



ASIC

Australian Securities & Investments Commission

Directors' Responsibilities: The reality vs the myths

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Introduction

- Directors are expected to meet an increasing range of obligations amidst commercial and legal expectations of their actions.

- All of us are fully aware that your responsibilities as directors extend well beyond legal duties alone.
 - The legal obligations imposed on directors underpin good corporate governance practices.
 - However, these need to be balanced with commercial realities so that directors can make good business decisions and, as a result, drive the maintenance of reputable Australian financial markets.
 - Meeting both commercial and legal expectations impacts more broadly on the rights and interests of stakeholders, which include, but are not limited to, shareholders.

- Your conscientious approach to obligations and duties as directors extend to both the commercial and legal perspectives.

- As the corporate regulator, ASIC takes your obligations seriously. We are responsible for enforcing the laws of the Commonwealth, which include directors' duties in the *Corporations Act*, but we are also responsible for facilitating the performance of the financial system and entities within it, as well as promoting the confident and informed participation of investors and consumers in that system.

- Today, I would like to discuss:
 - the dynamic regulatory environment in which you need to fulfil your responsibilities as directors, including the commercial expectations placed upon you in this environment;
 - ASIC's regulatory approach in relation to the *legal* obligations of directors; and
 - the need for you to stay abreast of current and future developments to continue to properly meet your responsibilities as directors.

The environment

- The regulatory environment for directors is evolving.

- In past times, I might have stood here and talked solely about your need to comply with the law and, specifically, our collective expectation that you would comply with your legal obligations as directors.

- However, while this approach puts on the table what is and is not expected of you as directors from a legal perspective, in our view, it is no longer realistic to focus solely on the legalities.

- Adopting this narrow view of your responsibilities as directors poorly reflects the commercial reality in which you are, in fact, required to act.

- Today, I would like to discuss the issue of directors' responsibilities from what I see as a more realistic starting point.
 - This includes the increasing commercial pressures and expectations placed upon you, of which your legal obligations are but one aspect.

Commercial expectations of directors

- As directors, you are generally expected, in the ultimate test, to drive the bottom line and provide appropriate shareholder returns.

- In our view, this involves, among other things:
 - achieving the efficient conduct of your business;
 - setting strategy that management can work towards;
 - safeguarding the assets of the company to whom you are responsible; and
 - providing an environment where instances of material fraud and error are not present, including by sitting on various Board committees (such as audit committees).

- Today, many of you have also been challenged to embrace triple bottom line reporting and consider the economic, social and environmental ramifications of your corporate activities.
- These objectives are entirely appropriate.
 - Their pursuit generates sustainable growth and opportunities for expansion and, in turn, increased occasion to enhance the dollar value attributed to assets such as goodwill.
 - It can also enhance corporate reputation and, as a result, drive the wellbeing of the Australian economy and market confidence, in turn, keeping the cost of capital competitive.
- How you choose to address these commercial expectations and pursue these objectives is a matter for you, your boards and the companies that you serve.
 - This is not an area that ASIC ventures into.
- However, your broader responsibility as directors is to balance the commercial expectations placed upon you with the need for you to comply with the law.
 - This is where ASIC steps in.
 - ASIC expects that you should pursue the commercial objectives of the company to whom you are responsible in a manner consistent with meeting your legal obligations.
 - The ramifications of our area of focus for you as directors are twofold:
 - first, you need to be satisfied that management is ensuring the company for which you are responsible is meeting all of its legal obligations; and
 - second, you need to meet the specific legal obligations that are attached to your privileged positions as directors of companies.
- I accept that many directors would consider that this is no easy task.

- Given the influx of regulation over the last 10 years or so, particularly in the financial services industry, the regulatory burden, complexity and perception of increased risk of personal liability for directors has resulted in many directors being concerned about whether they are fulfilling their obligations.
- This has led to a range of risk-averse behaviour in the market.
- It is true that many of the standards expected of you have been raised in recent times amidst heightened community expectations following corporate collapses¹.
 - Given your responsibilities to stakeholders (including shareholders), you cannot take a minimalist approach when carrying out your corporate duties.
- The remainder of my address today, therefore, will focus on ASIC's regulatory approach to directors' responsibilities and how you can better meet your obligations both now and in the future.

ASIC's regulatory approach

- ASIC's starting premise is that we expect you to comply with the law.
- There are five foundation responsibilities for directors, which I am sure are well understood by this audience, but that we expect you to comply with. They are to:
 - comply with the statutory duty of due care and diligence – that is, that you will discharge your duties with the degree of care and diligence that a reasonable person would exercise if they were a director of the company in the company's circumstances and occupied the office held by and had the same responsibilities within the company as the director;
 - exercise your powers and discharge your duties in good faith in the best interests of the company and for a proper purpose²;

¹ See also Austin J in *ASIC v Rich & Ors* (2003) 44 ASCR 341: 'It is now commonplace to observe that the standard of care expected of company directors, both by the common law, and under statutory provisions, has been raised over the last century or so'.

- not improperly use your position to gain advantage for yourselves or someone else or cause detriment to the company³;
 - not improperly use information you obtain as a director to gain an advantage for yourself or someone else or cause detriment to the company⁴;
 - disclose to other directors any material personal interest in a transaction⁵.
- We accept that the vast majority of business in Australia is undertaken legitimately, with directors complying with these obligations.
- ASIC will not intervene in such circumstances, despite some perceptions that we are lurking under every boardroom table.
 - We do not take enforcement action against those who make honest and reasonable efforts to comply with their legal duties as directors.
- Indeed, our record shows that we have not, and do not, take action on trivial issues.
- But we remain vigilant and will take strong action where that action is warranted.
- To do so, we have a range of regulatory responses at our disposal where directors breach their duties.
- We can commence civil penalty proceedings or alternatively, criminal proceedings where recklessness or intentional dishonesty is apparent.
 - Alternatively, we can take administrative action, for example, banning directors, where a particular situation warrants such an approach. In 2005–06, we had 44 people removed from directing companies for a total of 195 years.
- Part of our role in deciding which route to take is properly managing the community's reasonable expectations.

² Corporations Act 2001 (Cth), s181.

³ Corporations Act 2001 (Cth), s182.

⁴ Corporations Act 2001 (Cth), s183.

⁵ Corporations Act 2001 (Cth), s191.

- Community expectations appear to desire strong punishment, as we saw when we commenced civil penalty proceedings against Steve Vizard last year⁶.
- Where recklessness or intentional dishonesty is involved and we have enough evidence to mount criminal proceedings, we will refer the matter to the Commonwealth Director of Public Prosecutions for prosecution.
 - Let me reflect for a moment on the threshold for recklessness, which, of course, is distinguishable from carelessness or negligence.
 - In our view, you will be reckless where you are aware of substantial risk that a transaction is not for a proper purpose or to be entered into in good faith or not otherwise justifiable, but you are determined to proceed indifferent to the consequences.
 - Clearly, you cannot act in this manner and our enforcement actions to date have shown this.
- I would like to quickly reflect on a range of recent cases involving HIH, One.Tel and GIO to provide a perspective on the types of behaviours that we expect you to avoid in your capacity as executive or non-executive directors, including as Chairmen.
 - The corollary of this, of course, is that these cases set out guidance on what we expect of you in these privileged positions. And let me reiterate the comments made by Justice Kirby discussed in *Rich v ASIC*⁷ that being a director *is a 'privilege to be earned each day[, which]...may be withdrawn for misconduct but also for incompetent, improper or lax activities in the functions of corporate management'*.

Executive Directors

- Mr Williams, who was as an executive director and CEO of HIH Insurance Limited, pleaded guilty to recklessly failing to exercise his

⁶ *ASIC v Vizard* (2005) 54 ACSR 394.

⁷ *Rich v ASIC* [2004] HCA 42 (9 September 2004) (emphasis added).

powers and discharging his duties for a proper purpose⁸. In this case, Mr Williams signed a letter from HIH to FAI Insurance Limited Noteholders, which was misleading.

- Mr Cassidy, as an executive director and Managing Director of HIH Insurance Limited, pleaded guilty to criminal charges that he was reckless and failed to properly exercise his powers and discharge his duties for a proper purpose in signing a series of backdated documents concerning a subscription by HIH for shares in FAI, including minutes of a meeting of directors and a share certificate⁹.

- Earlier this month, court orders were made against Messrs Vines, Robertson and Fox, three former executive directors of GIO Insurance Limited.
 - The decisions related to their conduct during the course of AMP Insurance's 1998–99 takeover bid for GIO Australia.
 - The Court found that the defendants had breached their duty to act with reasonable care and diligence on occasions in this period.
 - Among other things, Messrs Vines and Robertson failed to ensure the due diligence committee was properly informed about the true potential effect of claims flowing from Hurricane Georges on the profit forecast contained in the takeover documentation, while Mr Fox failed to ensure the auditors were properly informed.
 - Additionally, Mr Fox was found to have breached his duty to act honestly in entering into an agreement that was not in the best interests of the company.

Non-Executive Directors

- Mr Adler, as a non-executive director of HIH Insurance Limited, pleaded guilty to being intentionally dishonest and failing to discharge his duties as a director of HIH in good faith and in the best interests of that company¹⁰. In this case, Mr Adler had put his personal interests

⁸ *R v Raymond Reginald Williams* (2005) 216 ALR 113.

⁹ *R v Terence Kevin Cassidy* [2005] NSWSC 410 (Unreported).

¹⁰ *R v Rodney Stephen Adler* (2005) 53 ACSR 471.

ahead of HIH's when seeking approval for an investment at a board meeting without providing information about the adverse financial position of the investment.

- Possibly the case that has provoked the most discussion about directors' responsibilities is that of Mr Greaves, the non-executive Chairman of One.Tel.
 - Mr Greaves was the subject of civil penalty proceedings in which ASIC alleged he had breached his duty to exercise the standards of care and diligence required by the law of a company Chairman.
 - Justice White, in the course of considering the approval of the settlement by Mr Greaves with ASIC, found that the statutory duty of care and diligence of Chairmen of listed public companies involves more specific duties¹¹.
 - Specifically, the higher duties of a Chairman could include taking reasonable steps to ensure that the Chairman themselves and other members of the Board:
 - monitor the management of the company, properly assess its financial position and performance, and properly and promptly detect and assess any material adverse development affecting its financial position or performance; and
 - are informed of all material financial information to enable them to carry out their obligations to ensure that the material financial information includes information, which reveals the adequacy of the cash reserves within the company, the actual financial position and performance of the company and key events or transactions that affected the financial position or performance.

Lessons learned

- These cases set out some important guidance for many of you in complying with your legal obligations as directors.

¹¹ *ASIC v Rich & Ors* (2003) 44 ACSR 341.

- They cover the field in terms of breaches of directors' duties involving, for example, issues as wide as conflicts of interest, improper purpose, recklessness and dishonesty.
- More broadly, the cases reflect our broader strategic intentions as a regulator to strengthen the integrity of Australian corporations through influencing your behaviour as directors undertaking corporate activity.
- You can take the lessons from these cases to enhance your own contributions to corporate activity, including:
 - ensuring company financial reports and audits are reliable;
 - acting against corporate fraud, breach of continuous disclosure and misconduct by other directors and officers;
 - pursuing and achieving corporate compliance;
 - encouraging directors and officers of financially troubled corporations to act promptly;
 - ensuring you have read and properly understood documentation upon which you are asked to make a decision, or which you are asked to execute; and
 - asking questions of management when documentation presented to you is not readily comprehensible or, by reason of your past knowledge and experience, questions arise as to the veracity of the decision you are asked to take.
 - This final point includes your duty as directors to make further enquiries when appropriate so that you are able to come to independent views on matters¹² and not merely act as a 'rubber stamp' on decisions that have wider ramifications.
- I would like to pause for a moment to reflect on directors' responsibilities regarding information provided to boards, including company financial reports.
 - Justice Austin, in the case involving the former GIO directors, recognised '...the fundamental importance of senior executives

¹² *Corporations Act 2001 (Cth)*, s189. See also *Daniels v Anderson* (1995) NSWLR 438.

providing their boards with all information they have that is material to the board's decisions...¹³.

- This cannot be overemphasised in the case of company financial reports.
 - These reports must comply with relevant accounting standards and represent a true and fair view of the company's financial position and performance, which will, inevitably, form the basis of decisions made by you as directors on boards.
 - The reliability and accuracy of financial reports, therefore, is vital to allowing you to carry out your directors' duties to the best of your ability and within the proper functioning of good corporate governance practices within your company.
 - In turn, the orderly conduct of financial markets is promoted.
 - Chief Justice Wood recognised these second-order effects the Crown's case against Mr Williams, where he said that the Annual Report is a most important document from which prospective and existing shareholders glean information about its current financial state and prospects. Chief Justice Wood went on to say:

'...a failure to properly discharge the duties owed in respect of the preparation and release of annual reports [which, of course, includes your role as directors signing off on those reports,] involves serious criminality, which risks undermining the public confidence in published accounts, that is essential for the orderly conduct of financial markets'¹⁴.
- The other issue that I would like to discuss briefly is the standards expected of *individual* board members.
 - In the Greaves case, the Court alluded to a 'higher' standard for particular board members based on their individual board position and responsibilities.
 - ASIC led evidence in this case that Mr Greaves' responsibilities were 'above and beyond' those of other directors by virtue of his position within the company and the mitigating circumstances. These included his positions as Chairman for an aggregate period of over four years and Chairman of the company's finance and audit

¹³ *ASIC v Vines* [2006] NSWSC760.

¹⁴ *R v Williams* [2005] NSWSC 315 (15 April 2005).

committee for eight months, as well as his extensive professional financial experience.

- Expert evidence presented to the Court by public company Chairmen and members of the corporate community supported this contention.
- I see no reason to waver on this point.

Facing the future

- Of course, we acknowledge that the regulatory settings in which you discharge your responsibilities as directors will not stand still.
 - Since the collapse of HIH Insurance Limited and the establishment of the Special Commission of Inquiry to report on the circumstances in which the Medical Research and Compensation Foundation established by the James Hardie Group had an estimated \$1.5 billion deficiency to meet asbestos related claims, public expectations have driven an increased focus on corporate governance requirements and directors' duties.
 - Developments in these areas have also been influenced by the most egregious examples of corporate governance and behaviour.
 - CLERP 9, for example, which has been in effect for just over a year, has enhanced continuous disclosure obligations and set out requirements for auditor independence.
- Today, I would like to focus on two areas currently being considered for reform.
- The Parliamentary Secretary to the Treasurer this week announced progress towards a simpler regulatory system, including a possible expansion of the business judgment rule.
 - Currently, directors meet their statutory duty of care and diligence where they:
 - make 'business judgments' in good faith for a proper purpose and in the absence of a material personal interest;

- inform themselves about the subject matter to the extent they reasonably believe to be appropriate; and
 - rationally believe the judgment is in the best interests of the company.
- The Government has now outlined for discussion a general protection for directors, which will excuse them from liability where they act:
- in a bona fide manner;
 - within the scope of the company's business;
 - reasonably and incidentally to the company's business; and
 - for the company's benefit.
- The second area of reform comes from work by the Corporations and Markets Advisory Committee, which is looking at whether a range of directors' duties should be expanded to apply to people below board level who take part in, or are concerned with, the management of the company, or otherwise act for or on behalf of the company.
- The Committee is also considering a proposal for broadening directors' duties to include corporate social responsibilities or explicit obligations to take into account the interests of stakeholders other than shareholders.
- We are yet to see the Government's full and final responses to this reform agenda.
- However, these issues will feature in debates on the evolution of directors' responsibilities and I look forward to an informed and constructive discussion, one to which ASIC will contribute.

Concluding comments

- To conclude today, I would like to emphasise the privilege that each of you has as a director of an Australian company.
- Companies are the lifeblood of the Australian economy and drivers of a high performing financial system with strong participation from

investors and consumers and flow-on effects for the rest of the Australian community.

- At the same time, I urge you to reflect on the themes discussed today.
 - While the issues you face as directors are often finely balanced, form your own views and probe deeper where you need to if you are going to make a genuinely informed decision.
 - I trust that you will each continue to undertake your duties as directors in accordance with the law and have no doubt that if you adopt a common-sense approach, acting with honesty and the utmost integrity, you will meet the reasonable expectations of stakeholders beyond shareholders alone and contribute to the sustainability of the Australian economy.

- I wish you every success in facing the challenges of your directorships.