated. In a sense, it is like determining a base-line non-negotiable set of obligations (which are legislated) and then inviting the business community to itself develop best practice standards to supplement that legislated base line. The alternative is to have everything legislated or prescribed – not a prospect that many of us would support.

ASIC's view is that the 'best practice' overlay should not be controlled by the corporate regulator because it would confuse the distinction between enforceable obligation and best practice. That is why we encouraged the ASX to play the co-ordination role through the new ASX Governance Council. The ASX is the only common point of reference for all listed companies. No business group can claim universal coverage and their agendas and positioning can differ. We have seen that in the somewhat different approaches taken by the BCA and AICD over the past year. So the ASX got the job and I believe that they managed an incredibly difficult situation well. I realise that some elements of the guidelines are contentious and I think the decision to establish a periodic review of the guidelines is sensible. But for the reasons stated, I intend to stay out of that debate and to focus on administering the Corporations Law, including changes resulting from CLERP 9.

Enforcement is an entirely different matter. In that area we have been both active and effective. To give you some perspective of that let me give you a few statistics. I do this not to boast but simply to emphasize the breadth of our enforcement role. In the past 3 years we have prosecuted over 500 civil and criminal cases; 70 offenders have gone to jail; more than $1 billion has been protected, recovered, or ordered in compensation for investors, creditors, shareholders and other members of the public; 40 directors have been removed from office; and 95 people removed from the securities and financial planning industries. This is not enforcement to invoke fear or to punish reasonable error. It is a tactical and necessary part of a total strategy designed to promote the public interest – a subtle part of which is to inspire investor confidence without the proliferation of regulation.

Most of our successes will be unknown to you, but a few of the more notorious cases will be more familiar.

Harris Scarfe – the CFO is in jail, the chief operating officer has been committed to stand trial on criminal charges and our investigation is not yet closed.

One.Tel – civil penalty proceedings have been commenced against former executive directors, Messrs Jodee Rich, Brad Keeling and Karl Silbermann and against the former chairman Mr John Greaves. Mr Keeling has already settled with ASIC on terms that include banning him from company management for 10 years and liability for $92 million compensation.

HIH – while the Royal Commission was engaged in its hearings, we took successful civil penalty proceedings against Messrs Rodney Adler, Ray Williams and Domenic Fodera. Messrs Adler and Williams were banned for 20 and 10 years respectively and ordered to pay $7 million compensation; all three were fined. The appeals by Messrs Adler and Williams were finalised yesterday, and the decision by the Court of Appeal to uphold the original penalties imposed by Justice Santow confirms the seriousness of the breaches committed by the defendants. Additionally, Mr Adler is presently engaged in a committal hearing over criminal charges laid against him over the PEE transaction and very recently criminal charges have been laid against three defendants in relation to sham reinsurance arrangements. We are now working on the remaining referrals received from the Royal Commission and I am confident that we will make good progress on that front over the next six months.

I think that we have fairly widespread support for these enforcement actions. However, it is inevitable that some will wonder whether the bar has been raised too high for directors and whether we have been unreasonable in pursuing some of the defendants.

Neither of those propositions withstands close scrutiny. In every case successfully prosecuted by us, a judge or jury (or both) has found that the defendant either engaged in deliberate dishonesty or failed to exercise a reasonable standard of care.

Even in the Water Wheel case, which involved insolvent trading and did not include assertions of dishonesty, the central thrust of Justice Mandie's judgement was that non-executive directors must act with *reasonable competence and diligence*. That does not seem too much to ask.

It is inevitable that some of our cases will from time to time involve high profile people. When that happens the media will focus on their involvement. However, ASIC's management of these cases and our approach to media coverage has been impeccable. Suggestions that we target individuals of profile are patently incorrect. Of the more than 500 cases I have referred to, only a small handful involve public figures. Indeed, this fact often results in the equally incorrect assertion that we are unwilling to pursue powerful or well-resourced defendants and that we concentrate on small fish. You can't have it both ways and, in truth, we make no such distinctions in our law enforcement activity.

One of the most interesting of our recent cases has been the proceedings against Mr Greaves, the former chairman of One.Tel. It has, I know, generated some concern in company Boardrooms, so I would like to make some brief comments about it.

Mr Greaves was the only non-executive director of One.Tel included as a defendant to our proceedings. Why did we do that?

Mr Greaves had been a qualified chartered accountant and had substantial practical commercial experience with listed public companies as the finance director or chief financial officer of Fairfax Limited, Optus Limited and Wormald. We believe that Mr Greaves was better qualified and more experienced than all of the other One.Tel directors to ensure proper Board supervision of the financial management of the One.Tel Group. He was also chairman of the Finance and Audit Committee, an unusual combination of positions for a company chairman

In all those circumstances, ASIC alleged that Mr Greaves had responsibilities additional to those of other non-executive directors, leading to a higher standard of care and diligence.

Mr Greaves filed a motion to strike out ASIC's statement of claim against him on the basis he should be treated no differently to the other non-executive directors.

He asserted that the position of chairman was no more than procedural or ceremonial.

In a landmark decision in February this year, Justice Austin of the NSW Supreme Court rejected Mr Greaves' arguments. In a considered and comprehensive judgement, His Honour reviewed past case law, academic writings, oversees expert reports and – in my view most importantly of all – affidavit evidence submitted by us from senior company chairman about the role of chairman of major listed companies in contemporary Australia.

I emphasise that last point because, in my view, very few of today's chairmen would see their role as ceremonial or procedural. In most large public companies the chairman is paid materially more than other non-executive directors, in recognition that they have a more demanding role. Most chairmen spend considerably more time with the company's CEO than other non-executive directors, discussing financial, operational and strategic issues. They are the pivotal link between the management and the Board.

In our view, therefore, while Justice Austin's judgement was a watershed in establishing the principle involved, it was a case of the law catching up with commercial practice.

Justice Austin himself put it this way:

'It should be remembered … that the Court's role in determining the liability of a defendant for his conduct as company chairman, is to articulate and apply a standard of care that reflects contemporary community expectations'.

I believe that those expectations are well understood by senior company chairmen and that they already observe them in the discharge of their office. I have not encountered a single chairman or prospective chairman who would consider foregoing office on the basis that this standard of care is too high.

I would like to add a couple of footnotes on Greaves case.

First, I want to emphasize that ASIC's success in these proceedings is centred on a point of legal principle and involves no finding of misconduct against Mr Greaves. He remains a defendant to the proceedings in which the substantive issues of conduct have yet to be tried.

Secondly, the question of precisely what duties of chairman might have (above those of other directors) in any particular case remain to be determined. The One.Tel case will be the first to test the principle and flesh it out. No doubt other cases will follow, gradually developing greater guidance under the common law.

I would like to leave you with two central messages. First, ASIC will continue to enforce the Corporations Act in a way that is impartial and fair. By doing so we reinforce to all involved in business that reasonable standards of care are demanded of those who manage other people's money. Our enforcement action also helps to underpin continuing confidence by domestic and international investors in the integrity of our market - a crucial imperative for a small economy in a global market for capital.

Secondly, directors and managers of integrity, honesty and diligence have no reason to fear ASIC. We are not out to punish people for honest mistakes. The standards of care that we have pursued in the Courts make that clear.

ASIC understands the importance of a strong and profitable business sector that is well regulated, not over-regulated. That objective has dictated our response to corporate failure in respect of both policy and enforcement.