ASIC

Australian Securities & Investments Commission

Monash Governance Research Unit
Inaugural Lecture

by
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CORPORATE GOVERNANCE – PRINCIPLES, PROMOTION AND PRACTICE

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Chancellor Ellis, Distinguished Guests, Ladies and Gentlemen.

It is a privilege for me to present this Inaugural Lecture for the Monash Governance Research Unit.

I congratulate all those involved in the formation of the Unit. It is an important initiative – one that might, in the current climate, be called well-timed and topical, but one that I think is in fact of enduring relevance as I hope to demonstrate this evening.

I note that the Governance Research Unit has four objectives:

- Promoting and coordinating the study of governance;
- Studying public governance;
- Studying corporate governance; and
- Studying institution building.

I will this evening limit myself to some observations concerning the third of those objectives; that is, corporate governance.

To describe corporate governance as a subject of topical interest would be masterly understatement. What had already become a hot topic in Australia during 2001 has since burst out across the world, involving the direct intervention of the President of the United States. I'd say that Monash University has got its timing pretty right.

The interesting question is whether this initiative would have received any interest or support in Australia two years ago. There is little doubt that by the end of the 1990s the business community was becoming wearied by the concept of corporate governance, seeing it as somewhat irrelevant, even passé: a response to the no longer relevant excesses of the 1980s.

Many years of sustained economic growth, and Australia's remarkable survival of the financial crisis in Asia, had led to a period of complacency about corporate governance - over time it became institutionalised and compliance focused, more driven by process and legal liability management for corporate officers than by notions of shareholder protection and wealth creation.

In retrospect this self-confidence looks particularly short-sighted. At the very time when most of Asia, supported by the World Bank and the IMF, was focussed on the importance of corporate governance and institution building, the more developed economies (including Australia) assumed that their existing standards were adequate.

We were, I think, partly lulled by the knowledge that some of the key economic contributors to the 1980s' failures were absent. We did not have runaway inflation; excessive over-valuation of commercial property; or undisciplined bank lending practices – all of which contributed to the 1980s' bust. We had addressed some of the more offensive manipulations of the corporate structure that were so effectively utilized by the so-called 'entrepreneurs' of the 1980s. We also appeared to have cleaned out most of the cowboys – (assuming that we can discount the dotcom bubble as just another of our periodic flirtations with the high spec end of the market). So yes, it is quite true that we had done much throughout the 1990s to justify a sense of confidence.

What we underestimated, I think, were some quite pernicious and endemic factors at play – a new outbreak of management greed, the failure of Boards to put a brake on excessive and structurally unsound remuneration practices, and the many commercial pressures that influence management and Boards to focus on short term pay-offs.

These excesses were nurtured by one of the longest sustained periods of market prosperity in our experience. The chance to make big money quickly appears to have seduced not only corporate management, but also a range of market participants – with analysts and at least some auditors also foregoing their ethics in return for record level fees and commissions.

In some countries the prevailing preference of Governments for so-called 'light touch regulation' played its part in abetting a decline in standards of governance. In the United States an apparent lack of political will to tackle the issues until too late has raised serious questions about the relationship between business and Congress.

It is still too early to assess how widespread these abuses have become internationally. However, on the evidence to date, it is reasonable to conclude that they are more embedded in the United States than elsewhere. In Australia, while our business and professional sectors cannot claim complete innocence, it does appear that, with some notable exceptions, we have done better.

This is an important point to make.

There has been a tendency in recent weeks to assume that the worst excesses of American capitalism must be fully replicated in our domestic market. While we need to acknowledge that some of the structural imperfections are common to our economies (eg. in relation to audit and executive remuneration), it does not follow that the degree of excess or the decline in governance is as serious in Australia as in the USA.

I have no reason, for example, to believe that the types of accounting abuses uncovered in the USA – improper capitalisation of expenses; wrongful recognition of revenue; non-consolidation of controlled entities – are widespread in Australia. However, because of the importance of ensuring public confidence in our financial reporting standards, I announced last Friday details of a surveillance project which will target these areas. I am hopeful that it will prove to be a positive stocktake of general compliance by our listed company sector with the relevant accounting standards.

I do not mean by these comments to discount the prospect of further governance failures in Australian business. However, based on information currently available to ASIC, I assess as a far greater risk the prospect that our economy and investor confidence will suffer adverse contagion as a consequence of America's crisis.

Placing those relativities aside, the critical message from this experience is that human nature does not fundamentally improve merely by the passage of time. Motivations of financial gain and competitive advantage, given sufficient opportunity and a lack of adequate accountability, will almost inevitably result in business excess and abuse.

We therefore need to view good corporate governance not as a fad, or a mantra to be invoked when convenient; but rather as an essential and enduring component of any sound economic and regulatory system.

What is corporate governance?

So what is corporate governance? It is one of those concepts that most people instinctively understand, but many find difficult to quickly and simply articulate. There are, however, a number of definitions of the term; and a plethora of codes or guides describing best corporate governance practice.

In Australia, the two major guides are 'Corporate Practices and Conduct' issued in November 1995 by the Bosch Committee; and 'Corporate Governance: A Guide for Investment Managers and Corporations' issued in July 1997 by the AIMA (now IFSA). The Australian Institute of Company Directors is one of the many other groups which has also published papers relevant to the definition of corporate governance.

Internationally, there are numerous guides. A recent study of Corporate Governance Codes, commissioned by the European Union[1] found that there are 35 codes just in the 15 Member States of the EU. Every Member State of the EU, except Austria and Luxembourg, has at least one code. The United Kingdom has 11 of them.

Since the Asian financial crisis, similar work has flourished throughout our region. For example, Malaysia, the Philippines, Singapore and, recently, China have all developed corporate governance codes.

At first glance, the sheer number of these publications seems discouraging, in that it might be assumed that in their diversity they are more likely to confuse than inform.

However, as the EU study found, there is a substantive convergence in the published materials, both in terms of the definition of and the principles pertaining to good corporate governance.

Most definitions of corporate governance refer to two things:

- the mechanisms by which corporations are **directed and controlled;** and
- the mechanisms by which those who direct and control a corporation are **supervised**.

[1] *Weil, Gotshal & Manges LLP, Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States.*

The **essential common points** in the codes or guides are:

1. Corporate governance is a means of ensuring that the exercise of economic power by the corporate sector is grounded in accountability – whether that is accountability to shareholders or to the broader community;

2. Boards (whether they be two-tiered or unitary) have a supervisory and managerial function;

3. That there should be separation between the supervisory and managerial roles. Some of the practices suggested in the codes for that purpose include (for example):
   - separation of the roles of the Chairman and CEO;
   - the appointment of independent directors; and
   - the use of board committees, particularly in the areas where the interests of management and the interests of the company may come into conflict - eg audit, remuneration and nomination.

4. Most codes also call for comprehensive disclosure to shareholders on all aspects of corporate governance and, in particular, on the issues of director and executive remuneration, independence of directors, and share ownership.

I think it is also important to note at this stage what corporate governance is *not*. Corporate governance is not a fail-safe means to prevent business failure. Good governance is of itself no assurance of corporate success, any more than corporate failure *necessarily* implies poor standards of governance. Our limited liability system is based on the premise that failure alone is not culpable, and that risk is to be acknowledged and shared – some businesses will always fail, due to a myriad of factors.

However, corporate governance - viewed not as merely a legal ritual to manage directors' liabilities, but as a living economic dynamic, integrated into the business – can help build a solid foundation to create wealth and protect shareholder interests. Corporations should strive to achieve a culture of governance; and resist the temptation to give formal, rather than substantive, compliance to the principles of good governance.

Nor should we assume that corporate governance is of relevance only to individual companies and their shareholders. The recent interventions of President Bush highlights the reality that there are underlying issues of national interest involved.

An OECD paper in 1999 aptly put it this way:

'[I]f countries are to reap the full benefits of the global capital market, and if they are to attract long-term 'patient' capital, corporate governance arrangements must be credible and well understood across borders. Even if corporations do not rely heavily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, may reduce the cost of capital and ultimately induce more stable sources of financing.'[2]

A similar point was also highlighted in a speech delivered in China last April by Sir Howard Davies of the UK Financial Services Authority[3] when he observed that:

> 'US academic researchers have found that in countries where the policing of insider trading is regarded as weak, or where the legal framework is poor, the cost of capital for firms is typically some three percentage points higher than in countries where insider dealing is policed effectively.'

An earlier 1996 survey by McKinsey[4] reported that investors surveyed would place an average premium of 11% on stocks of well governed companies.

The reciprocal, of course, is that investors will punish individual companies, or broader markets, or even whole national capital markets, for serious governance deficiencies. In the current climate these cautionary studies cannot be dismissed as academic theory. We are living through this reality in the most sophisticated and developed economy the world has ever seen.

ASIC's role in corporate governance

So what is ASIC's role in this field?

There are in fact several dimensions to our role.

First, ASIC monitors and enforces compliance with the various provisions of the Corporations Act that are designed to influence and control the exercise of power by directors and managers. These provisions include, for example, those dealing with:

- duties of directors;
- transactions with related parties; and
- meetings of company shareholders.

Recently this aspect of ASIC's responsibility has kept us rather busy. We embarked two years ago on a deliberate strategy of being more visible in our enforcement activity. We believe that without visible enforcement, regulation can never be fully effective. In fact, over-regulation and under-enforcement typifies many regulatory regimes across the world and requires more attention. Governments need to support the enforcement mandate of their securities and corporate regulators, providing them with effective

[2] Source: OECD Principles of Corporate Governance 1999.

[3] 'Corporate Governance and the Development of Global Capital Markets'

[4] Felton, Hudnut and van Heeckeren, 'Putting a value on corporate governance', The McKinsey Quarterly, 1996, No 4

powers and resources. Regulators have to improve their commitment to exercising those powers and taking litigation risks.

I am reasonably satisfied about the progress we have made at ASIC on this front, and the manner in which we have responded to Australia's corporate failures. We have successfully combined a range of administrative, civil and criminal actions to bring accountability to offenders. Some examples include:

- Harris Scarfe - criminal charges against former CFO, Allan Hodgson, resulting last month in a 6 year jailing;

- HIH - civil penalty proceedings against former directors Rodney Adler, Ray Williams and Dominic Fedora. 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 (fines) in each case.

- OneTel - civil penalty proceedings have been commenced against certain former executive directors seeking similar remedies of banning, fining and compensation. In that case ASIC is claiming compensation in excess of $75 million.

- GIO - ASIC has again used the civil penalty proceedings here, but in this case against certain officers who we allege mislead their own Board about the group's position at the time of the AMP takeover.

- Whitlam - an action we commenced against a company chairman because we consider that he improperly discharged his duties as chairman. The case has been argued and awaits judgement.

We have many other cases on foot – almost 200 in fact – which frequently include issues of failed governance. It is not always recognised how active and successful we are as an enforcement agency – but I know of no other counterpart that has been responsible for the jailing of 69 white collar criminals over the past 3 years alone.

Of course our role in promoting good governance extends considerably further than enforcement. We also have important regulatory responsibilities which are directly relevant to the area. Foremost among those are the areas of disclosure, the operation of exchanges, the regulation of audit and the licensing of intermediaries. In respect of audit I note that ASIC's role is more limited than in some peer group countries. We register auditors and commence disciplinary proceedings for misconduct, but for the main, audit standards and performance are self-regulated. That is a situation that requires review as part of the response to the Ramsay Report and the Government's recently announced CLERP 9 law reform proposals.

Finally, in the context of ASIC's role, I want to comment briefly on the type of legislative mandate that usually attaches to corporate and securities regulators.

In my experience there is considerable ignorance in the community about the role of regulation and the expectations we should have of securities regulators. In particular, segments of the media (and I should add of politics and academe) fail to distinguish between prudential supervision and conduct supervision.

Prudential supervision is specifically directed to the risk of failure. It seeks to address the core risks that might cause a financial institution to fail – capital risk; credit risk; operational risk and the like. It generally provides the regulator with powers to make rules or standards to cover those risks, and inspection powers to monitor the way that they are being managed. It is by nature a very intrusive form of regulation, applied only to those segments of the economy where the risk of failure is regarded as likely to inflict greater community damage than would normally be the case (eg bank or insurance company failure).

This philosophy does not generally extend to securities or corporate regulation. The regulator does not normally make the rules and cannot usually intervene until there are solid grounds for believing an offence has occurred. Of course, all policing services help to prevent crime. It can hardly be doubted that if we abolished the police force the crime rate would soar. The same goes for the corporate cop. But equally, we do not expect that community policing will ever eliminate breaches of law; we don't expect a policeman at every set of traffic lights to enforce the road laws; we wouldn't accept the unrestricted right of police to enter our houses at whim to ensure that there were no stolen goods on the premises. We require good cause. If someone is murdered we don't say: how could the police have allowed that to happen? Yet, when companies fail, the almost predictable chorus erupts: how could the regulator have allowed that to happen? It is an understandable response but, nonetheless, usually uninformed when directed to a conduct regulator.

This is another area that a Governance Unit like this might usefully consider. Is the traditional approach of leaving responsibility for corporate governance and compliance with Boards, shareholders and auditors still valid? Or should we be thinking about extending the scope of prudential supervision more pervasively throughout the business community? Should the corporate regulator, for example, have rights to enter, inspect and even seize records without cause? Should the regulator have powers to prescribe and enforce governance standards? These would be radical notions for a corporate regulator and would represent a major shift in managing governance responsibilities. I am not necessarily advocating such change, merely making the point that if you are not in control of governance, you cannot prevent failure.

Governance standards promulgated by Securities Exchanges

I would like to move now to speak briefly about the role of Exchanges.

One notable recent development in corporate governance internationally is the renewed interest shown in the topic by key securities exchanges. For example, the New York

Stock Exchange, Nasdaq, the Toronto Stock Exchange and the Stock Exchange of Hong Kong have all reviewed their corporate governance guidelines or listing rules this year.

The proposals released by the NYSE in June this year are interesting. Briefly, they include the following:

1. Independent directors must comprise a majority of a listed company's board (this has been combined with a tightening of the definition of 'independent director' and it represents a major change in US thinking);

2. The non-management directors must meet regularly without management;

3. All companies must have an audit committee, a nominating committee and a compensation committee, each comprised solely of independent directors;

4. Listed companies must adopt corporate governance guidelines, as well as charters for their audit, compensation and nominating committees;

5. Listed companies must adopt a code of business conduct and ethics; and

6. Shareholders must be given the opportunity to vote on all equity-based compensation plans.

In the light of these developments there have been increasing calls of late for the ASX to adopt a more assertive role in this area.

The ASX listing rules do, of course, include mandatory rules that are related to corporate governance. For example, those rules which require shareholder consent whenever the corporation enters into particular transactions that are prone to abuse, are clearly related to corporate governance. The ASX listing rules also require that listed entities must include, in their annual reports, a statement of their main corporate governance practices.

However, unlike many other exchanges, the ASX has specifically disavowed any intention to endorse best corporate governance practices. It argues that the diversity of entities that it lists, the existence of alternative solutions to address particular governance problems and the development of corporate governance ideas over time, mean that it is inappropriate for it to require particular practices to be adopted.

In seeking to assess this difference of approach, we should be mindful that, unlike the NYSE, ASX is a 'for profit' corporation; and regulatory responsibility often sits uncomfortably alongside the profit motive. The Corporations Act imposes a responsibility on ASX to ensure that its market is fair, orderly and transparent; it must supervise its market, including compliance with its listing and business rules; and it must have listing rules that comply with the relevant regulations. However, any additional regulatory role is a matter of choice for ASX – that is, it is up to ASX to decide whether it wishes to combine such a role with its 'for profit' business model.

This is an important dynamic created by the de-mutualised, for-profit exchange structure which is growing around the world. Responses to the new environment differ.

In the United Kingdom, for example, the government responded to the demutualisation of the London Stock Exchange by transferring the listing responsibility from the Exchange to the UK Financial Services Authority (ASIC's equivalent).

Time will tell whether the current Australian arrangements are sustainable, or whether the ASX will accept extended responsibilities in this area. It is always possible, of course, that additional governance obligations will be legislated or that ASIC will be charged with increased responsibilities in the area.

Performance remuneration

My concluding comments tonight relate to performance remuneration and market disclosure.

At the outset of this discussion I commented on the unsatisfactory way that executive remuneration has undermined good governance. At first blush one can understand how performance based packages, which link remuneration directly to the share price, are justified. By apparently aligning management's interests with those of shareholders, this form of remuneration overcomes the perceived problems created by the separation of ownership and control. However, as we all know, the theory does not always translate well in practice and it is clear that there are a number of dangers inherent in remuneration that is linked to share price. It can lead to an unhealthy pre-occupation with supporting the share price, and an unhealthy focus on short term performance.

In fact, market price is an inefficient and unsophisticated benchmark for performance remuneration. The market price of shares, as the past decade has shown, is influenced significantly by external factors that have little to do with management performance. Those external factors include sentiment and interest rates. We have seen several cases in recent times where market-linked remuneration measurement has coincided with poor governance – nowhere better illustrated than in the case of One.Tel .

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. For a regulator which rarely receives support from business on these matters, it is refreshing to see leading business figures at last speaking out. Hugh Morgan, Paul Anderson and, last week, David Crawford and Dick Warburton have all made important contributions to this part of the debate. Their stature provides an authority to their opinions and must cause Boards to sit up and listen.

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. The commitment of national leaders to tackle the structural causes of poor governance should be judged by their willingness to support not only this initiative, but other urgent reforms to our accounting standards. This is where the hard decisions rest.

In the meantime, Directors need to think creatively about performance measures that reflect real value added by management and sensibly combine both short and long-term performance hurdles.

Moreover, Boards need to do more to improve their own accountability. It is incongruous that we accept the need for sophisticated performance management techniques across most staffing levels of our corporations – but seldom extend the same disciplines to Board level.

The last Korn/Ferry International study on Australian Boards of Directors (released in 2000 – the next report comes out later this year) noted that only 18% of Australian boards surveyed had sought external feedback on their effectiveness. However, 27% of Australian boards reported that they did plan to formally assess board effectiveness in the future, which at least is encouraging.[5] Hopefully, we'll see some tangible evidence when the new survey results are released later this year.

Disclosure and Transparency

Finally, then, I arrive inevitably at the subject of disclosure and transparency.

Any manager understands that adequate, reliable and timely information about corporate performance is essential for them to do their job. Boards also recognise that without such information flows from their management, their capacity to govern is constrained. Similarly, ASIC, the shareholders, creditors and the broader market all need adequate, reliable information about corporate performance so that they can supervise and monitor the performance of directors and senior management; and so that investors can participate in the capital markets on a fair and informed basis. Australia has a comprehensive system of information disclosure, requiring both periodic and continuous disclosure. The continuous disclosure regime requires all listed entities to disclose immediately price sensitive information to the market operator, who makes the information available to market participants. On the whole, this regime works well and compares favourably to those in many other markets.

However, a number of recent high-profile instances of poor disclosure have highlighted some weaknesses in the present regime.

The most important of these are a perceived lack of clarity in the way the present disclosure test works in practice and the inadequacy of remedies for breaches of the regime. Both these shortcomings appear to result in many companies applying a strictly technical approach – looking for justifications to avoid disclosure – rather than in a culture of disclosure where companies make announcements unless there is a clear reason not to do so. The practice of re-positioning market expectations of profit

[5] *Source: Korn/Ferry International 2000 Annual Boards of Directors Study.*

performance through the selective briefing of analysts continues, despite a well advertised campaign by ASIC to eliminate the practice.

These problems can probably only be addressed by legislative amendment and changes to the ASX Listing Rules. In particular, we believe that the legislative framework for continuous disclosure will be improved by giving ASIC a power to impose administrative fines. Such a power will improve the flexibility, cost-effectiveness and timeliness of remedies, and underpin the integrity of the law by providing a proportionate remedy for conduct that is otherwise missing.

We understand some of the concern expressed about the ambiguity of the continuous disclosure obligations under the Listing Rules as they now stand. We believe that the rule should be redrafted to clarify the existing exclusions, shifting the balance in favour of disclosure in all but very limited circumstances. We also believe that the previous obligation for a company to respond to market rumour in certain circumstances should be restored. We accept that this is a vexed question. We understand the frustration of company managers about the non-accountability of the financial press who report false rumours. Nevertheless, I have to say that I have experienced more cases of press rumours having a sound factual basis than those which have not. If the publication of a story starts to move the share price, creating a disorderly and uninformed market in the stock, then in my view the company should do all within its power to improve the market's state of knowledge.

End piece

Ladies and Gentlemen, you have been most patient.

The unit that has been launched tonight will be grounded in research. That emphasis is welcomed.

This is a time for dispassionate assessment of structural shortcomings in our systems of governance.

It is a time for serious commitment to enhancing and embracing international accounting standards; for sensibly redressing conflicts of interest which have beset corporate managers, auditors, analysts and other intermediaries and professional service providers; for examining ways to motivate and empower shareholders – including institutions and fund managers – to accept greater responsibility for enforcing corporate accountability; and for examining methodologies by which Boards might better secure high governance standards.

I have taken more than my allotted time to speak about these issues tonight, yet still have only skirted the subject. You must be thankful that I wasn't asked to encompass all four terms of reference of the Unit's new charter.

I wish the Unit great success in promoting and coordinating the study of governance in all its guises and across all sectors. I trust it will fulfil your expectations in promoting the principles of good governance and encouraging valuable cooperation between academeme, industry, regulators, governments, the media – and let's not forget the investor.

Thank you for your attention tonight.