ASIC
Australian Securities & Investments Commission

Working with Australian company directors

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Broad overview

There are roughly 1.4 million companies in Australia, which adds up to a lot of directors. The great majority of them operate in one of the most light touch corporate regulatory environments available in the Western world. Small proprietary companies are not even required to lodge accounts with us and their only contact with the regulator is the odd form that needs to be lodged if they change one of their details and the annual statement which comes in a pre-printed format.

Naturally enough, the regulatory burden increases as the size and significance of the corporate entity expands towards the scale of the listed company.

At this end of the scale, company directors feel somewhat besieged by regulatory change, complexity and a perception that there is an ever increasing risk of personal liability. On these issues, perception is reality because what directors believe will affect the way they behave. In a number of areas, excessively cautious and risk-averse behaviour is creating regulatory challenges. For example, one of the key reasons why we are having trouble getting directors to produce clear, concise and effective disclosure documents is directors' fear of exposure to personal liability from investors or penalty from the regulator.

While ASIC believes there are very few company directors in Australia who have fallen foul of the regulator without good reason, we must accept that the perception is otherwise and that these views are genuinely held. We must therefore work harder with directors to get them thinking more positively about the role of regulation and liability in the financial system, while at the same time accepting that many of these perceptions are globally based.

What did ASIC do with directors in the last financial year?

In the 2005 financial year, we required directors to improve disclosure in relation to approximately $6 billion of fund raising out of a total of over $15 billion. ASIC also acted to reduce insolvent trading by directors by visiting 488 potentially troubled companies to assess their solvency. Following our visits, 63 companies appointed a voluntary administrator, including Henry Walker Eltin Ltd and Collins Booksellers Pty Ltd.

We banned 33 directors and officers, many of whom had acted dishonestly and two were permanently banned. Not surprisingly, a number of our banning orders are appealed to the Administrative Appeals Tribunal and in some cases successfully. This represents an ongoing challenge for ASIC.

Managing community expectations

The furore that erupted over ASIC's civil penalty proceedings against Steve Vizard last year[1] reminds us that community attitudes, and the desire for strong punishment, play a powerful role in the administration of justice. In discussing Steve Vizard's punishment Justice Finkelstein said:

> While shaming is a form of punishment, it is not a substitute for the formal expression by society through its courts that the offender has committed a wrong. Formal retribution is a necessary element in imposing a proper punishment because it ensures that punishment is just and appropriate to the circumstances. Formal retribution takes into account the moral culpability of the offender, having regard to his motive for wrongdoing, his intentional risk-taking, the harm (if any) that has been caused by the offence, and the standard of the offender's behaviour. In this fashion, punishment involves, as it should, both normative and utilitarian considerations.

While we are on community perceptions, the other one that relates to directors is the widespread public belief that there is large-scale, undetected insider trading by directors and other company insiders. While ASIC does not share this view, there is a definite tension in delivering corporate regulation that the general community can have confidence in when this sort of view prevails.

Pre-nuptial agreements

ASIC's view is that *Corporations Act* makes it clear that only the shareholders can remove a director of a public company and that attempts by directors to remove another director from office are void. This means that an agreement (or any other arrangement) that says that a director can be removed from office if the other directors decide is ineffective.

1 *ASIC v Vizard* (2005) 54 ACSR 394

In mid 2004, ASIC became aware that some companies had these agreements, commonly described as 'pre-nuptial' agreements, in place and were presenting them to shareholders as if they were binding. ASIC acted quickly to set the record straight by issuing a clarifying media release.

We were concerned that if we did not take action to stop pre-nuptial agreements quickly, a much bigger clean-up would have been required down the track.

While ASIC understands that companies and their boards want to be free to establish robust and effective measures for assessing the performance of individual directors, and of the board as a whole, the current law says that it is only the shareholders who can actually remove a director.

At the time, we said that while we thought our pronouncement represented the law as it then stood, we also encouraged discussion about, and the development of, mechanisms for assessing the performance of directors; suggesting a mechanism involving inserting appropriate provisions in the constitution for triggering the removal of directors via a general meeting. So far, there has not been a lot of interest shown by boards in revisiting these issues.

Enforceable undertakings

Under section 93AA of the *ASIC Act*, ASIC can accept enforceable undertakings. This power enhances ASIC's enforcement capability and gives us a legislative basis for negotiating administrative solutions to problems.

A good example of how we work with directors on negotiating appropriate solutions to problems is on foot at the moment. The matter involves a problem created by a profit forecast by a listed company and the subsequent management of its continuous disclosure obligations about its actual performance against the forecast.

We have been working with the company on various ways of dealing with the breach. One option is for the company to accept an enforceable undertaking requiring it to appoint a new director, familiar with these issues, and adopt a continuous disclosure compliance program that meets Australian standards. Alternatively, we could just issue an infringement notice or issue civil penalty proceedings. The former approach has the advantage that it might actually address the reason why the company had the problem in the first place, while still having some element of punishment and compulsion.

We are also finding that directors are often prepared to accept that there is a problem and the enforceable undertaking route provides a quick and efficient means of taking the medicine (ie accepting the potential damage to reputation) and moving on.

Behaviour management

When it comes to company directors, ASIC is really in the behaviour management business. We are seeking to have directors comply with the law with the least possible intervention from us. One of our express statutory functions is to facilitate the performance of the financial system and the businesses operating in it, so we take this role seriously.

There are, of course, times when we do take enforcement action directly against directors, such as in the *OneTel* proceedings, but this is where no other regulatory response is thought to be appropriate.

In this vein, we currently have two high profile actions against company directors in the early stages of proceedings. The first is the criminal prosecution of Geoffrey Cohen, the former chairman of HIH. The other is the civil penalty proceedings against Andrew Forrest, CEO of Fortescue Metals.

It remains the case that there will be always be room for enforcement action in addition to the other more constructive and immediate regulatory tools such as consultation, guidance and enforceable undertakings.

Listening to directors

One of the key areas where ASIC wants to do more is listening more closely and intimately to what company directors think. Over the last few years, we have spent a very great amount of time dealing with issues unique to the financial services industry as a direct by-product of the *Financial Services Reform Act*. There are about 25 listed financial services entities or groups in Australia. It is fair to say that we have spent a considerable amount of time with the directors of those entities, perhaps at the expense of directors more generally.

To address this, the Chairman and I are just putting the finishing touches on a consultative panel of about 5 company directors and executives in each of Sydney and Melbourne who can tell us what is on their minds in an informal and confidential setting. We are planning on having 3 or 4 meetings in each city per year. This liaison will be in addition to all the other consultation we have with industry bodies, professional associations and with companies directly.

We think that this will fill a gap in the way that ASIC helps business to do business.

Executive director remuneration

There are two important aspects of executive remuneration that ASIC has looked at in recent times.

Related party transaction regime

The first is in relation to the sheer quantum of executive remuneration. Under Chapter 2E of the *Corporations Act*, the payment of remuneration to an executive director of a public company is a related party transaction. Unless the remuneration is 'reasonable', it must be approved by shareholders in general meeting. This rarely happens in practice and ASIC asked itself, in the context of a particular director's remuneration package, what was the appropriate regulatory response. Should ASIC intervene? After a lot of thought, we decided that community angst at the level of executive remuneration (eg as a multiple of average weekly earnings) was a global problem and could not be solved from Australia. As an economic regulator, ASIC did not want to turn Australia into a remuneration 'island' where we tried Canute-like to turn back global market forces. Instead, we decided to leave this issue as a matter of judgment for directors, guided by the views of the shareholders as the owners. I think this was the right decision.

Non-binding vote on remuneration report

A non-binding resolution must now be held to accept the contents of the remuneration report at a listed company's annual general meeting.[2]

The new non-binding resolution was introduced as part of CLERP 9 and applied to most listed companies for the first time in late 2005. It seeks to introduce greater accountability and transparency into the remuneration policies of listed companies.

Such a regime puts Australia in line with other key jurisdictions such as the United Kingdom, where a statutorily mandated resolution has been in place since 2002. UK experience has shown that when a vote is substantially against adopting the remuneration report, companies have been subjected to damaging publicity and, in some instances, shamed into swiftly changing remuneration policies to appease shareholder concerns.

A recent survey released by the Chartered Secretaries of Australia shows that many companies are now convinced they should take note of shareholder concerns about pay even if “no” votes are as low as 10%. Some 40% of survey respondents said a “no” vote of 10% was enough to warrant a review of the company’s remuneration policies.[3]

Getting quick messages to the market

When we looked at the results of the first wave of non-binding votes on remuneration reports earlier late last year, we saw that, overall, compliance had been good, but there were 43 companies who had not given their shareholders notice of the vote. Seventeen of them offered various ways of remedying their oversight, but the remaining 26 did not. We thought the best way to deal with the situation was by way of quick guidance to the market; reminding companies about how the non-binding vote regime worked and 'naming and shaming' the 26 companies who opted to take no corrective action. We chose not to take any enforcement action against any of the companies on the basis that the vote was a new requirement, but we said we might not have the same approach next year.

[2] S 250R(2) of the *Corporations Act*
[3] “Non-binding votes hit the mark” *Company Director*, Vol 22 No 1 February 2006 p9

There were the usual howls of 'ASIC goes soft' from some sections of the media, but in general we believe it was the right approach. Also, the regulatory response of forcing a listed company to hold another meeting to hold a non-binding vote did not appeal.

Off-market share buy-backs

For some time now, ASIC has been on the receiving end of some fairly strident criticism from a concentrated quarter about the alleged inequities of off-market share buy-backs. The argument revolves around the proposition that a payment by a company to buy-back a share is a dividend and dividends can only be paid rateably to all shareholders and not, so the argument goes, the minority of low taxpaying shareholders who accept the buy-back offer.

To cut a long story short, we have decided to leave it up to directors to decide whether it is in the best interest of the company to engage in capital management techniques that include share buy-backs. We have encouraged directors to explain their reasoning for doing a buy-back a bit more clearly to shareholders, but otherwise are not minded to impose any further regulatory burden on the discharge of this aspect of their duties.

Global guidance on corporate governance

As you will all be aware, in 1999, the OECD published the OECD Principles of Corporate Governance which were expanded in 2004 and endorsed by the Financial Stability Forum as one of 12 key global standards for financial stability.

To make the Principles more accessible and useful, the OECD is working on a *Boardroom Guide to the OECD Principles of Corporate Governance*. The guide will focus on what should actually happen in the boardroom and will cover topics such as how to organise and compose a dynamic board, drawing the line between oversight and management and achieving independent board leadership. Public consultation on the Guide will occur sometime this year.

In addition, the IOSCO Technical Committee has established a Task Force to study how the OECD Principle on the need for boards to be able to bring "independent judgment" to its decisions is applied to listed companies in major securities markets globally (ie what rules are there, who applies them, are they prescriptive and so on).

This has involved providing a map of the independence framework operating in Australia. As co-chair of this Committee, along with the Spanish regulator, I am pleased to report that Australia is emerging as one of the world leaders in this area.

Hanel v O'Neill

I am pleased to say that on 10 November 2005, the Senate passed the *Corporations Amendment Bill (No 1) 2005* which addressed the problem created by the South Australian Supreme Court in *Hanel v O'Neill* decided in December 2003.

Hanel was a case about a corporate trustee that could not pay the rent under its lease. The landlord sought to make the director personally liable under s 197(1) of the *Corporations Act*. Hanel was the first time that s 197 has been considered.[4]

The Court found that the section meant that directors of a corporate trustee would always be personally liable if there were an insufficiency of trust assets even if the trustee had a legal right to indemnification.

The decision put directors of all corporate trustees (ie of super funds, managed investment schemes and family trusts) at a profound disadvantage to other directors. This was recognised by Treasury and the Bill addressing the problem was introduced to Parliament in mid 2005.

The only residual concern is one that could not really be fixed by legislation; being the gap of nearly two years between the decision and the amendment taking effect. Given the general repugnance of retrospective legislation, we are simply going to have to live with that risk.

Is ASIC concerned about anything currently going on in the boardroom?

Across the board, ASIC has a high regard for the way that 'mainstream' directors go about their business. There are, however, just two observations I would like to make.

[4] *Hanel* (2003) 48 ACSR 378; (2004) 22 ACLC 274; [2003] SASC 409 at [67] per Gray J.

Handling advisers

Most of you will probably have read the interesting address made by Bret Walker SC to the St James Ethics Centre last October entitled; 'Lawyers and Money'. One of its central propositions was that the big Australian law firms had an 'excessive proximity' with their clients and a 'diminishing connexion with justice'. From ASIC's perspective, and it is not just with lawyers, there is sometimes a fairly close connection between corporate wrongdoing and the following two problems:

- the deliberate manipulation of advisers by management; to lend credibility to unlawful or questionable conduct; and
- advisers who are too close to their clients (ie because of the commercial pressures on firms and their partners) to give the impartial advice that is required of them.

This, of course, is not a uniquely Australian issue and was a central theme in the problems in the United States that led to the Sarbanes Oxley legislation.

Notifying director interests to the market

Investors in a listed company, and in the market in general, have a legitimate interest in trading by directors in securities of the company. The obligation to notify interests is a central aspect of the Act and, together with the insider trading prohibition and the continuous disclosure requirements, helps to maintain the integrity of the market.

In late 2005, the BT Governance Advisory Service released research to the effect that in 2004 there was only an 85% compliance rate with the notification requirement. In other words, the market was not notified of 15% of the 2,936 trades by directors in that year (ie 432 out of 2,936). These statistics are consistent with our own information and represent some sort of a failure in the system. ASIC is currently working with ASX to introduce a tighter referral and prosecution program in this area.

How directors globally are feeling about regulation

A recent survey conducted by consultants Korn Ferry International[5] has found that 58% of company directors surveyed think that the Sarbanes-Oxley legislation has served only to make boards overly cautious, and should be repealed or overhauled.

Some of broad themes from the survey are that:

Impact of regulation

Rather than creating improved governance, 72 % of responding directors in the Americas believe that Sarbanes-Oxley regulations have served to make their boards more cautious. Sixty-one % of responding directors in the UK view the Combined Code as having this same effect on governance and 28 % of surveyed directors wanted it repealed or overhauled.

Risk that directors face

Perceived risk has made directors worldwide more choosy when accepting directorship invitations. Fifty-nine % of directors surveyed in the Americas have turned down a board seat due to risk. Risk was also characterised as the determining factor in turning down board seats by 83 % of surveyed directors in Australasia.

Because of the globalisation of business activities, there is no doubt that this thinking also affects the way Australian directors view their own regulatory environment and ASIC must accept this perspective in carrying out its work. This mood is even more acute in Australia at the moment because of the difficulties some directors are facing in coming to terms with the adoption of the Australian equivalent of the International Financial Reporting Standards.

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26 March 2006
Sydney

5 32nd Annual Board of Directors study, released on 23 February 2006, based on responses from nearly 1,200 directors from 15 nations in the Americas, Asia Pacific and Europe.

