ASIC

Australian Securities &
Investments Commission

Corporate Governance Summit 2002

The role of ASIC in corporate governance

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27 November 2002

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Thank you for inviting me to speak today about ASIC's role in corporate governance.

Conferences such as this make an important contribution to public debate on corporate governance and, ultimately, the improvement of corporate governance standards in Australia. I welcome the opportunity to be a part of that contribution.

What is corporate governance? (And a few observations on areas for reform)

Before I talk about ASIC's role in corporate governance, I think I should first define what we mean by corporate governance.

At the moment, rarely a day goes by without extensive media discussion of "corporate governance". You have all devoted two days of your lives to talk about, and listen to others talk about, corporate governance. Yet the term "corporate governance" is seldom described or explained. Moreover, it often seems that different commentators include different topics in the great "corporate governance" debate.

As many of you would know there are a large number of codes or guides describing best corporate governance practice. Many of these codes or guides have their own definitions of corporate governance. An analysis of these definitions shows that there is a reasonable consensus that, at a minimum, corporate governance is broadly about two things:

- Firstly, it is about the mechanisms by which corporations are **directed and controlled**; and
- Secondly, it is about the mechanisms by which those who direct and control the corporation are **monitored and supervised**. That is, it is about mechanisms that ensure those who are in control are **accountable**.

Of course, some definitions go further and refer to balancing the interests of different stakeholders in the corporation. They refer to the need to balance and align the interests of employees, creditors, suppliers, customers, and the local community, as well as the relationship between management, the board and shareholders.

The debate about whether corporate governance should be concerned about balancing the interests of stakeholders beyond management, the board and shareholders, is clearly an interesting one. However, I do not want to pursue it today.

What I want to emphasise is that, in ASIC's view, a great deal is encompassed, even by the narrower definition of corporate governance.

Directors duties and corporate meetings
Obviously, laws and practices dealing with the way in which boards and directors should behave all fall within the scope of corporate governance. For example, laws in relation to the duties of corporate officers and related party transactions are all relevant to corporate governance.

So too are laws dealing with the conduct of corporate meetings. Meetings are one of the prime tools available to shareholders. They enable shareholders both to monitor and supervise the conduct of management and the board and to exercise some control in relation to the corporation. At annual general meetings, shareholders can ask questions about and make comments on the management of the company. They can ask the auditor questions about the conduct of the audit and the preparation and content of the auditor's report. And, most importantly, they can exercise their power to vote on the composition of the board. The increasing interest in corporate meetings, among shareholders, the media and academic commentators, is an indication of the importance of meetings in the current environment.

However, I want to stress that corporate governance is about a lot more than directors' duties and company meetings.

Financial reporting
In my view, the debates involving both auditors and standards of financial reporting are part of the broader corporate governance debate in Australia. Financial reports and auditors fulfil a crucial role in the monitoring and supervision of management and the board. The financial reporting process is essential to the external accountability of directors and management. An audited financial report shows shareholders and the world at large how the board and the company are performing. Therefore, if the financial reporting and audit process is flawed, the whole external accountability framework is at risk. In other words, our system of corporate governance is as risk.

It is for this reason that accounting standards and audit standards must be complied with. It is for this reason that auditors must be truly independent of the companies which they audit. It is for this reason that those within the corporation who manage the relationship with the auditors must be independent of management and must be capable of monitoring the audit process. All these measures are essential to ensure the integrity of the financial reporting and audit process and, ultimately, the accountability of those that control and manage the corporation.

Having emphasised the importance of the financial reporting and the audit process to corporate governance, I would like to stress that I do not think that Australia's audit and financial reporting processes are deeply flawed. In Australia, we have

not seen the accounting abuses or frauds that have emerged in the United States recently. Nevertheless, our system can always be improved. I would like to offer some observations:

- Accounting standards should be principles based and applied to the substance of transactions or balances, irrespective of their legal form. I hasten to add that I am not advocating a return to a true and fair override. A substance over form requirement affects *how* an accounting standard is applied, rather than *whether* the standard should be applied. As many of you would know, before 1991, the duty of the directors to ensure compliance with the accounting standards was subject to the overriding requirement that the accounts must give a true and fair view of the matters with which they deal. There was evidence of serious abuse of this true and fair override. For example, companies refused to apply certain accounting standards on the basis that the application of the standard did not lead to a true and fair view. This would not happen with a substance requirement. The figure arrived at following application of the accounting standards by reference to the substance of transactions would still be included in the financial reports. A substance requirement would ensure that accounting standards are properly applied, rather than permitting a company to disregard an accounting standard.
- Accounting standards must be enforceable. I think that the Australian system of enforcing accounting standards could be improved. Ideally, disputes over accounting treatment should be resolved speedily and by experts, without the need to go to court. Judicial proceedings can be slow and this means that the market may be misinformed about a company's true financial situation for some time.
- I also believe that the obligation of auditors to be independent of the companies they audit should be unambiguously articulated in the Corporations Act itself. The independence of auditors is a matter of significant public interest and it is inappropriate to deal with it primarily through the ethical rules of professional bodies. Of course, the professional bodies should provide guidance to their members on independence. They have been and continue to do this. However, this guidance should not be the major source of the obligation to be independent. In this area self-regulation is not enough. The Corporations Act should clearly state that auditors should never enter into certain employment, financial and other relationships that threaten independence or the appearance of independence. It is also important to remember that our concern should not just be whether auditors actually are independent. In order to ensure market confidence, especially in the current environment, auditors should both be independent *and* appear independent.
- Finally, I note that we still need to educate some parts of corporate Australia to accept that, within the company, responsibility for the audit process should be clearly allocated to those who are not aligned with management. That is, responsibility for the audit process should lie

primarily with the board. When overseeing the audit process the board should clearly represent the interests of shareholders and be accountable to shareholders. I also note that we should ensure that the board is capable of managing the crucial relationship with the auditors. Capability in this context requires more than technical expertise. It requires more than directors who are financially literate. It requires directors who are given sufficient information and resources to manage the audit process.

ASIC is very pleased to see the Government is addressing these issues in CLERP 9, the latest instalment in the *Corporate Law Economic Reform Program*. We are certain that CLERP 9 will lead to the strengthening of the accounting and auditing framework in Australia.

Continuous disclosure

ASIC also considers that continuous disclosure plays an important part in corporate governance. There are clearly a number of justifications for continuous disclosure rules. One must be that, without continuous disclosure, shareholders and other market players would be less able to effectively supervise and control the conduct of those who control the corporation. In other words, continuous disclosure enhances accountability. Access to adequate, accurate and timely information on the activities of those in control of the corporation, whether it be through financial reports, continuous disclosure or analysts reports, is essential to the proper monitoring of those in control of the corporation and is, therefore, in ASIC's view, part of corporate governance.

Australia already has a strong continuous disclosure framework. However, it is important not to be complacent and, thus, again ASIC welcomes all moves to strengthen the existing system:

- We have supported the ASX's proposals to tighten up the regime by clarifying the obligations of companies to respond to credible rumours and speculation which are impacting on their share price, on the basis that, in such cases, the public interest requires the market to be as well informed as possible.
- We have also raised publicly the question of ASIC being given power to issue fines when companies fail to comply with their continuous disclosure obligations. This is a power which is available to a number of equivalent overseas regulators including the Financial Services Authority in the UK, the Securities Exchange Commission in the US, and equivalents in Hong Kong, Ontario, Saskatchewan, Greece, Korea, China and Poland. While currently we have both civil and criminal remedies available to us, we have been urging the government to give us additional fining powers because the existing remedies are expensive, time-consuming and disproportionate to the conduct. We believe that a power to impose administrative fines for contraventions of the continuous disclosure regime will improve flexibility, cost effectiveness and timeliness of remedies, and underpin the integrity of

the law by providing a proportionate remedy for conduct that may not otherwise be addressed. A power to fine is an important remedy particularly for late or inadequate disclosure, where existing remedies are ineffective or overly complex. In light of this, ASIC particularly welcomes the government's proposal, in CLERP 9, that ASIC be given the power to impose financial penalties and issue infringements notices in relation to contraventions of the continuous disclosure regime.

Now that I have outlined ASIC's definition of corporate governance – and along the way suggested some areas for reform - you can see why we consider ourselves to have an important role in corporate governance and why the theme of our latest Annual Report is "tackling ethics and governance". All these areas – directors duties, corporate meetings, auditors, financial reporting, continuous disclosure - fall within our field of responsibility.

What is ASIC's role in corporate governance?

So what exactly is our role in corporate governance? What do we do on a daily basis to improve corporate governance in Australia?

Essentially, ASIC's role in corporate governance is threefold:

1. ASIC monitors, enforces and administers compliance with the broad range of corporate governance provisions in the Corporations Act;
2. ASIC has a public education or advocacy role; and
3. ASIC contributes to law reform in relation to corporate governance

1. Enforcement

ASIC is responsible for enforcing the many corporate governance provisions in the Corporations Act. We monitor compliance with these provisions of the Act and, where appropriate, we initiate enforcement proceedings for breaches of these provisions.

Depending on the provision, a breach may give rise to criminal or civil sanctions. ASIC cannot actually bring criminal proceedings itself. It conducts the investigation into potential criminal breaches, prepares a brief and then refers the matter to the Commonwealth Director of Public Prosecution.

This aspect of ASIC's corporate governance role has kept it very busy in recent times.

Some of the major enforcement actions in the past year include:

- HIH – ASIC brought civil penalty proceedings against former HIH directors Rodney Adler, Ray Williams and Dominic Fodera. All were found to have breached their duties as directors under the Corporations

Act. Adler and Williams were banned from being involved in company management for terms of 20 years and 10 years respectively. They were held jointly liable to pay compensation of more than $7 million. And the court imposed substantial pecuniary penalties in each case.

- Harris Scarfe - We were also successful in prosecuting Alan Hodgson, chief financial officer of Harris Scarfe, and have laid charges against Daniel McLaughlin, the former chief operating officer of Harris Scarfe Holdings Ltd and director of Harris Scarfe Ltd.
- One-Tel – Civil penalty proceedings have been commenced against former executive directors seeking remedies of banning, fining and compensation. ASIC is seeking compensation in excess of $75 million.
- NRMA – ASIC brought an action against Nicholas Whitlam, the Chairman of NRMA. The court found that his conduct at the general meeting was such that he breached his duties as Chairman and director.
- Additionally, as you would be aware ASIC has very recently approached Justice Windeyer seeking orders about the timing of NRMA Limited's requisitioned Special General Meeting and its Annual General Meeting.

However, I would like to stress that our enforcement is not limited to these high profile matters. Last financial year:

- ASIC investigations resulted in 19 criminals being jailed and another 23 convicted from briefs prosecuted by the DPP. 11 of those who were jailed were company directors.
- ASIC took 81 civil proceedings, resulting in orders against 140 people or companies, $65 million in recoveries and compensation orders and $45 million frozen assets
- 20 people were banned from managing corporations as a result of ASIC enforcement action; and
- 10 company auditors and liquidators were disciplined for misconduct as a result of ASIC enforcement action.

I think it is important to note that all this enforcement action does more than target individuals who have breached the law. It has an education and market confidence impact.

It reminds directors and others in corporate management of their responsibilities and the liabilities that attach to failure to fulfil those responsibilities.

It also instils confidence in those who participate in the market. Investor confidence is enhanced if investors know that an independent regulator will take action against the most egregious wrongdoers. Many investors can and do look after themselves and, in fact, ASIC encourages investors, and other corporate players, to take advantage of the mechanisms the law gives them to protect their

own interests. Moreover, I think that some corporate disputes are more appropriately dealt with by the internal parties to the disputes, rather than by ASIC using public funds. This is especially the case where those internal parties are well resourced and informed. However, for a variety of reasons, some investors are not in a position to protect their own interests. These investors are reliant on ASIC's enforcement role. Moreover, everyone feels better if there is an independent umpire enforcing the rules of the game.

Our corporate governance enforcement activities are not related solely to judicial proceedings. Investigation or monitoring is clearly an important prelude to any judicial proceedings. However, we think the investigation itself can have a market impact.

For example, you would be aware of our accounting surveillance project. It targets the types of accounting abuses uncovered recently in the USA – improper capitalisation of expenses; wrongful recognition of revenue; non-consolidation of controlled entities. We are monitoring these aspects of financial reports, not because we believe these problems are widespread in Australia and not because we expect to see a spate of judicial proceedings result from our monitoring, but because of the importance of ensuring public confidence in our financial reporting standards. Newspaper reports suggest the project is having a public impact, on the approaches of both boards and auditors to company accounts. We see this as a positive development, particularly if it causes boards and auditors to review overly aggressive accounting practices which colour the reporting of the true financial position of a company. This project demonstrates that active monitoring can affect behaviour, even in the absence of enforcement proceedings.

We have also been proactive during the last 18 months in monitoring compliance with continuous disclosure obligations by so-called new economy companies. Our recent acceptance (on 17 October 2002) of an enforceable undertaking from Uecomm Ltd requiring the company to review its internal procedures for ensuring compliance with its continuous disclosure obligations, and to have those procedures independently audited by a senior member of the corporate finance industry, is an example of this.

Having said that ASIC's corporate governance enforcement role has kept us busy over the last year, I would like to stress that nevertheless, it has been, and remains ASIC's view that there is no systemic breakdown of corporate governance in Australia. Tentatively, I query whether the same could be said about the US earlier this year. We believe that the Australian environment is due in no small part to the responsibility and restraint exhibited in the main by Australian business leaders, by the maintenance of the legislative scheme at world best practice by the Government's CLERP programme, and by, we consider, continuing vigilance of the regulator. While there has been some domestic investor concern, essentially Australia's economic and regulatory structure has remained strong.

2. Public education/advocacy role

The second aspect of ASIC's corporate governance role is its public education or advocacy role. This could be described as the "finger-wagging" role. This role is much harder to describe than the enforcement role but it clearly exists. It is evidenced by ASIC speeches and public statements about matters relevant to corporate governance.

For example,

- The Chairman made a speech on corporate governance in July 2002. This speech attracted significant press coverage and generated extensive debate about matters relevant to Australian corporate governance practices. This sort of debate is essential to the development and evolution of Australian corporate governance practices and laws.
- The Commission also makes public statements about matters relevant to corporate governance generally. For example, ASIC has publicly stated its concerns when major listed companies in Australia appear to have adopted a technical and narrow approach to their continuous disclosure obligations, and pointed out that, despite the fact that there was an arguable case that the company had breached the ASX continuous disclosure rules, there appeared to be no effective remedy available to ASIC under the Corporations Act.

The public advocacy aspect of our role is related to our enforcement role. Through our monitoring and enforcement activities we frequently uncover matters, such as systemic abuses, or systemic misunderstandings of the law, which we consider we should make public. In some circumstances, a public statement can have a more widespread and immediate impact on behaviour than enforcement action.

3. Law reform

ASIC also advocates, comments on and contributes to proposals to amend the corporate governance provisions of the Act. This is an important, often less visible, contribution to corporate governance in Australia.

Once again, this aspect of our role is closely related to our enforcement role. We consider that our monitoring of Australian corporate practice and other enforcement activities put us in a position to make a valuable contribution to law reform. We know how the market operates and what impact suggested reforms may have. We know which parts of Australian law are not working and what changes need to be made to achieve the desired outcomes.

I am not suggesting that ASIC is the holder of all law-reform wisdom. Obviously, many parties can contribute to law reform in the corporate area. The government recognises this and consults widely on its CLERP and other reforms. Many

stakeholders make valuable contributions to the law reform process. ASIC is one of the relevant stakeholders and we think we can contribute a unique and valuable perspective.

Conclusion

I have said that it has been, and remains, ASIC's view that there is no systemic breakdown of corporate governance in Australia. On the other hand, I think it is important that we not be complacent. We should not spend our time congratulating ourselves that Enron did not happen here. Instead, we should be continually alive to ways of improving our system. We should not mimic the recent legislative and other corporate governance developments in the United States. However, we should monitor them and the reform proposals in other jurisdictions, such as the United Kingdom and Canada, to see what we can learn and what ideas can be beneficially adapted and adopted for Australia.

It is somewhat ironic to note that, until relatively recently, the topic of maintaining standards of corporate governance appears to have been unfashionable in many areas. During the mid 1990s for example, in academic circles, which seek to cater to the educational needs of the business community, it was something of a non-issue. Complacency had, I think, set in.

The amount of media interest, increases in shareholder activism, responses by corporate Australia to deal with practices clearly considered undesirable and, in fact, conferences such as this, indicate that corporate governance is well and truly back on the wider public agenda. That is a good thing.

Of course from the regulator's perspective, corporate governance and related issues have never been off the agenda. ASIC as corporate regulator has always monitored, and continues to monitor, conduct in the corporate arena. ASIC's mandate as corporate regulator includes maintaining and improving the performance of the financial system, and promoting the confident and informed participation of investors and consumers. No one can doubt that we take performance of our charter seriously.

Thank you.