CORPORATE GOVERNANCE: SUBSTANCE OVER FORM

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I INTRODUCTION

These are certainly interesting times to be commenting on corporate governance. The corporate collapses of the past 18 months, both in Australia and overseas, have raised inevitable questions about the state of corporate governance, and the role of directors and officers in discharging their responsibilities and duties to shareholders and the wider community. With greater direct and indirect share ownership, the whole community is affected by corporate governance; thus it is understandable that regulators and governments will be especially concerned to address this issue.

Debates about corporate governance and the possibility of introducing new provisions in the law to 'improve governance' surface in parallel to downturns in the economic cycle and resulting corporate failures. However, the best governed of companies can still succumb to competitive and economic forces. Therefore, corporate failure does not necessarily imply poor standards of corporate governance. Nevertheless, it is important not to be complacent about governance. Good corporate governance relies on the existence of effective checks and balances, and effective governance is not a static concept. Publicly available material about recent collapses has already revealed key governance weaknesses, and it seems inevitable that further lessons will be revealed in due course as regulatory investigations and inquiries are completed.

The challenge at a moment such as this is to understand which aspects of corporate governance can be strengthened by a regulatory or legislative approach, which necessarily focuses on form and disclosure. Regardless of the changes introduced, regulation and legislative prescription can only seek to avoid certain behaviours. The business community needs to develop a *culture* of valuing good corporate behaviour and its contribution to company performance

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and shareholder value in order for it to operate effectively. This requires a commitment from all market participants, including professional advisers, to improving the *substance* of governance.

Enhancing the substance of governance will necessarily involve not only the support of changes to deliver improved audit efficacy and independence and the entrenchment of better disclosure practices, but the empowerment of non-executive directors. The latter is perhaps the most significant challenge. It will require strengthening the framework in which independent directors operate, through better communication of corporate information; willingness on the part of non-executive directors to spend more time on each board membership, including an acceptance that they should be properly remunerated for so doing; encouraging an atmosphere of constructive questioning in the boardroom; improving practices relating to board selection, performance and succession; and boards developing a strong focus on business ethics.

A recent survey of the top 200 listed companies on the Australian Stock Exchange ('ASX') by Chartered Secretaries Australia has found that in response to recent collapses and governance concerns, 83 per cent of the companies have reviewed and changed some governance related procedures.[1] The focus for change has been on executive option plans, audit and compliance committee charters, rotating audit partners and reconsidering other work from audit firms. The speed of this response is a reflection of a desire on the part of many that there not be an overreaction by regulators and government.

While a corporate regulator can play an important role in reinforcing the importance of the element of governance through enforcement, discussion and education, ultimately, a focus by directors on culture, values and ethics, and an appreciation of the importance of the substance of governance, is needed.

II CORPORATE GOVERNANCE — DEVELOPMENT TO DATE

The concept of corporate governance is not a precise one — its content is affected by different cultural variables.[2] Consequently, it is not surprising that various definitions and interpretations have emerged over time.

Early debate about corporate governance generally revolved around issues relating to board structures and systems. Corporate governance has, for example, been defined as the system by which organisations are directed and controlled.[3]

Corporate governance generally tends to gain public attention when performance problems are apparent. Thus, the initial focus on corporate

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1 See Chartered Secretaries Australia, 'Corporate Australia Shaping Up New Survey Finds' (Press Release 2002/10, 12 September 2002).

2 See Roman Tomasic, 'Good Corporate Governance: The International Challenge' (2000) 12 *Australian Journal of Corporate Law* 142.

3 See Working Group on Corporate Practices and Conduct (chaired by Henry Bosch), *Corporate Practices and Conduct* (3rd ed, 1995) 7. The Cadbury committee in the United Kingdom adopted a similar definition: Sir Adrian Cadbury (chair), *Report of the Committee on the Financial Aspects of Corporate Governance — The Code of Best Practice* (1992).

governance arose as a result of the corporate collapses of the late 1980s and early 1990s.[4] In addition, globalisation and the growth of the world's capital markets, the growth of shareholder activism and market expectations in general have added to the focus and debate on governance.

In light of this increasing interest, aspects of corporate governance have been extensively examined over the past two decades by a number of publicly appointed committees. Australia had the Bosch committee[5] and the Hilmer committee.[6] In the United Kingdom, there were the Cadbury committee,[7] the Greenbury committee[8] and the Hampel committee.[9] The United States saw the development of the *General Motors' Board Guidelines on Significant Corporate Governance Issues* ('GM Guidelines'), and internationally we witnessed the development of the *OECD Principles on Corporate Governance* ('*OECD Principles*').[10]

The report of the Bosch committee was the first significant Australian attempt to set out corporate governance standards of best practice. It considered the function of the public company board, its structure, the role of company accountants and auditors, the conduct of directors, the role of shareholders and codes of ethics. Its main recommendations were that:

(a) the roles of chairman and chief executive officer ('CEO') should be separate;[11]
(b) the boards of public companies should include a majority of non-executive directors who have an appropriate mix of skills and experience, and whose abilities are appropriate to the needs of the company;
(c) each public company board should appoint an audit committee with at least a majority of non-executive directors; and
(d) public companies should develop, publish and enforce a code of ethics.[12]

The Bosch report also proposed that the annual reports of all public companies should include a statement by the directors that the company supports and has adhered to the principles set out in *Corporate Practices and Conduct*. It

4 See Justice Alex Chernov, 'The Role of Corporate Governance Principles in the Development of Legal Principles Relating to Directors' (Paper presented at the Conference on Key Developments in Corporate Law and Equity, University of Melbourne, 16 March 2001).

5 Working Group on Corporate Practices and Conduct, above n 3.

6 Frederick G Hilmer (chair), *Strictly Boardroom: Improving Governance to Enhance Company Performance — Report of the Independent Working Party into Corporate Governance* (1993).

7 Cadbury, above n 3.

8 Sir Richard Greenbury (chair), *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (1995).

9 Sir Ronald Hampel (chair), *Report of the Committee on Corporate Governance* (1998).

10 Organisation for Economic Co-operation and Development (OECD), Ad hoc Taskforce on Corporate Governance, *OECD Principles of Corporate Governance* (1999), <http://www.oecd.org/pdf/M00008000/M00008299.pdf> at 27 September 2002.

11 It did, however, acknowledge that this may not be appropriate in all cases, particularly where a company is a wholly-owned subsidiary of an overseas parent company.

12 Working Group on Corporate Practices and Conduct, above n 3.

was recommended that any departure from the principles should be noted and the reasons for them given.[13]

In September 1994, the ASX issued a discussion paper,[14] which noted that a large proportion of listed companies did not adhere to the Bosch committee's principles. This was a source of concern because local and overseas investor confidence in Australian equity markets could be adversely affected if there was a perception that appropriate corporate governance practices were not generally followed. The ASX also noted that several major overseas stock exchanges had introduced rules relating to corporate governance practices of listed companies.

In 1996, the ASX introduced Listing Rule 4.10.3, requiring a listed entity to include in its annual report a statement of the main corporate governance practices that the entity had in place during the reporting period. An indicative list of corporate governance matters is provided in Guidance Note 9.[15]

General thinking about corporate governance at the time was also greatly influenced by the Cadbury, Greenbury and (shortly thereafter) Hampel committee reports in the UK, which contained many similar recommendations. Broadly, these include the desirability of independent non-executive directors of sufficient calibre and number to improve board decisions; the establishment of audit committees, nomination committees, remuneration committees and other aspects of internal control; and the separation of the role of chairman from CEO.

Thus, by the mid to late 1990s, there were a number of different descriptions of 'good governance', both within Australia and overseas. Although the definitions differed in some respects, these differences, with one exception, were not really substantial and the essential 'structures' of good governance were largely agreed upon. The difference of substance related to the acceptance in the US of the combined role of chairman of the board and CEO; two roles which, in Australia and the UK, it was thought most important to separate.

The work of these committees added not only to the literature on governance, but to its development. Their largely structural approach underlay the Australian practice of governance — a practice which has been seen as 'institutionalised and compliance focused, more driven by process and liability management for corporate officers, than by notions of shareholder protection and wealth creation'.[16] Generally, the 'substance' was subsumed by the focus on 'form'. Corporate governance lost momentum and potential as an effective program for corporate risk management; instead it became a formula for boards to implement.

Some individuals, of course, appreciated that this focus on systems and structures should really be a focus on performance. The Hilmer committee in 1993, for example, emphasised that 'governance is about "performance" as well as "conformance"'.[17] The committee concluded that three elements were at the

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13 Working Group on Corporate Practices and Conduct (chaired by Henry Bosch), *Corporate Practices and Conduct* (1991) 1.

14 ASX, Discussion Paper, *Disclosure of Corporate Governance Practices by Listed Companies* (1994).

15 ASX, Guidance Note 9, *Disclosure of Corporate Governance Practices: Listing Rule 4.10* (2001).

16 David Knott, 'Corporate Governance — Principles, Promotion and Practice' (Speech delivered at the Monash Governance Research Unit (Inaugural Lecture), 16 July 2002).

17 Hilmer, above n 6, 17–21.

heart of poor performance and hence should be a focus for corporate governance:

(a) confusion over the role of the board, in particular, a failure to balance its interest in performance with its duty to oversee conformance with the relevant rules and regulations;
(b) weak director selection processes; and
(c) a lack of processes to keep performance at the centre of the board's agenda.

However, until recently, there has been very little discussion on how to overcome these obstacles and start focusing on substance and defective processes rather than on structures. In the current environment, regulators, legislators and the business community face the challenge of revitalising the essence, or substance, of governance.

Shareholders, too, are asking the more general question of how effective a board really is. The 'new shareholder' has evolved and corporate governance is high on their agenda when choosing between various investment options. Media commentators have noted that 'even before the collapse of Enron, HIH and One.Tel, shareholders and anti-globalisation coalitions were demanding better risk management by boards and senior management across a number of areas'.[18] Similarly, the demands on board performance have increased and 'in a world of active shareholder and fund manager interest, aggressive capital markets and carefully measured corporate performance, the requirements are much higher'.[19]

This growing concern about the performance aspect of governance, albeit in non-specific terms, was being expressed by a number of business leaders before recent collapses. A prominent director, the chairman of several leading companies, commented well before the recent flurry of interest in the subject:

> We need a fresh approach to how we think about boards and the real drivers of board performance, rather than the emphasis that we see today, which is focused on the formalised edicts of the corporate governance debate.[20]

Another director admitted that 'many boards are struggling and failing to make the transition from a reactive, compliance-oriented model to a new strategic, performance focused approach'.[21]

Therefore, the key challenge facing legislation, regulators and business, is how to respond to this latest crisis of governance, or at least, crisis of confidence in existing governance.

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18 Julie Macken, 'Transparent the Only Way to Go', *Australian Financial Review* (Sydney), 20 May 2002, 61.

19 Danny Samson, 'Board Games', *The Australian Financial Review* (Sydney), 13 June 2000, 34.

20 Stan D M Wallis, 'Corporate Governance — Conformance or Performance?' (Speech delivered at the Annual Corporate Public Affairs Oration, Centre for Public Affairs, Melbourne, 29 June 2000).

21 See Diane Grady, 'Breaking the Boardroom Mould' (2000) 16(8) *Company Director* 9.

III WHAT IS THE ROLE OF THE REGULATOR?

Within this ongoing debate about corporate governance, the role of the regulator is complex and multifaceted. Policy makers and regulatory bodies have a distinct and important responsibility for shaping a regulatory framework that allows market forces to operate efficiently and permits investors and companies to design their governance arrangements in accordance with their needs. The *OECD Principles*,[22] for example, recognise that governments have an important responsibility in shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and to respond to expectations of shareholders and other stakeholders.

In Australia, the regulator's role is a continuum of responses. It is bounded by enforcement at one end and education at the other, with policy guidance, industry support and disclosure guidelines in between.

At one end of the spectrum, the regulator plays a role in taking appropriate enforcement action to send strong messages about the legal governance framework encompassing duties of officers and directors. The Australian Securities and Investments Commission ('ASIC') has certainly sought to do that, as evidenced by its recent record. Before outlining that record, however, it is worth noting that there was no unanimity with its international counterparts, at least until recently, as to the extent of this role. For example, the then chairman of the US Securities and Exchange Commission ('SEC'), Arthur Levitt, said in 1999:

> Six years ago when I arrived in Washington, I wasn't fully persuaded that corporate governance should be a priority on the Commission's agenda. I felt that the issue lent itself to more of a subjective analysis rather than a more formal one. One size could never fit all. While I still very much subscribe to that premise, I have become increasingly convinced of the need to be more outspoken on this topic — particularly when it affects the quality and integrity of the financial reporting process.
>
> I have come to view strong corporate governance as indispensable to resilient and vibrant capital markets. It is the blood that fills the veins of transparent corporate disclosure and high-quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure. And without financial reporting premised on sound, honest numbers, capital markets will collapse upon themselves, suffocate and die.[23]

While it is doubtful that any Commissioner of ASIC in 1999 would have used such strong language to put that case, ASIC did publish the results of two of its investigations in 1998, in order to impart corporate governance lessons.[24]

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22 OECD, above n 10.

23 Arthur Levitt, 'An Essential Next Step in the Evolution of Corporate Governance' (Speech delivered to the Audit Committee Symposium, New York, 29 June 1999), <http://www.sec.gov/news/speech/speecharchive/1999speech.shtml> at 27 September 2002.

24 These lessons are discussed below in Part III(B). It should be noted that some specific failures of governance, such as excessive and uncommercial options and loans to executives, have only been in focus more recently. Hence these lessons, and earlier pronouncements from ASIC, need to be viewed in context.

It is perhaps equally unlikely that any ASIC Commissioner could ever have shared chairman Levitt's initial uncertainty about the relevance of corporate governance to capital market regulation, but that may be due in large part to the wide jurisdiction of ASIC compared to the SEC. ASIC is almost unique in being the regulator for both the corporate and the securities markets. If more securities markets regulators had that wider jurisdiction, the world body of those regulators, the International Organisation of Securities Commissions ('IOSCO'), may have produced the main international standard on corporate governance, rather than the OECD. Instead, the IOSCO *Objectives and Principles of Securities Regulation* feature only three (out of thirty) principles which are relevant, namely:

> 14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
>
> 15. Holders of securities in a company should be treated in a fair and equitable manner.
>
> 16. Accounting and auditing standards should be of a high and internationally acceptable quality.[25]

There is no longer any debate about IOSCO's interest in corporate governance, as indicated earlier this year by the chairman of the UK Financial Services Authority, Sir Howard Davies:

> a few words on why corporate governance is so important for the development of capital markets … if we look at the factors which are widely regarded as being essential to promote a healthy environment for long-term investment, then we can see that good corporate governance scores highly on the list …
>
> 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.
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> So good corporate governance, and effective regulation, contribute both to the attractiveness of a country in terms of inward investment and business development, and also to the efficiency of its capital markets, and their effectiveness in the service of the real economy. It is always as well to remember these points when considering what can sometimes be a rather dry topic. And it is important to make these arguments robustly to those who argue that efforts devoted to upgrading corporate governance are costly and bureaucratic, and add little value to the economy. In my view, investment in good corporate governance arrangements, and good regulation of those arrangements, is among the most effective and rewarding investments a developing market can make, and there are figures to prove it.[26]

Consistent with this philosophy, and its role in enforcing the standards for corporate behaviour laid down in the *Corporations Act 2001* (Cth) ('*Corporations Act*'),[27] ASIC has initiated several significant enforcement

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25 IOSCO, *Objectives and Principles of Securities Regulation* (2002), <http://www.iosco.org/iosco.html> at 27 September 2002.

26 Howard Davies, 'Corporate Governance and the Development of Global Capital Markets' (Speech delivered at the China Securities Regulatory Commission, Beijing, 22 April 2002), <http://www.fsa.gov.uk/pubs/speeches/sp96.html> at 27 September 2002.

27 This role is conferred on ASIC by the *Australian Securities and Investments Commission Act 2001* (Cth) s 11.

actions in relation to recent perceived failures of corporate governance. The most high profile of these proceedings include those against officers of GIO Insurance Ltd, HIH Insurance Ltd, Harris Scarfe Holdings Ltd and One.Tel Ltd.[28]

A Enforcement

1 *GIO Insurance Ltd*[29]

On 20 June 2001, ASIC commenced civil penalty proceedings against three former officers of GIO Insurance Ltd ('GIO Insurance'). The proceedings allege that the respondents, Geoffrey Vines, Frank Robertson and Timothy Fox, breached their duties as officers of GIO Insurance during the course of AMP's 1998–99 takeover bid for GIO Australia Holdings Ltd ('GIO Australia'). The alleged breaches centre on the actions of the respondents in advising GIO Australia and its Due Diligence Committee on the financial outlook for the group's reinsurance business.

ASIC alleges that the respondents improperly used their positions[30] and failed to exercise duties of care and diligence[31] when preparing forecasts and other relevant information for consideration by the GIO Australia Board and the Due Diligence Committee. Further, ASIC claims that, as a consequence of the respondents' failure to properly discharge their legal duties, information that was seriously defective and misleading was released to shareholders of GIO Australia.

ASIC is seeking orders for:

(a) civil penalties of $200 000 for each contravention by each officer;
(b) the banning of each respondent from managing or being a director of any company for such a period as the Court sees fit; and
(c) $489 000 compensation from Mr Vines and Mr Fox.

2 *HIH Insurance Ltd*[32]

The collapse of HIH Insurance Ltd ('HIH') in March 2001 was probably one of the largest in Australian history, and has had wide reaching effects in the community due to the company's significant place in the insurance market. The

28 There are many other proceedings on foot relating to the conduct of officers and directors. They cover similar alleged breaches of duty, insolvent trading offences, insider trading offences and a range of other conduct and market offences.

29 ASIC, 'ASIC Commences Civil Proceedings Against Former Officers of GIO Insurance' (Press Release 01/217, 20 June 2001), <http://www.asic.gov.au> at 27 September 2002.

30 *Corporations Act 1989* (Cth) ('*Corporations Law*') s 232(6), amended by *Corporate Law Economic Reform Program Act 1999* (Cth). The equivalent provision is now contained in *Corporations Act 2001* (Cth) ss 182, 184.

31 *Corporations Act 1989* (Cth) s 232(4), amended by *Corporate Law Economic Reform Program Act 1999* (Cth). The equivalent provision is now contained in *Corporations Act 2001* (Cth) s 180.

32 See ASIC, 'Court Finds Former HIH Directors Adler, Williams and Fodera Breached their Duties as Directors' (Press Release 02/92, 14 March 2002); ASIC, 'Court Imposes Penalties on Former HIH Directors Adler, Williams and Fodera' (Press Release 02/192, 30 May 2002); ASIC, 'Penalty Orders Finalised for Adler, Fodera and Williams' (Press Release 02/200, 6 June 2002), <http://www.asic.gov.au> at 27 September 2002.

establishment of the Royal Commission into that collapse[33] has understandably delayed some of the possible responses of ASIC and the liquidator. However, ASIC did commence a civil penalty action (in connection with the setting up of an investment vehicle) against former officers of HIH: former director Rodney Adler, former CEO Ray Williams and former chief financial officer ('CFO') Dominic Fodera.

In a judgment handed down in March 2002,[34] each was found to have breached their duties as directors in relation to a payment of $10 million by an HIH subsidiary (HIH Casualty and General Insurance Ltd) to Pacific Eagle Equities Pty Ltd, a company of which Mr Adler was a director. The NSW Supreme Court found that Mr Adler breached his director's duties to exercise care and diligence,[35] to exercise good faith,[36] not to improperly use his position[37] and not to improperly use information.[38] Mr Williams was found to be in breach of ss 180 and 182 of the *Corporations Act*, and Mr Fodera in breach of s 180.

Justice Santow:

(a) banned Mr Adler from acting as a director of any company for a period of 20 years;
(b) ordered Mr Adler and Adler Corporation Pty Ltd ('Adler Corporation') to each pay pecuniary penalties of $450 000 (totalling $900 000);
(c) banned Mr Williams from acting as a director of any company for a period of 10 years and ordered him to pay pecuniary penalties of $250 000; and
(d) ordered Mr Fodera to pay pecuniary penalties of $5000.[39]

In addition, Mr Adler, Mr Williams and Adler Corporation were ordered to pay aggregate compensation of $7 958 112 to HIH Casualty and General Insurance Ltd.[40]

The decision is the first such civil penalty decision for breach of directors duties after the business judgment rule[41] was introduced into the *Corporations Act*. It is being appealed, and in the meantime, ASIC's investigation into possible offences connected to the collapse of HIH continue, as do the proceedings of the Royal Commission.

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33 See The HIH Royal Commission <http://www.hihroyalcom.gov.au> at 27 September 2002.

34 *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities & Investments Commission v Adler* (2002) 41 ACSR 72.

35 *Corporations Act 2001* (Cth) s 180.

36 *Corporations Act 2001* (Cth) s 181.

37 *Corporations Act 2001* (Cth) s 182.

38 *Corporations Act 2001* (Cth) s 183.

39 *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities & Investments Commission v Adler* (2002) 42 ACSR 80, 85–6. These orders were finalised on 6 June 2002, but were stayed against Mr Adler and Adler Corporation until 3 July 2002 on the basis of certain financial undertakings: *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities & Investments Commission v Adler* (2002) 42 ACSR 74.

40 This amount was subject to verification of the calculation of interest at the time.

41 *Corporations Act 2001* (Cth) s 180(2).

3 *Harris Scarfe Holdings Ltd*[42]

In the Adelaide Magistrates Court on 19 April 2002, Alan Hodgson, the former CFO of Harris Scarfe Holdings Ltd ('Harris Scarfe'), pleaded guilty to 32 charges laid down by ASIC following its investigation into the Harris Scarfe group, which failed in April 2001. Mr Hodgson pleaded guilty to 18 counts of failing to act honestly as an officer[43] of Harris Scarfe, six counts of acting dishonestly as an employee[44] of Harris Scarfe and eight counts relating to the dissemination of false information to the ASX.[45]

ASIC claimed that Mr Hodgson procured the making of false entries in Harris Scarfe's books of account, which had the effect of increasing the level of profits in the consolidated accounts of Harris Scarfe. The alleged conduct occurred during the period from August 1996 to January 2001 and affected profit figures shown in monthly financial reports to the board, as well as the half-year and end-of-year financial reports to the board and the ASX.

Mr Hodgson appeared in the Adelaide District Court on 26 June 2002, and was sentenced to six years imprisonment with a non-parole period of three years.[46] The speed with which this aspect of the Harris Scarfe investigation reached finality should be noted.

4 *One.Tel Ltd*[47]

On 12 December 2001, ASIC commenced civil proceedings in the NSW Supreme Court against Jodee Rich and Bradley Keeling (former managing directors of One.Tel), Mark Silbermann (former finance director) and John Greaves (former chairman). One.Tel failed in May 2001.

ASIC alleged that Messrs Rich, Keeling and Silberman had information or access to information regarding the financial condition of One.Tel that was withheld from the board and the market. It alleged that their conduct constituted a breach of their duty to exercise care and diligence under s 180(1) of the *Corporations Act*. ASIC also alleged that Mr Greaves breached his duty, as the chairman, to exercise the care and diligence required by s 180(1).

ASIC is seeking orders that each of the four defendants be disqualified from managing or being a director of any company for such period as the Court thinks fit.[48] It is also seeking compensation of $93 million for the reduction in the value of One.Tel over the period during which the company continued to trade because

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42 ASIC, 'ASIC Commences Investigation into Harris Scarfe' (Press Release 01/115, 4 April 2001); ASIC, 'Former Harris Scarfe Officer to Face Court' (Press Release 01/453, 20 December 2001); ASIC, 'Former Harris Scarfe Officer Appears in Court' (Press Release 02/19, 18 January 2002); ASIC, 'Former Harris Scarfe Officer Pleads Guilty' (Press Release 02/135, 19 April 2002); ASIC, 'Former Harris Scarfe Officer Jailed' (Press Release 02/229, 26 June 2002), <http://www.asic.gov.au> at 27 September 2002.

43 *Corporations Act 1989* (Cth) s 232(2), amended by *Corporate Law Economic Reform Program Act 1999* (Cth). The equivalent provision is now contained in *Corporations Act 2001* (Cth) ss 181, 184.

44 *Corporations Act 2001* (Cth) s 184(2)(b).

45 *Corporations Act 2001* (Cth) s 999.

46 *R v Hodgson* (Unreported, District Court of South Australia, Judge Bright, 26 June 2002).

47 ASIC, 'ASIC Commences Civil Proceedings Against Former One.Tel Officers and Chairman' (Press Release 01/441, 12 December 2001), <http://www.asic.gov.au> at 27 September 2002.

48 *Corporations Act 2001* (Cth) pt 2D.6.

of the alleged failure of the defendants to properly discharge their responsibilities.[49] This matter is due to go to trial in the course of 2002. In the interim, appropriate orders have been obtained to restrict dealing in assets and to monitor travel.[50]

5 *Water Wheel Holdings Ltd*[51]

ASIC commenced proceedings in November 2000 in the Supreme Court of Victoria against Bernard Plymin, William Harrison and John Elliott, in relation to their conduct as directors of Water Wheel Holdings Ltd and its subsidiary Water Wheel Mills Pty Ltd ('the companies'). The companies were placed into voluntary administration by the directors on 17 February 2000 after announcing a loss for the year to December 1999 of $6.7 million.

The allegations are that the directors allowed the companies to incur further debts after they became insolvent, contrary to the then *Corporations Act 1989* (Cth) ('*Corporations Law*').[52] The action is by way of civil proceedings in which ASIC seeks:

(a) orders that the directors personally pay compensation for the benefit of the companies' unsecured creditors;
(b) orders that the directors be prohibited from managing any corporation for such period as the Court thinks fit; and
(c) monetary penalties of up to $400 000 on each of the directors.

These proceedings are continuing.

6 *ASIC v Whitlam*[53]

ASIC has also taken civil penalty action against the then NRMA Ltd President, Nicholas Whitlam. The alleged breaches related to NRMA Ltd's 1998 annual general meeting, when Mr Whitlam, as chairman, failed to exercise certain proxy votes against a resolution relating to the remuneration of the company's directors.

The Court found that Mr Whitlam breached his duties as an officer of NRMA Ltd under the then *Corporations Law*,[54] namely, his duty to act honestly,[55] to not

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49 *Corporations Act 2001* (Cth) s 1317H.

50 ASIC, 'ASIC Restrains Rich Assets' (Press Release 01/199, 8 June 2001); ASIC, 'ASIC Obtains Court Undertakings Freezing Assets of Former One.Tel Managers' (Press Release 01/205, 13 June 2001); ASIC, 'ASIC Obtains Modified Undertakings from Former One.Tel Officers' (Press Release 01/343, 24 September 2001); ASIC, 'ASIC Obtains Ongoing Undertakings from Former One.Tel Officers' (Press Release 01/446, 14 December 2001), <http://www.asic.gov.au> at 27 September 2002.

51 ASIC, 'ASIC Commences Enforcement Action Against Water Wheel Directors Bernard Plymin, William Harrison and John Elliott' (Press Release 00/500, 27 November 2000), <http://www.asic.gov.au> at 27 September 2002.

52 The equivalent provision is now contained in *Corporations Act 2001* (Cth) s 588G.

53 ASIC, 'Court Imposes Pecuniary Penalties on Whitlam' (Press Release 02/297, 15 August 2002), <http://www.asic.gov.au> at 27 September 2002.

54 *Australian Securities & Investments Commission v Whitlam (No 2)* (2002) 42 ACSR 407.

55 *Corporations Act 1989* (Cth) s 232(2), amended by *Corporate Law Economic Reform Program Act 1999* (Cth). The equivalent provision is now contained in *Corporations Act 2001* (Cth) ss 181, 184.

make improper use of his position[56] and his duty as a proxy holder.[57] ASIC chairman, David Knott, said in announcing the outcome:

> It is important to understand that this was never a case about a technical or unimportant breach of voting procedures. At the centre of this case lies the obligation of directors to observe proper standards of conduct when discharging their responsibilities.[58]

Justice Gzell found that Mr Whitlam had deliberately omitted to sign the poll paper:

> He had the deliberate intent to disenfranchise the members who had appointed him proxy and required him to vote against resolution six and he was seeking, deliberately, to override the intent of the members of NRMA which he knew to be against the passing of resolution six as a special resolution.[59]

ASIC had included in the same action, a claim that Mr Whitlam had failed to exercise due care and diligence[60] when he amended the proposed minutes of the August 2000 board meeting of NRMA Insurance Group Ltd. Although this claim was sustained, the Court exercised its discretion under s 1317S(2) of the *Corporations Act* to relieve Mr Whitlam from any penalty for this breach.[61]

The orders against Mr Whitlam in respect of the voting paper matter were that:

(a) he was banned from acting as a director of any company for a period of five years; and

(b) he was ordered to pay pecuniary penalties of $20 000.[62]

The decision is on appeal, preventing detailed comment, but the case does raise some important issues about the nature of the work of a chairman. The chairman appears almost as a separate category of officer from other directors.

The cases outlined above are diverse in relation to the specific offences concerned. Nevertheless, they illustrate a highly concentrated and active focus on the obligations of directors and officers to carry out their duties properly. Evidence from these cases will provide useful specific lessons on how some directors might have performed their duties better and how some corporate collapses could have been prevented.

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56 *Corporations Act 1989* (Cth) s 232(6), amended by *Corporate Law Economic Reform Program Act 1999* (Cth). The equivalent provision is now contained in *Corporations Act 2001* (Cth) ss 182, 184.

57 *Corporations Act 1989* (Cth) s 250A. The equivalent provision is contained in *Corporations Act 2001* (Cth) s 250A.

58 ASIC, 'Court Finds NRMA Limited President Nicholas Whitlam Breached His Duties as a Director' (Press Release 02/262, 19 July 2002), <http://www.asic.gov.au> at 27 September 2002.

59 *Australian Securities & Investments Commission v Whitlam (No 2)* (2002) 42 ACSR 407, 450.

60 In breach of *Corporations Act 2001* (Cth) s 180(1).

61 *Australian Securities & Investments Commission v Whitlam (No 2)* (2002) 42 ACSR 407, 407.

62 *Australian Securities & Investments Commission v Whitlam (No 2)* (2002) 42 ACSR 515, 522. See also ASIC, 'Court Imposes Pecuniary Penalties on Whitlam' (Press Release 02/297, 15 August 2002), <http://www.asic.gov.au> at 27 September 2002.

B Education

Through reports of its investigations,[63] ASIC can convey corporate governance lessons from real life. ASIC has sought to publish two such reports in the last few years.[64] Although these reports were written in 1998, and in the case of Spedley Securities Ltd, relate to events many years before that, they nevertheless reveal lessons which are applicable to alleged or perceived failures of corporate governance today. In fact, these lessons seem remarkably similar to a number of the new guidelines recently introduced by regulators to ensure best practice.[65] They focus not just on questions of form, but venture into issues of how the checks and balances are actually functioning. Insights from the Spedley report concern:

(1) *The dominant director:* If any one director has undue control over a listed company's assets and affairs, there is a dramatically increased risk of:
   (a) the company being party to non-commercial transactions, which favour that director's interests;
   (b) the company not making full and fair disclosure of its financial position; and
   (c) the company's funds being misused or stolen.[66]

(2) *The role of non-executive directors:* Non-executive directors must be active in carrying out their duty of ensuring that directors and management are accountable for the management of the company. They must follow up on matters, which come to their attention and require explanation.[67]

(3) *Senior executives must be vigilant:* Senior managers have an independent responsibility to report concerns as to improper behaviour by directors or other managers of listed public companies. Well-managed companies will have independent directors, audit committees and the like to whom such concerns can be taken.[68]

(4) *Effective internal controls are essential:* Internal control comprises the systems, methods and procedures adopted by management to assist in achieving efficient conduct of its business, adherence to management policy, safeguarding of assets and the prevention and detection of fraud and error. Internal control procedures commonly include checking the arithmetical accuracy of the records, preparation of reconciliations, using control accounts and trial balances, approval and control of documents, conducting cash, security and inventory counts, limiting direct physical access to assets and records and comparison of results with budget.[69]

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63 *Australian Securities and Investments Commission Act 2001* (Cth) s 17.

64 ASIC, *Report of the Special Investigation into Spedley Securities Limited* (1998) ('Spedley report'); ASIC, *Report of the Investigation into Burns Philp & Company Limited* (1998) ('Burns Philp report').

65 See, eg, New York Stock Exchange ('NYSE'), *Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee* (2002), <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf> at 27 September 2002.

66 Spedley report, above n 64, 17–24.

67 Ibid 25–7.

68 Ibid 29–30.

69 Ibid 31–2.

(5) *The auditor must maintain an independent outlook and fulfil all responsibilities:* Auditors of public listed companies must carry out their responsibilities to users of audited accounts, including shareholders, creditors and regulators, by drawing public attention to significant or material matters, which have aroused their suspicion and about which they have had no satisfactory explanation.[70]

A number of corporate governance issues were also revealed by ASIC's investigation into the $700 million write-down of assets by Burns Philp & Co Ltd in September 1997. ASIC concluded that the commencement of legal proceedings was not justified, and the company survived the write-down and is still operating. ASIC nevertheless decided to publish a report of its findings, which will be useful in providing guidance to the market about appropriate standards of conduct and governance practices. Key corporate governance issues highlighted include:

(1) The need for adequate reporting by management to the board.
(2) The need to ensure that shareholders are properly informed about the strategies adopted by a company, the risks associated with those strategies and the results produced by those strategies. In the case of Burns Philp & Co, there was no segmented reporting of the investments in, and the results of, the herbs and spices businesses in the published financial statements.
(3) The difficulties that can arise with the appointment of the current CEO as chairman. Previous strategies may not be reviewed and there can be a lack of independent leadership of the board.
(4) The use of optimistic accounting treatments, which can disguise the true performance of the business and delay remedial action.[71]

ASIC's report of its Burns Philp inquiry also outlines a number of guidelines for participants in Australian corporate life:

(1) *Directors are responsible to ensure that the board functions effectively:* The chairman of the board in particular, and all the board members, are responsible to ensure that:
    (a) the board works as an effective team;
    (b) on a regular basis, the board critically reviews the effectiveness of business strategies and the effectiveness of senior management;
    (c) progress is monitored and swift action is taken to remedy any deficiencies.
(2) *Directors are responsible to ensure they are appropriately informed about business performance:* It is part of good corporate governance for directors to have up-to-date and reliable information about the performance of all components of the business.
(3) *Directors must question and evaluate key features of asset valuation reports:* Directors cannot rely solely on the asset values determined by

70 Ibid 33–6.

71 Burns Philp report, above n 64, 47–8.

independent experts. The directors themselves must understand what the valuers are saying.

(4) *Directors are responsible to ensure that shareholders are appropriately informed:* In fulfilling their corporate governance responsibilities, directors must ensure that reliable information is provided in a timely manner to shareholders.

(5) *Auditors must question and evaluate material asset valuations.*[72]

It is interesting to note that the fundamental structural corporate governance standards described by Henry Bosch in 1995[73] — separate chairman and CEO, non-executive directors, independent audit committee, and a code of ethics — remain the underpinning foundational requirements to deal with the governance lessons, as revealed by the Spedley report and the Burns Philp report. However, these two reports do reveal, in particular, that auditors and audit committees, as well as independent directors, need to be made more effective in their respective roles in order to fulfil their appropriate governance role.

In addition to this educative role through formal reports, ASIC sends out information kits about directors' duties and responsibilities to all company secretaries of newly formed companies. ASIC Commissioners also devote considerable effort in attending industry and professional conferences and speaking on governance issues to ensure that the business community remains aware of the regulatory dimension of corporate practice.

C Policy Guidance and Discussion Forums

In releasing policy statements and practice notes, ASIC provides guidance to industry members and consumers about particular issues, and about ASIC's approach to those issues, which will govern its role as primary enforcer of the *Corporations Act*. One example of guidance related to governance is Policy Statement 128, *Collective Action by Institutional Investors*.[74] This sets out ASIC's views on when institutional investors which hold shares in a company can collectively discuss their intentions about voting at a meeting of that company without becoming associates or entering into a relevant agreement.[75] The policy statement also outlines how ASIC will give relief so that two or more of these institutional investors can enter into an agreement about voting at a meeting of that company. Institutional investors that comply with Class Order 98/649 will obtain relief from restrictions on acquiring shares and lodging substantial shareholder notices. This policy appears to be designed to ensure that the law does not have the unintended consequence of preventing institutions from actively participating in corporate governance issues.[76]

72 Ibid 50–2.

73 Working Group on Corporate Practices and Conduct, above n 3.

74 ASIC, Policy Statement 128, *Collective Action by Institutional Investors* (1998).

75 This may breach the takeover restrictions in *Corporations Act 2001* (Cth) ch 6.

76 It is worth noting that this policy statement has been viewed by institutional investors as unduly cumbersome and has not proven effective.

ASIC policy has both a normative function — it is designed to affect the way in which market participants do business — and a creative function, being an area where ASIC's innovative thinking is developed. It can be inferred that ASIC's objective is not only to develop an appropriate policy framework that facilitates emerging governance issues, but also to enhance the level of consumer protection (in this context, investor protection) within the financial services sector.

Participation in conferences and discussions is another means by which ASIC can encourage and stimulate industry discussion about corporate governance. An example is the Corporate Governance Roundtable forum,[77] which ASIC initiated (and hosted from time to time) to look at governance issues. First meeting in 1998, it explored general issues of governance including those relating to the *OECD Principles*[78] and better communication of governance matters. From mid-2001 to 2002, at the request of the then Minister for Financial Services, Joe Hockey, the Roundtable examined how to facilitate retail shareholder participation. This forum, chaired by ASIC, was deliberately given a reasonably low profile in order to ensure that the investor and industry participants were able to contribute freely. As the subject matter rarely related to the strict content of the law, ASIC was able to be a facilitator and not an enforcer. The ASIC version of the Roundtable may, in practice, have been superseded by the ASX Corporate Governance Council, announced in early August 2002.[79] This body intends to move quickly to develop best practice guidelines on governance issues critical to investor confidence. It has already met, and issued its first advice.[80]

D Disclosure

Another role for the regulator in improving governance is to ensure that proper disclosures are made, both to shareholders on a continuous basis as required under the *Corporations Act*[81] and to the market in order to improve transparency and consequently, market integrity. It is clear that the ultimate governance role of shareholders can only be performed effectively if they have sufficient and reliable information.

ASIC has taken a very active position in relation to selective disclosure. In 2000, it released guidance principles for the market,[82] which have been

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77 The ASIC Corporate Governance Roundtable includes representatives from a wide range of business and investor organisations such as the Australian Institute of Company Directors and the Australian Shareholders' Association.

78 OECD, above n 10.

79 ASX Corporate Governance Council, 'Corporate Governance Council to Broaden Disclosure' (Media Release, 1 August 2002), <http://www.asx.com.au/shareholder/pdf/CorpGovCouncil010802.pdf> at 4 October 2002.

80 ASX Corporate Governance Council, 'Statement by Participants' (Media Release, 15 August 2002), <http://www.asx.com.au/shareholder/pdf/CorpGovCouncil150802.pdf> at 4 October 2002.

81 *Corporations Act 2001* (Cth) ss 674, 675. These were inserted by the *Financial Services Reform Act 2001* (Cth). The equivalent provisions were previously contained in *Corporations Act 1989* (Cth) ss 1001A, 1001B.

82 See ASIC, *Better Disclosure for Investors* (2000), <http://www.asic.gov.au/asic/pdflib.nsf> at 27 September 2002.

amplified by industry guidelines.[83] ASIC is continuing to argue that the remedies for breach of the disclosure regime are inadequate and that additional enforcement remedies, such as the power for the regulator to impose administrative fines, are needed to establish a culture of disclosure that provides reliable information for shareholders and creditors.[84] Recently, the chairman of ASIC entered the debate about ructions within the Coles Myer boardroom, calling for more information to be provided to shareholders in order to enable them to exercise governance.[85]

The ASX Corporate Governance Council has also highlighted the relevance of continuous disclosure to standards of corporate governance.[86] In particular, it has noted the ASX Exposure Draft on enhanced disclosure issued on 19 July 2002, which emphasises the importance of disclosure and suggests some additional listing requirements for comment.[87] A key proposal in this paper is to amend Listing Rule 3.1, reinstating the requirement for a company to provide the information necessary to avoid a false market in its securities. It is, of course, the ASX that is the primary regulator of such disclosures by listed companies, with ASIC overseeing its supervision of the market.[88]

IV CORPORATE GOVERNANCE GOING FORWARD

Globalisation, which has been a major driver of change in many aspects of financial markets and communications, has had its impact on corporate governance. Not only have international organisations such as the OECD and IOSCO developed general principles,[89] but the significant recent corporate collapses, particularly in the US and the UK, have resulted in rapid regulatory change which will greatly influence the course of corporate regulation and corporate behaviour in other jurisdictions. Although governance can only be delivered at the individual board level, systemic change is needed in two areas: improving the credibility of the audit process and outcome, and strengthening the efficacy of non-executive, independent directors. Not surprisingly, it is in these

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83 See especially, Australian Investor Relations Association, *Best Practice Guidelines for Communication between Listed Entities and the Investment Community* (2001), <http://www.aira.org.au/AIRA%20 Guidelines%20August%202001.pdf> at 27 September 2002.

84 Knott, above n 16. It is expected that CLERP 9, the next phase in the government's Corporate Law Economic Reform Program, will deal with this issue.

85 ASIC, 'Coles Myer — ASIC Calls for More Information and Shareholder Activism' (Press Release 02/337, 16 September 2002), <http://www.asic.gov.au> at 27 September 2002.

86 ASX Corporate Governance Council, above n 80.

87 ASX, Exposure Draft, *Proposed ASX Listing Rule Amendments Enhanced Disclosure* (2002), <http://www.asx.com.au/about/pdf/ExposureDraft2002JulyEnhancedDisclosure.pdf> at 27 September 2002.

88 *Corporations Act 2001* (Cth) ss 792B(2), 792C, 792D, 794D.

89 OECD, above n 10; IOSCO, above n 25.

two areas that we have already seen regulatory initiatives in the US, while in the UK, a review of the role of non-executive directors is being conducted.[90]

A Improving the Credibility of Auditing

The *Sarbanes-Oxley Act of 2002*[91] in the US reflects a detailed and prescriptive style approach, which focuses on the audit profession and a new process for registration of auditors, audit committees and their operations, CEOs' and CFOs' responsibilities for filed financial statements, and internal controls and new requirements impacting the audit relationship such as the provision of other services. In Australia, Professor Ian Ramsay has prepared a report on audit independence with detailed recommendations for the federal government.[92] The government's response is contained in the next phase of its Corporate Law Economic Reform Program ('CLERP 9').

ASIC has noted for some time that the role of auditing is broader than just the issue of independence.[93] A gap has developed between the community expectation of the audit role and the role it is at present fulfilling in many companies. The investing public see audit as an independent check on the veracity of the accounts, confirming that the figures are a 'true and fair' view of the state of the company. In a range of other circumstances, regulators use audit to provide an independent verification and sign off. For example, s 601HG(1) of the *Corporations Act* requires the responsible entity of a registered scheme to ensure that a registered company auditor is engaged at all times to audit compliance with the scheme's compliance plan. Section 601HG(4) provides that the auditor of the compliance plan must, as soon as possible, notify ASIC in writing if the auditor:

a) has reasonable grounds to suspect that a contravention of this Act has occurred; and

b) believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report under subsection (3) or bringing it to the attention of the responsible entity.

The aforementioned expectation by the investing public reveals little understanding of the complexity of accounting standards and the auditor's

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90 The Department of Trade and Industry and the UK Treasury have appointed Derek Higgs, a veteran investment banker, to head their review into the role of non-executive directors in the UK. See John Kiphoff, 'Investment Banker Chosen to Head DTI Review', *Financial Times* (London), 15 April 2002, 2.

91 Pub L No 107–204, 116 Stat 745 (2002).

92 See Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform — Report to the Minister for Financial Services and Regulation* (2001), <http://www.treasury.gov.au/contentlist.asp?classification=14&titl=Publications> at 23 July 2002.

93 David Knott, 'Corporate Governance — 1980s Revisited?' (Speech delivered to the Australian Institute of Company Directors, Western Australia, 17 October 2001); Jillian Segal, 'Everything the Company Director must know about Corporate Financial Disclosure and Continuous Disclosure' (Speech delivered at the Australian Institute of Company Directors Conference, Sydney, 31 October 2001); Jillian Segal, 'The Future of Corporate Regulation in Australia' (Speech delivered at the 18th Annual Company Secretaries' Conference, Surfers Paradise, 19 November 2001).

verification of them. Further, as ASIC has noted,[94] there is an inevitable tension between the auditor's 'watchdog' role[95] and their commercial provider/client relationship role.

As illustrated by the New York Stock Exchange rules[96] and the first statement by participants of the ASX Corporate Governance Council,[97] even if regulation specifies more detailed rules for independence, broader issues need to be examined by audit committees. These may include considering the scope of work for the company's auditor; whether the audit mandate is considered as a key strategic decision; whether the board or audit committee, if there is one, as opposed to management, sets the terms of the mandate; whether the audit budget is sufficient to ensure a high quality audit; and whether any changes are needed to ensure that the audit does deliver substance over form.

It is essential that companies debate these issues in order to leverage the potential checks and balances of the audit process and the work of audit committees into effective corporate governance. Over the last year, ASIC suggested a number of measures to restore confidence and credibility to accounting and audit, including:[98]

(1) Australia should remain committed to the development and adoption of a complete and consistent package of international accounting standards with no local finetuning. Those standards must address key areas of current international disparity and gaps that currently exist. In particular, accounting for acquisitions and the resulting goodwill; accounting for other intangibles; accounting for executive and other stock options; recognition of off-balance sheet commitments resulting from leasing and similar arrangements; accounting for financial instruments including derivatives; and accounting for debt/equity instruments.[99]

(2) International accounting standards should reintroduce to the law an overriding qualitative accounting consideration and audit opinion that the accounts 'truly and fairly' report the financial condition of the corporation, but such reintroduction should be accompanied by enforcement sanctions to prevent the repetition of past abuses.[100]

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94 David Knott, 'Protecting the Investor: The Regulator and Audit' (Speech delivered at the CPA Congress 2002 Conference, Perth, 15 May 2002).

95 That is, the duty to notify ASIC under s 311 of the *Corporations Act* if the auditor has reasonable grounds to suspect that a contravention of the *Corporations Act* has occurred; and believes that the contravention has not been, or will not be adequately dealt with, by commenting in the auditor's report or bringing it to the attention of the directors.

96 See NYSE, above n 65.

97 ASX Corporate Governance Council, above n 80.

98 See generally the references above n 93.

99 The Financial Reporting Council has confirmed that Australia will adopt International Accounting Standards by January 2005: Financial Reporting Council, 'Government Proposals and Accounting Regulation' (Press Notice 66, 24 July 2002), <http://www.frc.org.uk/publications/publications384.html> at 27 September 2002.

100 The 'true and fair' override was removed in Australia some years ago due to perceptions that it was abused by preparers of financial statements who used the override to avoid standards that they did not agree with.

(3) Auditing standards should have the force of law (as do accounting standards) and ASIC should have effective powers to police them.
(4) At least for listed entities, it should be compulsory for the board (in the absence of management representatives) to agree to the audit mandate and to review audit issues with the auditors at least every six months. It is imperative to reinforce the need for active dialogue between the board and auditors, independent of management sanitisation. In most cases, an audit committee may well be the best way to manage that dialogue.
(5) It should be compulsory for auditors to attend annual general meetings of listed companies and make themselves available to answer questions from shareholders.
(6) Consideration should be given to strengthening not only the current reporting obligations of auditors to the regulator, but extending those obligations to a nominated officer of the corporation itself, or at least extending the protection available to those who might wish to report matters to the regulator.

While these areas clearly require regulatory focus, other issues related to audit efficacy have been raised for legislative attention which are more problematic.

The first difficult issue relates to audit partner rotation. On one hand, there is scepticism as to whether audit *partner* rotation can be sufficient. People doubt whether a partner from the same audit firm will question key findings or assumptions of another partner in a previous audit. On the other hand, addressing this problem through mandatory rotation of firms after five years may considerably reduce the incentive to perform high quality audits. At the same time, the existence of only four major firms may create different pressures amongst the profession to endorse each other's work. One solution may be to mandate partner and manager rotation, and to increase the involvement of specialist technical partners (whose remuneration must be linked not to audit, but compliance with standards). These would act as advisers to audit partners, being consulted on certain audit standards issues, and assisting audit partners to resist pressure from clients. The involvement and independence of technical partners is a matter for audit firm governance while partner rotation may be mandated by the government. This issue is one which Australia will probably not be able to resolve in isolation. It will need to take account of developments in the US and UK; both are still to report their views on mandatory firm rotation.

A second difficult issue is the principle of auditor independence. This encompasses the relationship between auditors and their clients and the scope of other related services which may be provided to these clients. The *Sarbanes-Oxley Act of 2002* creates some relevant requirements for US companies as well as non-US companies which file in the US.[101] It remains debateable whether any

101 It is arguable that the present provisions of the *Sarbanes-Oxley Act of 2002* in this regard are uncertain. The conflict principle framework from the report of the US Senate Committee on Banking, Housing and Urban Affairs was not included, only a list of example services: Committee on Banking, Housing and Urban Affairs, *Report together with Additional Views to Accompany S 2673* (2002) 15–19. This is an area that may need to be further addressed by the US Public Company Accounting Oversight Board.

greater legislative prescription is required on non-audit services beyond a general statement of principle on independence, with application of that legal principle left to audit committees and the independence guidelines established by the profession.[102] Individual corporations will still need to establish a policy on auditing and non-auditing services and it will be important that these, as well as details of fees paid for non-audit services, are publicly disclosed.[103] It is also important that legislative restrictions are established governing auditors serving on boards of their clients and having financial relationships with clients.

B Empowerment of Non-Executive Directors

The second key area of corporate governance requiring reform is not a structural one, but one focusing on the empowerment of non-executive directors. According to Jay Lorsch:

> empowerment means that outside directors have the capability and independence to monitor the performance of top management and the company; to influence management to change the strategic director of the company if its performance does not meet the board's expectations; and, in the most extreme cases, to change corporate leadership.[104]

The empowerment of non-executive directors therefore requires companies to address the role of non-executive directors, the accessibility of information, processes relating to director selection and succession, and the process of reviewing board decisions.

Non-executive directors, who typically spend a fraction of the time spent by executives on company matters, and who usually only receive the information the chief executive wants them to receive,[105] have a difficult task in acting as 'checks and balances' on the executive team, overseeing audit and representing the interests of shareholders where they might diverge from management.[106]

The National Association of Pension Funds ('NAPF') in the UK recently published guidelines on what institutional investors expect from non-executive directors.[107] These stress the importance of *independent* directors, as opposed to non-executive ones who may be connected with the company. Independent directors are defined as persons who are 'independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding'.[108] In its guide, NAPF lays out eight key qualities expected of

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102 The Institute of Chartered Accountants in Australia and CPA Australia, *Professional Statement F1: Professional Independence* (2002), <http://www.cpaaustralia.com.au/01_information_centre/10_audit/1_10_0_f1_draft.asp> at 10 September 2002.

103 See, eg, ANZ Banking Group Ltd, 'ANZ Enhances Governance Standards' (Press Release, 24 April 2002).

104 Jay W Lorsch, 'Empowering the Board' (1995) 73(1) *Harvard Business Review* 107, 107.

105 See Michael Skapinker, 'A Simple Job Becomes a Thankless Task', *Financial Times* (London), 2 March 2002, 15.

106 See Martin Dickson, 'The Perils of Directorship', *Financial Times* (London), 25 April 2002, 24.

107 *NAPF Sets Out 'Investor Expectations' of Outside Directors* (2002) Independent Director <http://www.independentdirector.co.uk/NAPF_investor_expectations.htm> at 4 October 2002.

108 Cadbury committee, above n 3.

independent directors:

(1) a willingness to contribute to strategy and to challenge executives on strategy and other matters, as necessary;
(2) a readiness to challenge the company's mergers and acquisitions policy;
(3) an ability to contribute to financial and capitalisation issues;
(4) relevant experience for the needs of the company's business;
(5) independence of mind;
(6) individuals with sufficient time to devote to the needs of the business;
(7) integrity and a preparedness to resign over matters of principle, should that be necessary; and
(8) a willingness to learn and continue to learn, not only about the business and its market sectors, but also about the role of the independent director.

Among its recommendations, the NAPF also suggested that 'non-executive directors should restrict the number of posts they hold to no more than five'.[109]

The Bosch committee also emphasised the importance of access to information.[110] The Hampel committee noted that the board should have timely information in a form and of a quality appropriate to enable the board to discharge its duties effectively.[111]

The present governance debate therefore presents as a conundrum. On one hand, the role of independent directors is perceived as critical.[112] However, the limited nature of this role to date, both in terms of time commitment and access to information, provides a severe constraint on what independent directors can achieve. Indeed, some have recently seen the role of independent directors as impossible and hence called for their abolition.[113]

Although the difficulties for non-executive directors cannot be underestimated, the answer is probably not a board composed purely of executives. Before we decide to abandon the present philosophy of governance which has developed over many years, non-executives must be assisted in several important ways. They need to be assured of a more active role in the governance of the company. They need to be much better informed about the companies on which they sit, and about the business community in general. They need to spend more time on each board and therefore should hold fewer positions. There is not necessarily a fixed number suitable for all directors, but

109 *NAPF Sets Out 'Investor Expectations' of Outside Directors,* above n 107. See also Tony Tassell, 'Non-Executive Directors "Should Limit Positions Held"', *Financial Times* (London), 10 May 2002, 4.

110 Working Group on Corporate Practices and Conduct, above n 3.

111 Hampel, above n 9, 17.

112 Ernst & Young conducted a survey of 94 board members from the UK's leading 500 companies which suggests that, with the increased interest in corporate governance issues, the role of non-executive directors will become far more important. Key findings of the survey include that 96 per cent of respondents believed the role of the non-executive director was either fairly valuable (40 per cent) or very valuable (56 per cent). When asked specifically what it was they valued, 79 per cent mentioned their insight and experience, 74 per cent their independence and 70 per cent the challenges they make: Market and Opinion Research International ('MORI'), *A Force for Good — Captains of Industry Say that Non-Executive Directors Will Become Increasingly Important and Valuable*, Ernst & Young (2002).

113 See Alistair Osborne, 'Lord Young Takes Final Shot at Fat Cats and Non-Execs', *The Daily Telegraph* (London), 25 April 2002, 31.

part of the corporate governance disclosure made by the board should be its policy on length of directors' terms, and how many other directorships members of the boards have.

The amended governance rules of the New York Stock Exchange ('NYSE') recognise that rules alone cannot guarantee the competence and integrity of company officers, but they emphasise that honest and competent executives still need appropriate checks and balances to operate effectively.[114] These rules place particular emphasis on the role of audit committees, and on bolstering the activities and workings of independent directors. Thus, independent directors are required — amongst other detailed functions — to meet without management,[115] serve on audit committees[116] and work with management to develop governance guidelines to support the education and evaluation of board members.[117] In addition, specific activities such as discussions on risk assessments are required.[118]

Another suggestion has been that non-executive directors meet their top shareholders once a year.[119] To that end, plans are being drawn up for a three-year trial with 20 companies and their shareholders.[120]

All of these issues and more will no doubt be examined by the review of the role and effectiveness of non-executive directors being conducted for the UK government by UBS Warburg adviser, Derek Higgs. The UK government launched the review in April this year, following concern about the role of non-executives in the wake of Enron's collapse. It is expected that the review will be completed, and a report tabled, by the end of 2002. It will be interesting to see what impact the UK government's inquiry will have on the remit of a non-executive director and the expectations of the role in the future.

Other suggestions which have been made for improving board performance, relate to diversity in non-executive director selection and reviews of performance. These are increasingly seen as necessary to enhance the capacity of non-executives to contribute to board performance.[121]

Traditionally, boards have tended to judge their performance against the share price of the company, the financial performance of the CEO and the board's level of compliance with laws and regulations. While these indicators of performance remain important, broader performance measures need to be

114 See NYSE, above n 65. This sets out the proposed corporate governance listing requirements for companies listed on the NYSE. These requirements are to be codified in a new s 303A of the NYSE's Listed Company Manual.

115 Ibid, proposed s 303A(3).

116 Ibid, proposed s 303A(6).

117 Ibid, proposed s 303A(9).

118 Ibid, proposed s 303A(7)(b)(ii)(F).

119 See Simon Targett, 'Call to Reshape Role of Independent Directors', *Financial Times* (London), 18 February 2002, 31.

120 Ibid.

121 See generally Ann-Maree Moodie, *The Twenty-First Century Board: Selection, Performance and Succession* (2001).

adopted to assess the board as a collective group and as individuals. As Ann-Maree Moodie points out,

> progressive boards will also consider other attributes in an assessment of a board as a collective, such as commercial acumen, judgement in decision-making, communication skills, the ability to develop and implement a strategic vision, and succession planning for the board.[122]

Given that the board makes the key decisions that determine a company's prosperity and viability, assessing its effectiveness and performance is important. Progressive boards should reassess whether the way in which they have traditionally reviewed their performance is appropriate for the future of the organisation, and if not, embrace contemporary performance measures. A board should set objectives for what it wants to achieve and use performance appraisals as an opportunity to assess if it and its members are making a meaningful contribution to the organisation. Board appraisals not only improve the board's effectiveness, but also the relationship between the board and its management.

The professional development of directors is the cornerstone of the process of ensuring that directors are able to perform their duties and responsibilities to maximum effect. Insufficient time and money is spent developing directors for their role on the board.[123] It is ironic that companies spend large amounts of money and time in developing and training their staff, yet they spend very little on similar programs for those who are in control of their corporations. More consideration needs to be given to board training and access to courses to broaden the knowledge of directors of issues relevant to the business of the organisation.

Given the current business landscape — the significant number of non-executive directors approaching retirement,[124] the trend for shorter terms of directorship and the impact of globalisation — succession planning is an important issue for all Australian organisations today. However, succession planning for the board is not always an easy matter for boards to develop. It is not just about selection, but about long-term skills planning, which requires a long-term vision and an audit of existing skills on the board.

In addition to formally strengthening the role of non-executive directors, and encouraging their strategic selection and review, a key challenge is to develop and, where it exists, consolidate a culture of ethical behaviour. Companies with audit committees and independent directors have still suffered spectacular collapses.[125] Others have suggested that other factors, particularly external ones, such as buoyant market conditions and easy access to capital might be more important contributors to poor behaviour.[126] Clearly, not only do structures need to be reinforced by active independent directors, but an ethical business culture

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122 Ibid 22.

123 See Mark Watson, *Developing Directors* (2002) Boardroom Practice Articles <www.iod.com> at 27 September 2002.

124 See Moodie, above n 121, 41.

125 For example, both HIH and Enron had an audit committee with outside directors.

126 Geoffrey P Miller, 'Catastrophic Financial Failures: Enron, HIH and More' (Speech delivered at the Ross Parsons Lecture 2002, *The Global Regulation of Banking and Insurance: From HIH to Enron*, University of Sydney Law School, Sydney, 11 July 2002).

needs to be reinforced. Arguably, such a culture would ensure excessive executive remuneration would be checked by appropriate constraints and performance hurdles; audit standards would be observed in spirit and not just in a legalistic way; and disclosure to shareholders would be made in a meaningful way. Bosch listed a code of ethics as a key feature in 1995.[127] The new NYSE governance rules require each listed company to adopt and disclose a code of business conduct and ethics for directors, officers and employees and promptly disclose any waivers.[128] Senior directors have warned against a legislative over reaction and called for such a cultural response.[129] It will be interesting to see if such codes do lead to the development of such a cultural shift.

Governance can be viewed as a pyramid of influences. Legislation and law enforcement is a necessary base. Policy guidance, both through regulators and industry guidance, is an important shaping secondary layer. Governance structures then provide a framework for checks and balances to operate. However, the apex of the pyramid through which the other layers are interpreted, and which then controls the effectiveness of the structure underneath, is the culture and ethics of the organisation. Just as regulators and legislators are considering important amendments to the structural elements regarding audit and the role of non-executive directors, so boards need to focus on their own culture. Appropriate director selection, the approach of chairmen to encouraging the contribution of independent directors, and the dedication of those independent directors to their task with all that it entails, will help develop a culture which supports governance in substance.

V CONCLUSION

Until recently, the focus on corporate governance has been more on corporate structures and committees than on practices and processes designed to provide effective checks and balances. Recent major corporate collapses, both in Australia and overseas, have led to a renewed legislative and regulatory focus. Some of the lessons from these collapses are yet to be revealed, and the Australian government's CLERP 9 proposals are still to be discussed and debated. In the US, the focus of new legislation and revised stock exchange rules has been on improving the efficacy of audit, the independence of auditors and the scope for a greater role by independent directors. These areas are those where a stronger regulatory framework was needed, although, at least in the US, additional focus on the role and independence of analysts, rating agencies, financiers and lawyers, may still be forthcoming.

Despite these changes, it is time to recognise that such additional regulation needs to be accompanied by a cultural shift. A dynamic, strategic, transparent

127 See Working Group on Corporate Practices and Conduct, above n 3.

128 See NYSE, above n 65.

129 See Allesandra Fabro, 'Leave Governance to Business — Warburton', *Australian Financial Review* (Sydney), 6 September 2002, 3, reporting on a speech by Dick Warburton to the Press Club, Canberra.

and performance-based model of board governance is more relevant to the success and progress of a company than one which is reactive, monitoring and compliance-focused. Clearly, there needs to be strong commitment from the corporate community to the fundamental principles of corporate governance. However, individual boards will need to adopt a cultural and ethical stance, which will enable the structures of governance to operate effectively.

The regulator will no doubt remain active and energetic in pursuing breaches of the law and in enforcing the minimum standards of corporate behaviour, and the regulatory framework will be amended to emphasise audit independence and the greater role for independent directors. However, although a regulator can go beyond enforcement and provide guidance and education, ethical standards remain within the purview of the corporate sector.

As noted at the beginning of this article, more and more Australians are now direct and indirect shareholders, following a decade of demutualisations, privatisations and compulsory superannuation. The American investing community is angry, and justifiably so, about the behaviour of parts of corporate America, and Australian investors should at least be alert to some of these concerns regarding corporate Australia. It is now for those within the corporate sphere — directors, managers, media commentators, fund managers, investment analysts, professional bodies, and regulators, *but not just regulators* — to ensure that high standards of business practice, which investors have a right to expect, become a reality in Australia's boardrooms.