



ASIC

Australian Securities & Investments Commission

CORPORATE GOVERNANCE: AN IOSCO PERSPECTIVE

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Table of Contents

BACKGROUND.....	1
IOSCO CORPORATE GOVERNANCE TASK FORCE.....	2
ABOUT THE SURVEY	2
"OBJECTIVE INDEPENDENT JUDGEMENT"	3
DETERMINING INDEPENDENCE	4
INDEPENDENCE FROM CONTROLLING SHAREHOLDERS	4
VOLUNTARY CODES AND ENFORCEMENT.....	4
OUTCOME OF THE MAPPING EXERCISE.....	5
AUSTRALIAN CORPORATE GOVERNANCE	5

Background

Any discussion of corporate governance invariably involves a reference to the Organisation for Economic Co-operation and Development (**OECD**) Principles of Corporate Governance.

By way of background, the OECD Principles were originally developed in 1999, with the OECD releasing its revised Principles in 2004. Since their development, the significance of the Principles to the development of corporate governance practices has been recognised by a number of international bodies. The Principles have been endorsed by the Financial Stability Forum as one of the 12 key standards for financial stability.

The International Organisation of Securities Commissions' (**IOSCO**) interest in corporate governance, like so many regulatory reforms, finds its origins in financial frauds such as Parmalat Finanziaria SpA. Following the collapse of Parmalat, IOSCO formed the Securities Fraud Task Force to examine ways that international securities regulators could strengthen important mechanisms in combating financial frauds.

The report of the Securities Fraud Task Force focused on seven separate areas that had featured prominently in recent collapses:

- corporate governance;
- auditors and audit standards;
- issuer disclosure requirements;
- bond market regulation and transparency;
- the role and obligations of market intermediaries;
- the use of complex corporate structures and special purpose entities; and
- the role of private sector information analysts.

The work of IOSCO's Securities Fraud Task Force confirmed in the mind of IOSCO members the link between strong corporate governance, as espoused by the OECD Principles, and strong financial markets.

The Securities Fraud Task Force identified the following corporate governance issues as being critical, given the circumstances contributing to the collapse of Parmalat, and other financial frauds:

- the ability of the board to exercise independent judgement; and
- the importance of protection for minority shareholders.

The Securities Fraud Task Force noted that the presence of strong independent directors might have the effect of discouraging majority shareholders from engaging in conduct to derive a private benefit at the expense of other shareholders. Independent directors provide a means by which minority shareholders can monitor how majority shareholders and management utilise corporate assets.

Independent directors can also be one of a number of mechanisms that provide a safeguard against abusive related party transactions.

While it was recognised that majority shareholders have the same interest as minority shareholders in maintaining the viability of the corporation, the controlling shareholder may be in a position to expropriate assets of the corporation for its own benefit at the expense of minority shareholders.

Corporate laws generally counter predatory conduct by imposing duties on the directors of the corporation to act on behalf of all shareholders. Many jurisdictions also provide specific protections to minority shareholders.

IOSCO Corporate Governance Task Force

IOSCO formed the Corporate Governance Task Force to take the work of the Securities Fraud Task Force forward.

The Task Force was formed in October 2005 with participation of all IOSCO Technical Committee member jurisdictions, plus Brazil, India, Portugal, Thailand and Turkey.

The Corporate Governance Task Force is co-chaired by Mr Manuel Conthe from the Spanish Securities Commission and Jeremy Cooper from the Australian Securities and Investments Commission.

In forming the Task Force, IOSCO:

- acknowledged the expertise of the OECD in the area of corporate governance and its intention not to “reinvent the wheel”;
- confined its interest to corporate governance as it applies to *listed* companies in *major capital markets*; and
- recognised that regulation of corporate governance in many jurisdictions is **not** the responsibility of the securities regulator.

IOSCO gave the Task Force the mandate to conduct a 'mapping' exercise, to study how members have implemented OECD Principle VI.E on the exercise by boards of "independent judgement" about corporate affairs. The mandate is concerned solely with the position in relation to boards of listed corporations in Task Force member jurisdictions.

The Task Force surveyed 18 member jurisdictions on:

- their general corporate governance framework; and
- how "independent judgement" has been implemented in practice in their jurisdictions.

About the Survey

The survey is a purely factual, and not a normative, exercise. IOSCO is interested in summarising various practices rather than looking at developing or recommending best practices. The report summarising the findings of the survey has recently been published as a consultation paper on the IOSCO website.

Some statistics about the survey:

- 18 major jurisdictions were surveyed (with Australia, Japan, Hong Kong and Thailand being the Asian jurisdictions surveyed);
- the survey covered approximately 27,500 listed companies;
- the market capitalisation of those companies was approximately US\$35 trillion as at March 2006.

The survey also disclosed that of the surveyed jurisdictions, three countries had diffuse ownership as the dominant form of ownership of major listed entities. (These jurisdictions were Australia, the United Kingdom and the United States). There were nine jurisdictions where block ownership (ie: ownership by a controlling shareholder or shareholders) was the predominate form of ownership of listed companies. These jurisdictions were Canada, Brazil, Germany, Hong Kong, Italy, Mexico, Portugal, Spain and Turkey. The remaining six jurisdictions did not have sufficient data to identify a predominate pattern of ownership.

In terms of board structures, the single-tier structure is used in 11 jurisdictions. The two-tier structure, which is used in Germany and the Netherlands, is also common. This model is used in Brazil with the added requirement of a fiscal board.

Japan has two types of corporate structure. The most common form is where the company has a management board and a separate board of corporate auditors who undertake an oversight role. The other form is the single board of directors with specialised sub-committees carrying out particular functions. The latter form was introduced in 2003.

Italy is another jurisdiction where there is a choice of corporate structure. Companies can choose from the single tiered model, the two tiered model and the "traditional model" where the board co-exists with a board of statutory auditors elected by the shareholders. The "traditional model" is the most common structure for Italian listed companies.

"Objective Independent Judgement"

In all the surveyed jurisdictions, there are standards setting out the basic duties of a company's management bodies. Although the source of these duties varies from jurisdiction to jurisdiction, they fall within three main categories, namely:

- a duty of loyalty;
- a duty of care; and
- a duty of confidentiality.

In addition to these broad duties applying to all board members, the majority of surveyed jurisdictions have additional corporate governance requirements contained in either mandatory or voluntary corporate governance standards or codes. The main exception to these additional requirements is the United States, where corporate governance requirements are firmly entrenched in either legislation or the listing rules of the relevant exchange.

Determining Independence

Of the participating jurisdictions, nearly all have adopted criteria for categorising 'independent' board members. Generally, these criteria are expressed as negative criteria, for example, a board member is considered to be independent if they have no business relationship with the company.

On the question of who determines whether a board member meets the relevant criteria to be categorised as independent, in France and the United Kingdom it is the company's board that makes the final determination. In Hong Kong, India and Thailand the respective Stock Exchange can re-classify directors who have been incorrectly labelled as "independent". In Italy and Spain it is the securities regulator that is the final arbiter of whether a board member is considered to be "independent".

Independence from Controlling Shareholders

One of the criteria that was relevant in many jurisdictions when determining the independence of a board members was independence from major shareholders.

In considering this issue, the survey also identified jurisdictions where there were particular voting rules applying to "special shareholders" that recognised the entitlement of such shareholders to board representation. In Portugal, if minority shareholders holding more than 10% of the capital vote against the majority candidate, the minority shareholders are entitled to appoint one board member. Similarly, in Mexico, shareholders holding more than 10% of the capital are entitled to appoint one board member.

Voluntary Codes and Enforcement

The survey also focused on how corporate governance requirements or recommendations were "enforced" in responding jurisdictions. The prevalence of voluntary corporate governance codes means that traditional enforcement tools do not automatically apply. In jurisdictions that have adopted voluntary corporate governance codes, there is a heavy reliance on disclosure as a means of enabling the market or other interested parties to evaluate a company's adherence to code requirements. The term "comply or explain" is often used in this context. "Comply or explain" is a system of disclosure whereby a company is required to report on its compliance with the corporate governance code and if they do not adhere to the recommendations the company must disclose the reasons for non-adherence.

Notwithstanding the voluntary nature of most corporate governance codes, in Italy there is scope for companies to choose to be bound by the Stock Exchange Code. Similarly, in the Netherlands the code can become enforceable if shareholders endorse compliance with the code.

Disclosure of personal information about potential board members is also common in most surveyed jurisdictions. In all jurisdictions (except Germany) information about candidates for election to the board are submitted to the shareholders prior to voting. In Australia, Canada, Hong Kong, Mexico, Netherlands, Portugal, Spain, Switzerland, Thailand, Turkey and the United States, there are additional disclosure requirements

that also apply to board members once elected. These requirements include, for example, a requirement in Australia to disclose for each board member details of the number of board meetings attended each year.

Outcome of the Mapping Exercise

As indicated above, the focus of the report will be illustrative rather than normative, with the report drafted to be easy to read and digest. The report aims to identify both the common and unique approaches to corporate governance in surveyed jurisdictions and to allow for comparison of those practices between jurisdictions. Above all, the aim is for the report to be a useful tool to assist securities regulators in appreciating the role of their counterparts in the corporate governance debate.

Australian Corporate Governance

By way of conclusion, it is useful to consider corporate governance in Australia.

Australia is unusual, because the Australian Securities and Investments Commission is both a securities market regulator and a corporate regulator.

A mix of mandatory and voluntary requirements governs corporate governance in Australia. This includes the Australian Stock Exchange's Corporate Governance Code, which are voluntary guidelines underpinned by an "if not, why not" (ie: comply or explain) disclosure mechanism. This system, particularly the Code, is working well in practice, with Australian listed companies either adopting the recommendations of the Code or providing shareholders and the market with an explanation of their non-adherence.