BUSINESS COUNCIL OF AUSTRALIA

Submission to the Parliamentary Joint Committee on Corporations and Financial Services

on the

Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill

17 November 2003

FOREWORD

The Business Council of Australia is an association of chief executives of leading Australian corporations. It was established in 1983 to provide a forum for Australian business leaders to contribute directly to public policy debates to build a better and more prosperous Australian society. A list of companies comprising the Business Council is given below.

The key role of the Business Council is to formulate and promote the views of Australian business. The Business Council is committed to achieving the changes required to improve Australia's competitiveness and to establish a strong and growing economy as the basis for a prosperous and fair society that meets the aspirations of the whole Australian community.

The Business Council has a particular responsibility to apply Australia's business experience and understanding to successfully resolving the challenges now facing Australia. In a global environment, Australia's future depends on achieving world class performance and competitiveness. On the basis of sound research and analysis, the Business Council seeks to play a key role with government, interest groups and the broader community to achieve performance and world class competitiveness.

With this in mind, the Business Council of Australia makes the following submission to the Parliamentary Joint Committee on Corporations and Financial Services.

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Westpac Banking Corporation
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EXECUTIVE SUMMARY

The Business Council of Australia welcomes the opportunity to provide the Parliamentary Joint Committee on Corporations and Financial Services with this submission on the Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill (CLERP 9).

The CLERP 9 Bill is complex legislation covering complex areas of corporate regulation. In the light of well known yet isolated instances of corporate collapse and misconduct and the sustained yet cyclical downturn in the value of the share market, the CLERP 9 Bill also covers areas of corporate behaviour and regulation that are highly topical and political. While accepting the need to address corporate governance concerns, the Business Council believes that Parliament's response should be based on a balanced, principle based approach, rather than one of excessive prescription. Good corporate governance comes from integrity, transparency and accountability, not from ticking the boxes on check lists or rigidly following set processes. This latter approach risks placing a higher value on form over substance. The Business Council has serious concerns, however, that elements of the CLERP 9 Bill are overly intrusive and go beyond what is necessary to achieve the objectives of the Bill.

In considering this Bill, the Business Council submits that the Parliamentary Joint Committee should bear in mind the reality that the performance of corporate Australia has been among the best in the world, as evidenced by the sustained performance and growth in Australia's economy over a long period of time. Australia's system of corporate governance matches, and in a number of instances, exceeds best practice in other markets. Nor have we witnessed the instances of corporate governance failure on the scale seen overseas, particularly in the US. It is also important to draw the distinction between failures of corporate governance and failures of business strategy.

Despite this, the CLERP 9 Bill proposes powers that, while addressing short-term concerns, are counter to corporate performance and long-term shareholder interests. These powers represent significant intrusions on the function of Boards of publicly listed companies to perform their role as agents appointed by shareholders to manage their investment. As such, they would not be countenanced in other areas of activity. In particular, the BCA has concerns in the areas of continuous disclosure and executive remuneration. These issues are the main focus of this submission.

The Business Council is aware of a range of concerns that also arise in the audit and financial reporting areas of the CLERP 9 Bill. These issues are being specifically addressed by other organisations and in the very limited time that has been made available for consultation on this complex Bill, the Council has elected to focus on the areas of its principal concerns. This should not be interpreted as a sign that the Business Council is not concerned with the practical and inadvertent consequences that appear to arise in other areas of the Bill.

The Business Council submission makes the following points in relation to the proposals on executive remuneration and continuous disclosure.

Executive Remuneration

Remuneration information to be on a group basis

The Business Council does not support the proposal to increase the remuneration disclosure requirements to cover up to ten executives. It recognises the principle behind the CLERP 9 proposal is to ensure the true state of remuneration levels across a corporate group is disclosed, not just the remuneration levels within the listed entity. The Council believes, however, that the same effect could be achieved by requiring companies to disclose the remuneration of the top five executives employed within the group, regardless of whether they occupy positions within the listed entity or other entities within the group.

Increasing the number of executives covered by the disclosure requirements will only exacerbate unintended consequences from the disclosure requirement, particularly the 'ratcheting up' of executive salaries in a competitive market where demand for experienced and proven executives is strong. It is also inconsistent with general privacy principles and the movement towards greater protection for personal information.

The Business Council believes that CLERP 9 provides an opportunity to re-assess the current disclosure requirements and to address these unintended consequences. Specifically, the Business Council proposes that the current requirement to disclose the remuneration of named individual executives be replaced with a requirement to disclose the combined remuneration of a set number of executives. In effect, this would require the disclosure of the average remuneration of a company's top managers, providing a valid means of comparing remuneration with the company's performance and that of its peers and competitors, without disclosing the remuneration of individuals.

Discussion of remuneration disclosures at company AGMs

Annual general meetings are an important element of corporate governance and the main opportunity each year for ordinary shareholders to comment and question the Board and management of their companies. The Business Council therefore supports shareholders having the opportunity to have a company's remuneration policies and practices presented and explained by the Board. The Council also supports shareholders being able to express their views on the remuneration paid to directors and senior managers and the Board's remuneration policy.

The Business Council does not condone excesses in the area of executive pay. Nor does it condone what are isolated examples in which pay has clearly not been linked with performance. However, it is concerned that what are effectively a small number of instances have become the sole reference point of the debate over executive remuneration. Therefore, it believes the proposal for a non-binding vote on executive remuneration is unnecessary and infringes the basic principle that it is the function of shareholders to approve the remuneration of directors and the function of directors to determine the remuneration of executives. In this regard, the proposal goes beyond the new UK requirements upon which it is based.

Australia already has among the most extensive requirements for disclosing executive remuneration in the world. The new proposal is therefore unwarranted. The proposal also potentially raises legal issues for Boards that do not abide by the shareholders' vote, even though it is meant to be non-binding.

Continuous Disclosure

Civil Penalties Against Individuals

The Business Council does not support the proposal to extend civil liability for contraventions of the continuous disclosure provisions of the *Corporations Act 2001* to individuals involved in a breach.

Continuous disclosure decisions are rarely the responsibility of any one individual. They are typically corporate decisions taken collectively, for example by a Board or senior management team, often acting on the advice of a range of internal and external advisers. Ascribing individual responsibility to one or more individuals within that team or group will be difficult and may place an unfair onus on particular executives, such as the company secretary.

Increased Penalties

The Business Council continues to support increasing the maximum penalty for contravention of the continuous disclosure regime by a corporation from $200,000 to $1 million. The Council believes that meaningful penalties need to be applied, to underpin the seriousness of the continuous disclosure regime and to act as an adequate deterrent for wilful breaches of the requirements.

Infringement Notices

The Business Council submission on the Federal Government's initial policy paper, released late last year, raised a number of concerns with this proposal, both in terms of the underlying principle and the practical implications. A range of other business groups echoed these concerns, as has the Australian Law Reform Commission. The Business Council is therefore very disappointed that these concerns have gone largely unaddressed in the proposed CLERP 9 legislation. The Council recognises that steps have been taken to ameliorate some of these concerns, such as the risk of 'trial by media', however, the fundamental flaws in the proposal remain.

Fundamental to the consideration of an appropriate enforcement regime for continuous disclosure is the subjective nature of decisions on what information should be disclosed, and when. The subjectivity of continuous disclosure decisions means there is often considerable scope for differences of opinion on what information is material to the market and therefore requires disclosure. There is also considerable scope for differences of opinion on the appropriate time for the release of that information to the market.

Given this subjectivity, it is important that there are more checks and balances on regulatory power in this area, rather than less, as under this proposal. Allowing ASIC to determine unilaterally when the continuous disclosure regime is breached and to penalise companies accordingly greatly increases the risks of regulatory error and the uncertainty for business over intervention by the regulator.

The CLERP 9 Commentary sets out a number of suggested safeguards for the new infringement notices. These safeguards may largely be illusory, however. There are still significant incentives in place for a company to pay the ASIC fine rather than challenge ASIC's decision, given the relative costs involved. The proposed checks and balances do

nothing to address the fundamental concern that the new power puts ASIC in the position of investigator, prosecutor and judge.

Should it be decided to proceed with the proposal for infringement notices, the Business Council believes two further checks should be added to minimise the risks inherent in that proposal:

1. To avoid ASIC being investigator, prosecutor and judge, third parties should be involved in the decision on whether an infringement notice is warranted. This could be achieved through a separate panel drawing on individuals with experience in decision making in the area of continuous disclosure (experience gained as regulators, corporate executives or corporate advisers). The functions of investigating alleged breaches and issuing infringement notices should also be clearly separated within ASIC. The proposal to exclude ASIC's decisions from review by the Administrative Appeals Tribunal should also be dropped.

2. The provisions should only be introduced with a three year sunset clause. This guarantees that the use of the powers is reviewed after that period and provides an incentive for the regulator to only use the power as intended. A commitment to undertake a review of an entrenched power after three years does not provide the same degree of reassurance to business nor incentive to ASIC to see the power appropriately used. A precedent for providing regulators with additional powers for a limited period of time can be seen in the additional trade practices powers granted to the Australian Competition and Consumer Commission in relation to the introduction of the goods and services tax.

The Business Council would be happy to discuss the development of these proposals further.

INTRODUCTION

The Business Council of Australia welcomes the opportunity to make a submission to the Parliamentary Joint Committee on Corporations and Financial Services on the Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill.

There can be no doubting the level of concern in Australia and elsewhere over the standards of governance some corporations have applied that. The Boards and management of companies are under intense pressure, from shareholders, markets, the media, politicians and the general community, to address perceived failings in the corporate governance system. Similar pressure is being applied to governments. In this environment, great care needs to be taken to ensure that problems are real and that the proposed solutions are merited and will not have unintended consequences. While accepting the need to address corporate governance concerns, the Business Council believes that Parliament's response should be based on a balanced, principle based approach, rather than one of excessive prescription and 'knee jerk reactions'.

Much of the debate about corporate governance has been linked to corporate collapses, such as Enron and Worldcom in the US and HIH, One.Tel, Ansett and Harris Scarfe in Australia. A clearer relationship exists, however, between the level of concern over corporate governance and performance of the share market. As the share market dropped in 2002, corporate governance concerns skyrocket. This point is important for legislators to remember, as it was not a failing of corporate governance that caused the share market to drop. The effect of the drop in the share market, however, was to exposed company weaknesses in management structures, business strategies and to a lesser extent, corporate governance. As a result, increasing governance requirements will not cause the share market to recover. Excessive prescription in legislators' responses to corporate governance could in fact have the opposite effect of dampening a recovery in the value of the share market, as Boards and companies become risk adverse and distracted from their businesses.

Despite the claims in some quarters, there is no crisis in corporate governance in Australia. Australia is at the forefront in terms of the quality of its corporate governance systems and practices. In some areas, such as director independence, Australia leads comparable countries such as the UK and US. To assist the Parliamentary Joint Committee's consideration of the CLERP 9 Bill and to place it in an international context, the Business Council sets out in Attachment A of this submission a comparison of corporate governance requirements in Australian, the UK and the US.

The Business Council accepts that it is timely to review Australia's corporate governance standards and practices. The CLERP 9 Bill is a further stage in that review process.

Much has happened in this area since the Federal Government released its policy consultation paper on corporate governance in late 2002. Most importantly, the Australian Stock Exchange (ASX) Corporate Governance Council has made a major contribution to refining and developing corporate governance through its *Principles of Good Corporate Governance and Best Practice Recommendations*. This initiative was important as it brought together a wide range of representatives of company management, Boards, institutional investors, retail investors and others to develop an agreed statement on best practice corporate governance. While companies are not obliged to respond to the

guidelines until 2004, there are already strong indications that major listed companies are adopting the approaches set out in the guidelines or explaining their alternative approaches.

In addition, there are clear indicators that companies are responding to shareholder and community concern about corporate governance issues, particularly in relation to executive and director remuneration.

It is important that these initiatives are taken into account when considering the need for additional legislation and additional powers for corporate regulators.

Corporate governance is important to the financial performance of companies and the returns and rights enjoyed by shareholders. Concern for corporate governance alone, however, will not drive a recovery in the share market nor increase total returns to shareholders. The increasing amount of time spent by Boards and executives on managing ever growing governance requirements runs the risk of distracting Board's from their other primary role, namely setting the strategic direction of the company. Ironically, excessive pressure to tick the corporate governance boxes could have unintended consequences through making Boards and management risk adverse, reducing company performance to the detriment of shareholders. Nor will measures to improve corporate governance, no matter how prescriptive, prevent future corporate collapses.

The Business Council urges the Parliamentary Joint Committee to be conscious of these considerations in considering the new governance requirements in the CLERP 9 Bill.

SCOPE OF THIS SUBMISSION

The Business Council submission focuses on two main areas: continuous disclosure and executive remuneration. These represent areas of principal concern for Business Council members.

The Business Council is, however, aware of a range of concerns with the audit and financial reporting areas of the CLERP 9 Bill. We understand that these issues are being specifically addressed by other organisations and in the very limited time that has been made available for consultation on this complex Bill, the Council has elected to focus on the areas of its principal concerns. This should not be interpreted as a sign that the Business Council is not concerned with the practical and inadvertent consequences that appear to arise in other areas of the Bill.

By way of illustration, the Business Council is aware of issues that have arisen in relation to the following matters.

(i) The requirement that auditors report suspected breaches of the *Corporations Act 2001* to ASIC within seven days may undermine the relationship between auditors and their clients, including the effective role auditors can play in encouraging compliance with the Act. This requirement is also likely to lead to a flood of reports to ASIC of potential breaches, as auditors seek to minimise their personal risk.

(ii) Requiring the directors' report of a listed company to contain "*information that members of the company would reasonably require to make an informed assessment of…the entity's business strategies and its prospects for future financial years*"[1] is potentially in conflict with other provisions of the Corporations Act and the Trade Practices Act regarding forward-looking statements.

This new section would effectively require a due diligence review of the company's operations and forecasts, as well as predictions about the economy and markets, which may be unable to be substantiated. The requirement may also lead to the company breaching confidentiality arrangements and put sensitive potential investments in jeopardy. Moreover, it has the potential to be used out of context by aggrieved investors suing for damages where predictions do not come to pass.

The new requirement is also likely to cause conflict with trade practices requirements, with the Australian Competition and Consumer Commission suggesting that it will target companies that it believes are engaging in price signalling in the market by releasing information on likely future pricing policies.

1 Proposed section 299A(1)(c)

REMUNERATION OF DIRECTORS AND EXECUTIVES

Director and executive remuneration is undoubtedly the current focal point for the corporate governance debate, with rarely a week going by without some commentary on CEO pay or director benefits. Despite a strengthening share market and a return to healthy company profits, views continued to be expressed by media commentators, politicians and trade union leaders that CEO pay is unreasonable and divorced from the reality of corporate results. This has led to calls for further regulation and intervention in the level and type of remuneration paid to CEOs and other senior executives.

Conversely, there appears to be acceptance that Australian corporations need to provide competitive remuneration levels for corporate leaders if our economy is to compete successfully in an increasingly global market place. This is reinforced by the practice of recruiting internationally for executives to lead our companies and the growing number of talented Australian executives recruited to companies offshore.

The Business Council recognises that this debate has the potential to damage shareholder and general community perceptions of, and confidence in, governance across corporate Australia. No other issue strikes more directly at the standing and integrity of the corporate sector than perceptions that CEOs are generously rewarded for poor performance or the destruction of investor value.

There is a danger, however, that the current mood will lead governments to take actions that are at best unnecessary and at worse counterproductive. The Business Council accepts that community concerns need to be responded to, but is concerned that some measures proposed in the CLERP 9 Bill go too far.

The Business Council is particularly concerned with the proposal to allow shareholders a non-binding vote on executive remuneration. The Council supports the view expressed in the CLERP 9 Commentary that "*it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives*"[2]. The proposal to allow shareholders a non-binding vote on executive remuneration, however, flies in the face of this principle. Our concerns are set out in detail below.

As part of its response to concern over executive remuneration, the Business Council recently released a guide to best practice principles on remuneration. The guide brings together, for the first time, concise information on best practice proposals, practices and recommendations on executive pay and is designed to assist companies and their Boards develop and structure executive pay packages. A copy of the guide is at Attachment B.

Remuneration information to be on a group basis

The Business Council understands that the policy intent behind the proposal to extend the remuneration disclosure requirements to the top five senior managers in a consolidated entity is to ensure the true state of remuneration levels across the group is disclosed, not just the remuneration levels within the listed entity.

2 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, p 101

While the Business Council supports this in principle, it does not believe that the total number of executives whose remuneration is disclosed needs to be expanded to achieve this objective (from five to a maximum of ten). No policy reason has been advanced for why the absolute number needs to be increased. The proposal therefore just seems to be a surrogate means of increasing the total number of named executives whose remuneration is made public.

The Business Council is concerned that the disclosure of individual executives' remuneration has unintended consequences, which will be exacerbated by increasing the number of executives covered. There is strong anecdotal evidence to suggest that the disclosure of individual executives' remuneration leads to a 'ratcheting up' of salaries, as an executive can see how much peers and colleagues within the company, and its competitors, earn.

Disclosure can also lead to executive remuneration being adjusted upward so that it falls within the top quartile of remuneration paid across comparable companies. Companies are wary of being seen to underpay their executives, or employ executives that are apparently only good enough to warrant remuneration at lower levels, compared with their competitors.

In addition, extended disclosure may, in some cases, result in the remuneration of relatively junior executives being disclosed. Such disclosure requirements also put publicly listed companies at a disadvantage to private or foreign owned corporations, which are able to see the 'price tag' of individual executives working for a public company, without having to disclose the remuneration of their own executives.

Identifying senior executives and their remuneration levels is also contrary to general privacy principles and the movement towards protecting personal information. It is surprising that company's face financial penalties under the *Privacy Act 1988* for revealing personal information, yet have to disclose, and see reported in the media, the details of remuneration of individuals employed by the company.

Extending the disclosure requirements to 10 executives will exacerbate these problems and may lead to further increases in executive remuneration.

The policy objective of ensuring that the remuneration of the senior most executives across the consolidated group, not just of the listed entity, is disclosed, could be achieved without expanding the number of executives for whom disclosure is required. The same effect could be achieved by requiring companies to disclose the remuneration of the top five executives employed within the group, regardless of whether they occupy positions within the listed entity or other entities within the group.

The Business Council believes that CLERP 9 provides an opportunity to re-assess the current disclosure requirements and to address the unintended consequences detailed above.

The Business Council accepts disclosure of the remuneration of the senior most executives, however, it believes alternative means of disclosure that do not result in 'ratcheting' nor conflict with privacy principles need to be considered.

The principle behind disclosure is that it allows shareholders the opportunity to judge whether the remuneration of the company's executives is consistent with the performance of the company and to compare remuneration with that of peers and competitors.

This objective could be achieved through disclosing the total, combined remuneration of the top executives. In effect, the company would be disclosing the average remuneration of its top managers, providing a valid means of comparing remuneration and performance, without disclosing the remuneration of named individuals. Shareholders have the opportunity at the annual general meeting to question the Board on how total remuneration relates to the company's performance.

If this change is made, the ratcheting effect of remuneration disclosure on individual remuneration would be significantly reduced, but companies would still need to report and justify significant changes in remuneration.

If such a proposal were implemented, the Business Council would be less concerned whether the remuneration disclosure requirement covered 5 or 10 executives.

Specific content of the remuneration section of the annual directors' report

The Business Council notes that the contents of the remuneration report are to be determined by regulations and will comment on the coverage of the report once regulations have been promulgated. In the meantime, the Council welcomes the CLERP 9 commitment that the requirements of the regulations will be the same as under the accounting standards.

Discussion of remuneration disclosures at company AGMs

Annual general meetings are an important element of corporate governance and the main opportunity each year for ordinary shareholders to comment and question the Board and management of their companies. The Business Council therefore supports shareholders having the opportunity to have a company's remuneration policies and practices presented and explained by the Board. The Council also supports shareholders being able to "*express their opinion on the remuneration paid to directors and senior managers and the board's policy of remuneration*"[3].

The Business Council does not, however, support the proposal for a non-binding vote on executive remuneration. The proposal is unnecessary and infringes the basic principle that "*it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives*"[4].

Existing Requirements

Australia already has among the most extensive requirements for disclosing executive remuneration in the world, with listed companies required to disclose the remuneration of Board members, as well as the five top paid senior company managers, including the CEO.

Shareholders already have the right to discuss and question executive pay at annual general meetings, as executive remuneration is reported in the annual directors' report. If

3 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, pp 104-105

4 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, p 101

shareholders wish to elevate that discussion to the level of voting on a resolution, under the Corporations Act, 100 shareholders are already able to require such a resolution. Experience since the introduction of that provision is that it is not at all difficult for shareholders to place resolutions on the agenda of general meetings. Mandating such a resolution for all companies is therefore unnecessary.

In addition, shareholders vote on any equity component of executive remuneration. This is appropriate, as providing executives with an equity interest in the company has a direct effect on other equity holders, namely shareholders. Requiring an additional vote on non-equity remuneration is an unnecessary additional step.

Confusion of Roles

The proposal also raises fundamental questions about the role of Boards and their relationship with shareholders. The concept of a publicly listed company involves shareholders delegating authority for the management of their investment to a Board. It is appropriate that, as is already the case, shareholders vote on the appointment and remuneration of the Board of directors. As noted above, it is also appropriate that shareholders vote on the allocation of equity in the company to executives or others. However, it is the role of the Board, on behalf of shareholders, to determine the remuneration of executive managers.

As a matter of principle, there is no difference between the Board's decision on executive remuneration and its decisions on a wide range of other matters that may affect shareholder value. If a shareholder vote is accepted as a matter of principle on executive remuneration, it is difficult to see why a shareholder vote would not be considered appropriate to verify a wide range of other Board decisions, such as decisions to acquire or divest company assets. Such a principle would, however, undermine the whole basis on which the listed company structure is based.

No Confidence Vote

The proposed vote on executive remuneration is effectively a confidence (or no confidence) vote in the Board and its Remuneration Committee. Boards are in the position where they are aware of the skills, experiences and contributions to the company of individual executives. They are also aware of the significance of retaining particular executives and the costs to the company if experienced executives cannot be retained. Boards also seek independent external advice on appropriate remuneration, given the executives involved and the circumstances of the company and the markets in which it operates. Boards may also have access to information about remuneration rates at comparable non-listed and multinational corporations; information that is not readily publicly available. The judgements and decisions of Boards and their Remuneration Committees are therefore based on a sound understanding of all of the factors influencing executive remuneration. Shareholders invariably have considerably less information upon which to base their judgements.

If shareholders vote to reject the judgement and decision of the Board, this effectively amounts to a vote of no confidence in the Board and its Remuneration Committee. Such a vote could be expected to lead to the resignation of, at the very least, the Chair of the Remuneration Committee.

Legal Concerns

The proposal potentially raises legal issues for Boards that do not abide by the shareholders' vote. A Board's decision to go against a shareholder vote, even though it is meant to be non-binding, might be used as evidence in subsequent legal proceedings to suggest that directors have not fulfilled their duties. Even if it would not amount to legal evidence, the fact of the Board disregarding shareholders' expressed wishes could weigh on the mind of the court, against the directors.

If a court had to interpret the provision it would seek to give some meaning to it in order to implement parliamentary intention. It might be that the court would hold that a duty was imposed on directors to take some action on the basis of the resolution of the shareholders. For companies operating in a number of countries, this risk will be multi-jurisdictional.

Any increase in the risk or perceived risk associated with being a director will also lead to higher indemnity insurance premiums. This will increase the costs to companies of their directors, either through having to pay higher director remuneration to offset the increase insurance premiums or through paying the increased premiums where the company covers the costs of insurance.

It is understood that under the Bill, it is not intended that directors would be subject to any legal consequences if they do not act in accordance with such a resolution of shareholders. This should be made clear in the amendments to section 250R. At the very least, an additional provision should be inserted in the Bill to state that if the directors do not accept or otherwise act in accordance with such a resolution, such actions of the directors may not be used in any legal proceedings against either the directors or the company.

Overseas Comparisons

Finally, the Business Council notes that while similarities and comparisons are being drawn publicly between the proposed shareholder vote for Australian companies and requirements which recently came into effect in the United Kingdom, the Australian proposal goes beyond the UK requirements. In particular, in the UK, only directors' remuneration is put to the vote. While this covers executives who sit on the Board, other members of senior management are not included, as is proposed for Australia. The UK requirements therefore do not conflict with the basic premise that it is the function of shareholders to approve the remuneration of directors and the function of directors to determine the remuneration of executives.

Practical Implications

The introduction of a shareholder vote on executive remuneration raises a number of practical issues for Boards seeking to employ the best executives for their companies.

The following hypothetical demonstrates one of the perverse outcomes that will flow from the introduction of a shareholder vote on remuneration, namely that there will be higher barriers for companies wishing to recruit senior executives from outside of their firms. This in turn can reduce the opportunity to bring executives with different experiences, skills and cultures into the recruiting company, with ultimately negative effects on shareholder value.

> *Company A wishes to fill an executive position within the company. They hire an executive placement consultant and undertake a search for the most suitable candidate, both within and from outside of the company.*

An executive working for a rival firm (Company B) is identified and selected as the most appropriate candidate for the position. The executive agrees to take the position and terms of employment are negotiated. Company A, however, advises that in her new position, the executive will be one of the top five paid executives in Company A and therefore her annual remuneration will need to be disclosed, in accordance with s 300A of the Corporations Act. Her remuneration arrangements will also therefore be subject to a non-binding shareholder vote at the next annual general meeting. Company A advises the executive that, should the resolution on executive remuneration be rejected by the shareholders, even though the vote is non-binding the company will abide by the vote. The company is concerned that to ignore the vote would expose it to public criticism and may increase the legal risk to its directors. Company A therefore makes the final employment offer to the executive conditional on the passing of the remuneration resolution. This is further complicated as there may be months before the company's AGM, at which the vote will take place.

The executive is placed in an impossible position. Once it becomes know that she is considering a move to Company A, her career at Company B is finished. If her contract with Company A is voted down as part of the non-binding vote, she is left in limbo. To offset this risk, the executive demands an up front payment in return for her agreement to enter into the employment contract with Company A. The payment will need to be considerable, as the executive is potentially risking her successful career. Company A is now faced with additional risk in employing an executive from outside of the company. If the shareholders vote against the company's remuneration report, Company A will lose both the new executive, and the up front payment.

The Business Council recognises the validity of shareholders wishing to discuss a company's remuneration policies and practices. This opportunity already exists by virtue of executive remuneration disclosure in the annual report. If there is sufficient shareholder concern over remuneration that a resolution is warranted, 100 shareholders can have such a resolution placed before the meeting. The CLERP 9 proposal therefore adds nothing of substance to the existing opportunities, while raising a range of concerns.

Shareholder approval of termination payments

The Business Council believes the proposal to require a shareholder vote on payments to directors above a certain threshold, including retirement or termination payments, needs to be reconsidered. In particular, this proposal does not recognise the potential effect of legitimate superannuation on the total of retirement payments and implies that payments above the threshold are somehow excessive and therefore require specific approval. Should this provision be introduced, however, existing entitlements and agreements should be "grandfathered"; that is, excluded from the operation of the new provision.

CONTINUOUS DISCLOSURE

The Business Council strongly supports effective continuous disclosure as a vital component of the Australian disclosure framework. The Council believes that the current continuous disclosure regime is sound and serves investors, regulators and companies well. We welcome the opportunity, however, to consider proposals for further improvements to the continuous disclosure regime. The Business Council supports the ASX continuing to have the primary supervisory role for compliance with the continuous disclosure regime, backed up by appropriate regulatory powers for the Australian Securities and Investments Commission (ASIC).

In its initial policy paper, the Federal Government proposed the introduction of a power for ASIC to issue infringement notices for alleged breaches of the continuous disclosure requirements. In its submission to the Government, the Business Council raised a number of concerns with the proposal.

While some attempt has been made to address some of the issues raised, the Business Council remains deeply concerned with the proposed new power and strong opposed to its introduction.

Civil Penalties Against Individuals

The CLERP 9 legislation would extend civil liability for contraventions of the continuous disclosure provisions of the Corporations Act to individuals involved in a breach.

The Business Council does not support these amendments to the Corporations Act. Extending liability to individuals assumes that there is a readily identifiable individual with responsibility for a particular decision or action. In contrast, disclosure decisions are rarely the responsibility of any one individual. They are typically corporate decisions taken collectively, for example by a Board or senior management team, often acting on the advice of a range of internal and external advisers. Ascribing individual responsibility to one or more individuals within that team or group will be difficult and may place an unfair onus on particular executives, such as the company secretary.

In addition, it must be recognised that decisions about what to disclose and when are decisions of judgement made on the basis of information available at that time, and often within very tight timeframes. It can therefore be inappropriate to assess these judgements, often with the benefits of hindsight, to the standard appropriate for imposing individual liability.

The Business Council also notes that a strong case has not been presented for why such an extension of liability is necessary.

Given the difficulty of assigning responsibility for continuous disclosure decisions to one or more individuals and the judgemental nature of the decisions, the Business Council does not believe that individual liability is appropriate in this area. A contrast can be draw with insider trading, for example, where the action and behaviour of an individual lies at the heart of the offence. As noted below, the Business Council does support an increase in the fines for

corporations contravening the continuous disclosure requirements from $200,000 to $1 million and believes this is a more appropriate approach than individual liability.

If the continuous disclosure regime is to expand personal liability in this way, then this extension must be tempered by a legislated due diligence/business judgment defence. This would provide protection to directors, executives and advisers who follow proper procedures and who reach honest and reasonable decisions regarding the disclosure of information.

Increased Penalties

The Business Council supports increasing the maximum penalty for contravention of the continuous disclosure regime by a corporation from $200,000 to $1 million. The Council believes that meaningful penalties need to be applied, to underpin the seriousness of the continuous disclosure regime and to act as an adequate deterrent for wilful breaches of the requirements. The Council believes this is achieved by increasing the penalties to $1 million. In line with this, however, market operators must ensure that they provide listed entities with education and guidance in regard to continuous disclosure provisions and obligations.

Infringement Notices

The CLERP 9 policy paper proposed that ASIC be given the power to issue infringement notices and impose financial penalties in relation to contraventions of the continuous disclosure regime. In effect, ASIC would be able to fine companies when ASIC formed the view that a company had breached the continuous disclosure requirements. In the Business Council's submission to Federal Government on this policy paper, it raised a number of concerns with this proposal, both in terms of the underlying principle and the practical implications. A range of other business groups echoed these concerns.

In addition, the Business Council notes that the Australian Law Reform Commission (ALRC) Report on Civil and Administrative Remedies, released in April 2003, was highly critical of this proposal. The Federal Government has responded to neither that report nor the criticisms raised by the ALRC.

The Business Council is disappointed that these concerns have gone largely unaddressed in the proposed CLERP 9 legislation. The Council recognises that steps have been taken to ameliorate some of its concerns, such as the risk of 'trial by media', however, the fundamental flaws in this proposal remain.

Subjectivity

Fundamental to the consideration of an appropriate enforcement regime for continuous disclosure is the subjective nature of decisions on what information should be disclosed, and when. This is the case regardless of detailed legislative and administrative guidance on the requirements of the continuous disclosure regime. This issue has already been touched on in relation to the proposal to extend civil liability to individuals.

The subjectivity of continuous disclosure decisions means there is often considerable scope for differences of opinion on what information is material to the market and therefore requires

disclosure. There is also considerable scope for differences of opinion on the appropriate time for the release of that information to the market.

Recognition that these are subjective judgements must be a critical consideration in the enforcement regime for continuous disclosure. While in some cases it will be apparent whether and when information should be released, in many others it will not be. This makes compliance with the continuous disclosure regime more difficult than, for example, compliance with periodic financial reporting requirements.

Given this subjectivity, it is important that there are more checks and balances on regulatory power in this area, rather than less as under this proposal. Allowing ASIC to determine unilaterally when the continuous disclosure regime is breached and to penalise companies accordingly greatly increases the risks of regulatory error and the uncertainty for business over intervention by the regulator.

As decisions on continuous disclosure require a considerable degree of subjective judgement, any enforcement regime should be light handed, with adequate checks and balances and minimal potential for misguided or inappropriate use of regulatory power.

Is there a need?

The proposed infringement notice powers are highly discretionary and interventionist and would require considerable evidence of their need to be justified. Only superficial justifications for the proposed powers have been provided, however, through the original consultation paper and in the Commentary accompanying the draft legislation. According to these, the penalties are designed to deal with minor contraventions of the continuous disclosure regime, which do not warrant court proceedings and are designed to give ASIC another way to signal its views on continuous disclosure practices.

ASIC has previously argued that it needs additional powers if it is to effectively enforce the continuous disclosure regime. In particular, ASIC has argued that, where court proceedings are the only option for enforcing the regime, only very serious breaches are likely to be acted upon and ASIC therefore has no effective power in relation to more minor breaches. ASIC believes that having a power to impose administrative fines will "*improve the flexibility, cost-effectiveness and timeliness of remedies, and underpin the integrity of the law by providing a proportionate remedy for conduct that is otherwise missing*"[5].

Such concerns may have had some validity prior to recent amendments to the Corporations Act. Before the *Financial Services Reform Act 2001* (FSR Act) came into effect on 22 March 2002, ASIC's only option for securing a penalty for a contravention of the continuous disclosure regime was to institute criminal proceedings.

The FSR Act amended the Corporations Act so that civil penalties can now be imposed for breaches of the continuous disclosure requirements. Allowing civil penalties reduces the administrative and legal burden upon ASIC to prove a contravention of the requirements, for example, by lowering the burden of proof. Since the FSR Act amendments came into effect, however, ASIC has chosen not to institute civil proceedings. These new powers are therefore untested. The deterrent effect of the current powers is also significantly reduced when ASIC has not prepared to institute prosecutions. The Business Council considers that there is therefore a strong argument that further powers should not be given to ASIC until the

5 Monash Governance Research Centre Inaugural Lecture, Mr David Knott, Chairman of the Australian Securities and Investments Commission, *Corporate Governance – Principles, Promotion and Practice*, 16 July 2002.

effect of the current powers, particularly the recent additional power to seek civil penalties, has been properly tested.

Are there adequate safeguards?

The Commentary accompanying the draft CLERP 9 legislation argues that the "*proposed new mechanism strikes an appropriate balance between enhancing ASIC's capacity to deal with relatively minor contraventions of the continuous disclosure provisions and ensuring there are adequate procedural safeguards*"[6] to ensure those powers are not inappropriately used. The Business Council supports the need for such a balance, but disagrees that the balance has been achieved.

Judicial Scrutiny

The CLERP 9 Commentary sets out a number of suggested safeguards for the new infringement notices. The principal check and balance is that ASIC's decision to issue an infringement notice would, in effect, be challengeable in court. That is, rather than pay the fine, a company could force ASIC to prove its case before the courts.

In reality, there is a danger that companies will not challenge inappropriately issued infringement notices. Under the draft legislation, infringement notices are to be used for relatively minor breaches of the continuous disclosure regime, with penalties ranging from $33,000 to $100,000. These penalties are significantly less than the managerial and legal costs associated with defending a court action, even when some of those costs may be recoverable by a successful company. In addition, ASIC taking court action may result in additional adverse publicity for the company and its management. There would therefore be strong incentives for companies not to challenge infringement notices, even when they felt strongly that the notice had been wrongly issued.

The role of judicial scrutiny as a check on the use of the proposed infringement notice powers is therefore likely to be largely illusory. In addition, if infringement notices are rarely challenged, the penalties associated with infringement notices may be seen by some as just part of the cost of doing business and, as such, will provide little deterrence for minor contraventions of the continuous disclosure regime. From the regulator's perspective, there is also a danger that the number of infringement notices issued will be viewed as a measure of its enforcement activities in this area, adding to the incentive for ASIC to issue notices where either court action, or no action, are more appropriate.

ASIC as Investigator and Enforcer

Under the proposal, ASIC will have the dual role of investigating alleged contraventions and then holding a hearing to determine whether it should form the opinion that a contravention has occurred and, if it believes so, whether an infringement notice should be issued.

The Business Council is concerned that under such a model, ASIC would undertake an investigation and, having concluded that a contravention has or is likely to have, occurred, initiate the process for issuing an infringement notice. ASIC would then conduct a hearing to determine whether, in its judgement, a contravention has occurred. The relevant company would have the opportunity at the hearing to make submissions to ASIC.

6 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, p 112

This process raises two fundamental, related issues. The first is whether a company can expect natural justice through an independent and impartial hearing from ASIC when ASIC has already satisfied itself of the likelihood that a contravention has occurred. If ASIC had not already formed that view it would not have initiated the hearing. Secondly, in effect, this process reverses the onus of proof, with the company having to prove that it has not contravened the continuous disclosure regime, rather than ASIC having to show that it has.

The Commentary accompanying the draft legislation points to other areas where ASIC have similar administrative powers as precedent for this proposal. These areas, however, do not relate to subjective matters such as continuous disclosure, which as has been noted require a considerable degree of judgement on whether a contravention has occurred. An infringement notice regime may be an appropriate remedy for offences that are objectively provable, such as late payment, speeding or parking infringements. These offences are characterised by the certainty over when a contravention will occur, providing clear guidance on what is required for compliance. However, in the case of continuous disclosure, it is often much less clear and more subjective as to when a contravention will occur, and therefore companies and individuals do not have the certainty of knowing when they are going to step over the line.

The Commentary also cites similar powers held by the United Kingdom Listing Authority, but does not note that in the UK, arrangements have been made to separate out the functions of investigation and the issuing of the notices. The Financial Services Authority (FSA), which has taken over this power from the Listing Authority, has separated out the roles of investigator and judge, with investigations undertaken by FSA staff and decisions to take action made by a separate Regulatory Decisions Committee (RDC). In addition, the decisions of the RDC are subject to review by the Financial Services and Markets Tribunal, in contrast with the Australian proposal, which explicitly precludes review by the Administrative Appeals Tribunal. If overseas models are to be cited as precedent for the introduction of new regulatory powers, the full range of checks and balances on those powers must also be taken into account. The Business Council believes that as an absolute minimum, similar checks and balances are needed here.

No Admission

Under the draft legislation, the payment of a financial penalty under an infringement notice would not be taken as an admission of liability by the company and the company, having complied with the notice, would not be subject to any further civil or criminal proceedings by ASIC in relation to that alleged contravention.

While the legislation limits the way in which ASIC can publish information about compliance with an infringement notice, publicity continues to be seen as an important part of the infringement notice proposal. The Commentary states that publicity "*will send a signal to the market that ASIC is taking prompt action to deal with inadequate disclosure*"[7]. and that the "*capacity to issue an infringement notice also allows ASIC to signal its views concerning appropriate disclosure practices to listed entities more effectively than through court action alone*"[8]. This suggests that publicity will be a standard part of the infringement notice process. The Business Council notes that the restrictions upon ASIC in relation to publicising infringement notices only appear to relate to information published by ASIC and may therefore not cover other means of publicity, including comment reported in the media.

7 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, p 122
8 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, pp 111-112.

Nor do there appear to be any consequences for ASIC if it acts contrary to the proposed publicity restrictions.

Even where ASIC's publicity is carefully worded to make it clear that the payment of the fine does not imply an admission of liability, there is no guarantee that such subtleties will be conveyed in the media. There is also a risk that third parties who may feel they have suffered as a result of an alleged contravention will present the payment of the fine as an admission by the company to liability. It is also clear from the draft legislation that compliance with an infringement notice does not remove a company's potential liability under "*compensation proceedings, contravention proceedings, enforcement proceedings and public interest proceedings to seek redress*"[9], including such proceedings brought by ASIC.

The relationship between the proposal for individual liability for breaches of the continuous disclosure requirements and the proposal that the payment of an infringement notice gives the company indemnity from further prosecution by ASIC also needs to be clarified. For example, it is not clear whether the indemnity for the company will extend to individuals employed by the company.

The fact that an infringement notice may be imposed by ASIC without the need to prove a contravention, and can be paid by a company without an admission of liability, but with the company gaining immunity from further prosecution by ASIC, must also raise serious questions about the scope for this power to be inappropriately used.

Additional Checks and Balances

The Business Council is concerned that the Federal Government's response to the significant issues with the proposed infringement notice regime raised by a wide range of business groups has been limited. The Council recognised attempts to minimise the risks of "trial by media" and, by limiting the quantum of fines, to remove incentives for ASIC to use the fining power rather than pursue serious matters through the courts. The Council's fundamental concerns with this proposal, however, remain.

Should it be decided to proceed with this proposal, the Business Council believes two further checks must be added to minimise the risks inherent in this proposal.

1. To avoid ASIC being investigator, prosecutor and judge, third parties should be involved in the decision on whether an infringement notice is warranted. This could be achieved through a separate panel drawing on individuals with experience in decision making in the area of continuous disclosure (experience gained as regulators, corporate executives or corporate advisers). The functions of investigating alleged breaches and issuing infringement notices should also be clearly separated within ASIC. The proposal to exclude ASIC's decisions from review by the Administrative Appeals Tribunal should also be dropped.

2. The provisions should only be introduced with a three year sunset clause. This guarantees that the use of the powers is reviewed after that period and provides an incentive for the regulator to only use the power as intended. A commitment to undertake a review of an entrenched power after three years does not provide the same degree of reassurance to business nor incentive to ASIC to see the power appropriately used. A precedent for providing regulators with additional powers for a limited period of

9 Treasury, *CLERP (Audit Reform & Corporate Disclosure) Bill – Commentary on the Draft Provisions*, October 2003, p 119

time can be seen in the additional trade practices powers granted to the Australian Competition and Consumer Commission in relation to the introduction of the goods and services tax.

The Business Council would be happy to discuss the development of these proposals further.