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Australian Securities & Investments Commission

Current corporate governance issues
An ASIC perspective

A speech by ASIC Commissioner, Prof Berna Collier, to the Northern Territory Chapter of the Business & Professional Women's Association and the ASIC Women's Network, Darwin, Northern Territory, 19 September 2003

I am very pleased to address this function, which is part of the ' Women of Influence Series' here in Darwin.

In preparing my address to this function, two preliminary thoughts sprang to mind. First – that it is only in recent times that women have been able to play a meaningful role in the workplace, and indeed have influence in that respect. I was looking at some statistics the other day and saw that

- it has only been since 1949 that single women have been allowed to work in clerical jobs;
- the marriage bar was only abolished in 1966, which is well within the life time of some of the people in this room (or am I just showing my age?);
- men only and women only jobs were only abolished in 1972; and
- even in government, workplace diversity has only been a policy since 1998.

So it is a pleasure to see so many talented women —and men for that matter — at a function like this.

The second thought that occurs is that functions like this are valuable and worthwhile as networking experiences. As time goes by it becomes clearer to me that ' networking' is a much underrated tool, and indeed, skill. I have come to very much appreciate its value — as a way of learning, of sharing ideas, and indeed making one's working environment more meaningful and potentially supportive. In ASIC, we have established an ASIC Women's Network to both

foster internal networking and to promote networking opportunities for women outside the agency. And so I congratulate the organisers for their initiative in not only networking within their own workplaces, but by seeking to extend their network by inviting you all along here today.

I have been asked to speak to you on a topic which is very important to the Australian Securities and Investments Commission — namely our perspective of a number of current corporate governance issues. This is something close to our hearts, but also of considerable complexity considering the multitude of developments in the community related to corporate governance. Indeed it is difficult to know where to start.

Perhaps one place to begin is to comment that as the corporate regulator, ASIC has been at the forefront of enforcing legal standards of corporate governance in this country. Our 2001-2002 Annual Report was themed 'Tackling ethics and governance', and I think that ASIC has certainly delivered very positive results in that area. (Incidentally, that Annual Report won a gold award for the third time — I can strongly recommend it as a good read). Our tackling of these issues has been particularly the case over the past two years in the light of the almost simultaneous large corporate collapses which occurred in this country and I am talking in particular of cases like Harris Scarfe, One.Tel and HIH. In Australia the ramifications of these collapses continue to echo in ways including

- in the determination of government to strengthen the financial reporting framework through such initiatives as CLERP 9;
- in the development of the Principles of Good Corporate Governance and Best Practice Recommendations by the ASX Corporate Governance Council; and
- in the vigilant pursuit by ASIC of those responsible. Our investigations into the collapse of Harris Scarfe have concluded - the CFO is in jail, the Chief Operating Officer has recently been committed to stand trial on criminal charges, and criminal charges have been laid against the former Executive Chairman. We have settled with Brad Keeling of One.Tel and been successful on an interlocutory matter against the former chairman of that company (I will come back to this later). And we were already in the process of taking further action in relation to HIH before we received the 56 referrals by Justice Owen in the HIH Royal Commission. We were allocated further funding by the Federal Government to take action in light of those referrals, and indeed we have established a taskforce of around 40 staff to do so. Even before the formal referrals however we had laid

criminal charges against Rodney Adler in relation to matters arising out of the collapse of HIH.

ASIC has had a number of wins in the courts during the past year on issues of corporate governance. We take enforcement action for many reasons including, obviously, to enforce the law, but also to obtain compensation for creditors where possible, and to send a clear message in appropriate circumstances to the market that egregious conduct will not be tolerated. However it is also notable that actions brought by ASIC will, in some cases, have the effect of clarifying the law. For instance, the decision by Justice Austin of the New South Wales Supreme Court in relation to the application by John Greaves, the former Chairman of One.Tel, was in our view a landmark decision affecting the legal responsibilities of company Chairs. While the case is not yet over, and indeed it is likely that the trials will not take place until 2004, we believe that the results of the case will raise – and indeed have raised – corporate governance standards in this country. To refresh your memories, we argued that the responsibilities of Chairs included such things as

- the general performance of the Board
- the flow of financial information to the Board
- the establishment and maintenance of systems for information flow to the Board
- the public announcement of information
- the maintenance of cash reserves and corporate solvency and
- making recommendations to the Board as to prudent management of the company.

Justice Austin concluded that ASIC had made out a reasonably arguable case, and that therefore the matter should go to trial. There is no doubt that this result, while interim, has had the effect of acknowledging that the Chair of a company does have special responsibilities, and, potential liabilities. In my view this makes sense, and was in fact a case of the law catching up with reality.

Another recent success of ASIC in the courts was in relation to Water Wheel, where on 5 May Justice Mandie of the Supreme Court of Victoria found for ASIC in our civil penalty action against directors Bernard Plymin and John Elliott. (We had previously reached a settlement with the Chairman of the Board, William Harrison, who made full admissions). This case involved a claim of insolvent trading, which is notoriously difficult to prove as any insolvency practitioners in

the audience would appreciate. In our view insolvent trading by corporations is an issue which deserves to be treated seriously — it is damaging to creditors who may have been dealing with the company in good faith, and it is a breach by directors of their broader corporate obligations not to cause the company to engage in trading whilst the directors should have reasonably suspected that the company was insolvent. In this case we sought orders that the directors should be banned, as well as pecuniary penalties against each director and an order that they pay compensation for the benefit of the company's unsecured creditors (which in this case is approximately $1.428 million). This case has, we believe, sent an important message to the market.

I would like to point out, however, that in addition to these high profile cases ASIC takes on many other cases each year. Sometimes when I read about ASIC in the press I wonder whether we are in a no-win situation — when we are successful in a case involving people who are well known in the community we are accused of concentrating on 'tall poppies', but when we are successful with lesser-known matters, we are accused of 'being afraid to take on the big end of town'. The fact is that we take on cases where appropriate. Over the past three years we have had over 140 criminal convictions, and successfully completed over 350 civil and civil penalty cases.

I would now like to turn to two issues which are of particular relevance to corporate governance issues, and in which ASIC has a particular interest.

The first is the ASX Corporate Governance Council ' Principles of Good Corporate Governance and Best Practice Recommendations' , which I mentioned before. We are pleased that the Council has developed these Principles, and encourage corporate Australia to support them. It is interesting however to hear criticism of these Principles and the associated Recommendations in the business community. One criticism in particular which interests me is what I saw described by an Australian Financial Review journalist as 'a fear that the gene pool of suitably qualified directors here is not broad enough for the bar to be raised too high.' I have also seen this issue described as a claim that the Australian director market is ' too thin.' Curiously this claim has also been reflected in the USA, obviously a much bigger market than Australia, where there are fears that there will be what I saw described as ' a severe shortage of qualified people willing to serve as directors.'

These claims relate primarily to Principle 2 and its associated recommendations, in particular

- Recommendations 2.1 : a majority of the board should be independent directors, and
- Recommendation 2.2 : the chairperson should be an independent director.

Further, Recommendation 4.2 is that the board should establish an audit committee, and Recommendation 4.3 is that the audit committee consist of only non-executive directors, a majority of independent directors, an independent chairperson who is not chairperson of the board, and at least three members.

For the purposes of the Principles, an ' independent director' is defined by Box 2.1 as being a non-executive director who, among other things, is not a substantial shareholder; has not been employed in an executive capacity within the last three years; and has not been a principal of a material professional adviser or a material consultant to the company within the last three years.

Recommendation 2.1 appears to assume that a person is either independent or not *as a general rule* – directors considered by the board to be independent are required to be identified as such in the corporate governance section of the annual report. This is inconsistent with another suggestion which has been put to me – that is, that the Principles can be satisfied by corporations having directors who are ' independent' *in defined circumstances*. An example which has been put to me, and frankly about which I have doubts, is the case of a lawyer who is a partner of the firm used by the company, and is also a director of the company. In one discussion I have had, the suggestion was put to me that the lawyer was ' independent' unless the board was making decisions which impacted on the company's relationship with the firm. To my mind, the lawyer/director cannot be said to be ' independent' in terms of Box 2.1, even if the director is participating in a decision which has no impact on the company's relationship with the legal firm.

And so, according to some sections of the community, one allegedly insurmountable stumbling block to recruiting suitable non-executive directors is the lack of suitable ' talent' in the community. I cannot help but wonder however whether this is a reaction to a perceived threat to the status quo rather than a genuine concern. Frankly, without thinking too hard I can bring to mind of a number of people who would be not only willing to act as a non-executive director, for a reasonable fee, and who would not only work hard, but could bring valuable skills and an independent eye to board deliberations. So, for example, a woman who is a lawyer and currently on a number of boards of privatised entities; a man who has engineering, legal and a business background; a woman who has an accounting background and is on the both cultural and government boards; a

man who is a legal financial services wizard and does charity work; a woman who has an IT background and now how has high-level hands-on experience in a rural industry. In addition to these backgrounds, these people also all have an in depth knowledge of corporate governance principles. I would be very interested what ' talents' make up the ideal director of a listed company. One list of skills I saw recently in the press suggested by a professional director – i.e. to be of good character and business standing, to bring to the board table experience in one of the company's business areas, or skills in areas such as finance or law, or a network of contacts which could be of use to the company – strike me as being characteristic of many potential candidates for directors' positions, and in the realm of achievable in many cases.

I would also be very interested to see more genuine attempts made to marry corporations which will be in need of independent directors, with individuals who have the skills and interest in doing so. To my mind this necessity goes beyond the realm of headhunters. I was very pleased to see a recent initiative by the Australian Institute of Company Directors in establishing its register of directors, and I wish them well in this regard.

The ASX has forecast that, in cases of non-compliance with the Principles by listed companies, it would in certain cases be prepared to refer matters to ASIC. The circumstances in which this would occur remain to be seen – it would be unfortunate however to say the least if non-compliance was due to inertia and resistance to change.

The second issue I want to raise is the issue of executive remuneration. There is no doubt that this is a hot topic. There have been recent outcries in relation to what is perceived to be excessive remuneration paid, especially to outgoing CEO's of failed corporations. In Australia, although there have been a number of high profile recent examples (but for various reasons I would prefer not go to there today), to pick a safe example one need look no further than the community outrage accompanying the ' bonuses' paid to the joint managing directors of One.Tel despite the company's fortunes being in tatters. This has also been a big issue in, for example, the UK, where earlier this year a Bill was circulating proposing that so-called ' hefty pay-offs to 'fat cat' executives' be banned.

There appears to have been a hardening of attitudes on this issue since the beginning of the year. This is evident in such developments as :

- Views expressed by the ASX, not only to the effect that entering employment agreements with key executives or those obligations falling due may trigger a continuous disclosure obligation under Listing Rule 3.1

(which in turn is enforceable under the *Corporations Act*), but in the form of guidelines as to the form in which disclosure of remuneration should take place (note, for example Box 9.1 in the Principles)

- A recommendation by Justice Neville Owen in the HIH Royal Commission Report to the effect that the relevant accounting standards and the ASX Listing Rules that relate to directors' remuneration be reviewed as a matter or priority, to ensure a clear and comprehensive disclosure of all remuneration or other benefits paid to the directors in any form
- Comments by Senator Campbell in March this year that the Government is considering new legislation in relation to disclosure of executive remuneration, with ASIC being given power to enforce such disclosure. If this does emerge, the CLERP 9 legislation is a likely candidate.

Last year ASIC's Chairman David Knott observed that 'the question of options as part of executive remuneration has also become increasingly controversial and is part of the governance jigsaw that must be resolved,' and further that 'the disproportionate inclusion of options in a CEO's remuneration package is an affront to the general body of shareholders and to principles of good governance. All developed countries should support urgent adoption of international accounting standards to expense such options in company accounts.'

I would also make the point that frequently the situation boils down to an issue of disclosure to shareholders. If shareholders are prepared to support what could be considered to be a lucrative remuneration package for a director, CEO or other executive, so be it. The problem however is that it appears that often the nature of these packages are hidden, only to be revealed at the time of payout.

Options for directors and executives are clearly an issue of some controversy, to say the least if one recalls the circumstances of the WorldCom collapse last year. Valuation of options has, in Australia, been an area of dispute – on 30 June this year ASIC issued a media release containing guidelines as to *how* listed Australian companies should include values of options in disclosures of directors' and executive officers' emoluments in their annual directors' reports and financial reports for years ending on or after 30 June 2003. Section 300A *Corporations Act* requires the annual directors' report in the case of listed companies to include details of the nature and amount of each element of the emolument of each director, and each of the 5 named officers of the company receiving the highest emolument. We take the view in our Practice Note 68 that ' emolument' includes options.

These guidelines deal with the valuation methods to be applied and when to recognise option values for this purpose. The guidelines draw on the International Accounting Standards Board's exposure draft ED 2 ' Share Based Payment' (' ED 2'), which provides an appropriate basis for valuing and recognising options for this purpose (and which has been issued by the AASB as Exposure Draft ED 108).

ED 2 provides clear guidelines on the types of option valuation models that can be applied. In the case of listed companies, exchange-traded options should be valued at their market price at the grant date, or in the case of other types of options, by a valuation method that meets the requirements of ED 2. In the second case, the method chosen would be disclosed in the directors' report. ASIC considers that these models can be applied to value all types of options granted to directors and executive officers.

The guidelines do not deal with the expensing of options or other share based payments in the financial statements. However, all entities preparing financial reports under the Act are encouraged to apply the guidelines in this release in determining remuneration of directors and executive officers for disclosure in their annual financial statements in accordance with accounting standards.

I won't discuss the detail of the guidelines much more at this point. I suggest that you look at them in conjunction with ED 2. Perhaps a few additional peripheral points however :

- We have stated publicly that we will be reviewing compliance with these guidelines in our surveillance of financial reports and directors' reports of listed companies for the year ending 30 June 2003. Companies which fail to disclose the value of emoluments relating to options granted should expect ASIC attention.
- As I have already said, the guidelines pick up what is in the international exposure draft. The ED itself does not prescribe valuation to the ' nth' degree — rather the parameters outlined provide the appropriate basis for disclosure, and within those guidelines companies are able to choose a detailed calculation which produces a permissible result. I understand that we have had good feedback from the Big 4 firms on this point.
- We see our guidelines as an interim measure to clarify the requirements of section 300A, pending acceptance of the standard by the IASB. Further, I understand that Treasury may be looking at more specific guidance for companies in CLERP 9. In the meantime however we consider it

important to provide some degree of certainty in respect of director and executive disclosure. This is a topical issue, and one justifying the regulator's attention.

Our actions in relation to valuation of options go some of the way towards addressing issues which have arisen in relation to executive remuneration. At the end of the day however, accurate and timely disclosure of information to the market is critical. The ASX has already taken steps in this direction, and it appears likely that government will be doing the same.

Conclusion

As I indicated at the beginning of this presentation, corporate governance issues are a key area of concern for the agency.

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, gatherings 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. It is clear from our outcomes in court, both criminal and civil, and from our contributions to discussion, debate, and proposed legislation, that we take our charter seriously.

Thank you

