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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

(Subcommittee)

Reference: Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003

FRIDAY, 7 MAY 2004

SYDNEY

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Friday, 7 May 2004

Members: Senator Chapman *(Chair)*, Senator Wong *(Deputy Chair)*, Senators Brandis, Conroy, Murray and Mr Byrne, Mr Ciobo, Mr Griffin, Mr Hunt and Mr McArthur

Senators and members in attendance: Senators Brandis and Conroy and Mr Griffin

Terms of reference for the inquiry:

To inquire into and report on:

The exposure draft bill, CLERP (Audit Reform and Corporate Disclosure) Bill, and relevant matters.

WITNESSES

Subcommittee met at 1.48 p.m.

COLEMAN, Mr Paul John, Registrar, Companies Auditors and Liquidators Disciplinary Board

MAGAREY, Mr Donald Rees, Chairman, Companies Auditors and Liquidators Disciplinary Board

ACTING CHAIR (Senator Brandis)—I call to order this hearing of the Parliamentary Joint Standing Committee on Corporations and Financial Services. The committee will today continue its public hearings in relation to the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 and relevant matters. Before we begin taking evidence, I remind everyone that all witnesses appearing before the committee are protected by parliamentary privilege with respect to their evidence. Parliamentary privilege refers to the rights and immunities attached to the parliament, its members and committees, necessary for the discharge of parliamentary functions without obstruction and fear of prosecution. Any act by any person which operates to the disadvantage of a witness on account of evidence given by him or her before the parliament or any of its committees may be a breach of privilege. Unless the committee should decide otherwise, this is a public hearing and, as such, members of the public are welcome to attend.

I welcome to the table Mr Magarey and Mr Coleman from the Companies Auditors and Liquidators Disciplinary Board. The committee prefers all evidence to be given in public, but should you at any stage wish any part of your evidence to be given in private, you may request that the committee take the evidence in private. I now invite you, Mr Magarey, to make a brief opening statement and then I will invite Senator Conroy to ask any questions he may have.

Mr Magarey—I do not have an opening statement to make except to say that, when we received the first inquiry from the committee about making a submission, we sent back with our reply a copy of our annual report for the year ended 30 June 2002. We had already prepared and sent to the minister our annual report for the year ending 30 June 2003, but it had not yet been tabled in parliament, so we did not feel free to circulate that. But today we have bought a couple of copies of our 2003 annual report for the committee's benefit.

ACTING CHAIR—Thank you very much, Mr Magarey.

Senator CONROY—How many auditor registrations have you suspended in the last year and how many have been cancelled?

Mr Magarey—Those statistics will be in the 2003 annual report, and we have up-to-date, year-to-date figures for 2004. The figures for 2003 on page 10 show that one registration was cancelled, four registrations were suspended—

Senator CONROY—What were the grounds?

Mr Magarey—I have not got that detail with me. Do you have it, Mr Coleman?

Mr Coleman—No, I do not have that. We could take that on notice.

Mr Magarey—The year-to-date figures for 2004 show that there have been two registrations cancelled and three suspended.

Senator CONROY—Could you take it on notice to tell us what the grounds were for those?

Mr Magarey—Certainly.

Senator CONROY—Apart from the suspension or cancellation of registration, what other powers do you have? What else could you do?

Mr Magarey—We have other powers to admonish or reprimand either in lieu of a suspension or cancellation or in addition to a suspension or cancellation and we have the power to require undertakings to be given by the practitioner concerned, once again either in lieu of any other remedy or in addition to any other remedy—and we use all of those remedies.

Senator CONROY—How many times have all of those other remedies been exercised?

Mr Magarey—In the 2003 year, there was one reprimand and five cases where undertakings were required to be given, and the remaining three cases in that year were withdrawn by the commission. In the year to date for the year 2004, there has been one reprimand and, again, five cases where undertakings have been required to be given.

Senator CONROY—Putting aside CLERP 9, could you give us a brief outline of the sorts of circumstances at the moment where you would suspend a person's registration as auditor? What fits the bill as being serious enough?

Mr Magarey—For an auditor, suspension is a reasonably serious order to make. Of course, they are all judged on a case-by-case basis, although over a period we try to achieve a level of consistency. Firstly, there are not a large number of cases and, secondly, they are all so different that it is hard to compare them. It has to be a reasonably serious offence for us to suspend an auditor. There are two forms of order that we make in conduct matters. One is where ASIC and the respondent negotiate and reach agreement on a proposed order and bring that to the board. We then look at the material and, if we decide that that is an appropriate order to make, we will make that, knowing that the parties in advance have consented to that and that we do not have to hold a contested hearing. If they do not reach agreement and cannot negotiate or mediate for one reason for another, it goes to a full-scale contested hearing. That may last some days and, in some cases—very few cases—it lasts a couple of weeks, with counsel briefed on the whole hearing. In those circumstances, we make up our own mind about the order.

Basically, auditor cases deal principally with failure to observe auditing standards. The vast majority of the respondents who come are members of one or other of the two professional organisations, who are obliged to abide by the auditing standards. It has to be a reasonably serious matter to achieve a suspension—failure to observe auditing standards, failure to make the right inquiries, failure to follow up and failure to apply a going concern test.

Senator CONROY—Have you overturned a deal that has been put to you? Have you occasionally said, 'We think that's more serious than the deal you've done'?

Mr Magarey—Not often. In fact, we have only done a couple over the years. I have been chairman for just approaching a year, although I was acting chairman for a few months before that. There has not been one since I have been in the chair. But I believe the board under the previous chairman rejected one for being too strong and one that the board felt was not strong enough. But they do not happen very often. They are mostly agreed. ASIC are very experienced at this sort of thing and they are normally very close to what the board thinks is appropriate anyway.

Senator CONROY—Your judgments are appealable. That is right, isn't it?

Mr Magarey—Yes, they can go on review to the AAT or they can go on a point of law under the ADJR Act to the Federal Court. Both of those happen occasionally—not often to the Federal Court; more often to the AAT, but even that is not very often.

Senator CONROY—I remember one famous case when you made a finding against Stuart Gooley.

Mr Magarey—Yes, I actually sat on that, because the chairman was unavailable at the time and I was acting chairman.

Senator CONROY—The AAT did not overturn your finding that he had breached standards; they just overturned the penalty.

Mr Magarey—Our findings on the fact and our determination were not challenged by Mr Gooley. He only challenged the penalty. It was reduced by the AAT from suspension to a reprimand.

Senator CONROY—I do not want to go through the cases. I remember one case where there was a successful appeal against your finding. I will move on. The CLERP 9 bill amends the matters in relation to which you may cancel or suspend registration as an auditor to include failing to lodge an annual statement, failing to comply with the condition of a person's registration and ceasing to have the practical experience necessary for carrying out audits.

Mr Magarey—Yes.

Senator CONROY—Do you have the powers to investigate those sorts of matters?

Mr Magarey—I do not believe under the statute we have any investigative powers. We rely on matters that are referred to us by ASIC, and then we only rely on the matters that are put in evidence by either of the parties—either ASIC or the respondent. We do have power, I believe, under the act to summon witnesses if we want to. I am not aware of that power ever having been exercised but I believe it is in the statute—the ASIC Act.

Senator CONROY—If an auditor was convicted of breaching a requirement in the Corporations Act under these new provisions, would this result in automatic disqualification of their right to practice?

Mr Magarey—There are only a limited number of breaches of the Corporations Act which can be referred to us as such. Other breaches of the Corporations Act may be referred to us as a breach of duty by the auditor or the liquidator—or a breach as being not a fit and proper person. But in terms of a breach of the Corporations Act, the only matters that are referred to us at the moment—before the amendments are made—are breaches of section 1288, which is the obligation to file a triennial statement. That is going to be amended by CLERP 9 but only in the case of auditors. It is going to be an annual statement. For liquidators it is still going to be, under 1288, a triennial statement. But if the auditor or liquidator breaches that then they come to us. Unless that is fixed beforehand, there is a mandatory order under subsection (7) of 1292 that says we must cancel their registration.

Senator CONROY—Is it possible for an auditor to be convicted for a breach of the Corporations Act and then not automatically end up suspended? Do you have to make the decision to suspend their licence?

Mr Magarey—That is the only one that is automatic. It is in section 1292, subsection (7).

Senator CONROY—What about the other cases?

Mr Magarey—The other cases are all at the discretion of the board.

Senator CONROY—I might want to come back to you and ask you about some examples—whether or not this would lead to automatic suspension. I presume if someone is convicted of a breach of the Corporations Act it is going to get referred to you or you would notice.

Mr Magarey—If they are a person who has been disqualified from managing a corporation under the provisions of the Corporations Act, that can be brought to us and results in a mandatory cancellation. Bankruptcy is an example—

Senator CONROY—Is that under the existing laws, though?

Mr Magarey—Yes. We have had bankruptcy cases before, which is an automatic cancellation.

Senator CONROY—I think you have answered this already, but do both ASIC and the professional accounting bodies refer matters to you?

Mr Magarey—No. Only ASIC and APRA are entitled under the act to refer matters to us. I am not aware of APRA having done one.

Senator CONROY—Maybe they could refer Stuart Gooley, over HIH—

Mr Magarey—Perhaps; I do not know.

Senator CONROY—There was some very famous evidence in the HIH royal commission. I am sure that you are familiar with it.

Mr Magarey—We read what we read in the paper. We wait for it to be referred to us. We have no power to generate these things.

Senator CONROY—You cannot get the transcript of the royal commission and say, 'That sounds like we should have a chat with X.'

Mr Magarey—No, we just have to wait. We periodically talk to ASIC and say: 'There is not much coming through. How are you going? What does it look like over the next six months?' In other words, we try to plan our activities.

Senator CONROY—What about an informal nudge: 'Fellers, this one looks pretty red hot.'

Mr Magarey—It is not quite like that. For the purposes of planning our own operations, we like to know what ASIC's upcoming referrals are going to be, but it is up to them.

Senator CONROY—You do not have the capacity to draw to the attention of ASIC that a particular case looks a bit—

Mr Magarey—We do meet with them reasonably regularly to talk about matters of interest arising—

Senator CONROY—The royal commission had some fairly strong words to make about the conduct of the audit and some of the people—

Mr Magarey—We talk about a range of things.

Senator CONROY—What is the current composition of the board?

Mr Magarey—The current composition of the board includes a chairman—that is me—who is required by the act to be a lawyer of certain standing in years. There is one accountant selected by the minister from a list put forward by the chartered institute and one accountant selected by the minister from a list put forward by the CPA Australia. Each of the two accountant members has a deputy appointed, and the chairman has an acting chairman appointed, not a deputy chairman. The current composition of the board includes all those people.

Senator CONROY—How did you sneak in there—by definition, you would not have been on the board then?

Mr Magarey—I was not, by definition, on the board—other than when I was sitting as chairman, which I did back in 1999 on the Gooley case. Unfortunately, Phil King, who was our chairman, passed away in January last year and, as acting chairman, I was obliged to act as chairman. I was then formally appointed as chairman by the Treasurer in the beginning of June last year.

Senator CONROY—ASFA, who are appearing next, have made a submission saying that the board must be seen to be independent of the accounting profession and recommending that a majority of the board is made up of non-accountants. Do you have a view on that?

Mr Magarey—Yes and no—in the sense that we did talk to Treasury when the proposals were first being mooted a couple of years ago. They asked us about that and we expressed a view about it. Now that that consultation has gone and the government has expressed its policy view on it, being the object of the perception, we do not regard it as appropriate for us to express a view on it.

Senator CONROY—Are you independent—

Mr Magarey—Yes, we are. We are established under the act. We understand that the two concerns that CLERP 9 has in mind in relation to this board are, firstly, the perception of a lack of independence from the accounting profession because we have a majority of accounting members and, secondly, the concerns about our operating capacity.

Let me say this: when I said yes and no, we did give Treasury some information about accounting members. We are not aware of any evidence that there is a perception of lack of independence—that is not to say that there is not. We think it is a matter for our stakeholders to say whether there is a perception or not. We do not think we are well placed to know what the perception is about ourselves.

Senator CONROY—But you did give advice on this matter to Treasury?

Mr Magarey—It was not advice.

Senator CONROY—Thoughts?

Mr Magarey—Yes, some thoughts.

Senator CONROY—But you do not want to share them with the parliament?

Mr Magarey—It is gone now. We do not have the views anymore.

Senator CONROY—It has not gone.

Mr Magarey—CLERP 9 is there and—

Senator CONROY—CLERP 9 has not gone anywhere. It is a subject of the parliament, not the government, and you are an independent statutory authority. My concern is that you have been prepared to express a view to the government but you are not prepared to share your views with the parliament, and you are an independent statutory officer.

Mr Magarey—I do not believe we have a view on that now that it has gone—

Senator CONROY—It has not gone anywhere. It is a proposed bill. It is not a bill in parliament that you are criticising; it is a proposed bill. The Senate and members of the committee would actually value your independent view on it as an independent statutory officer.

Mr Magarey—I think our view is that we are not aware of any evidence that there is a perception about independence. We are aware of some people having said that. We have never seen any evidence of that. No-one has ever come to us—

Senator CONROY—So people have said it? I am a bit confused when you say that are not aware of anyone's view but that people have said it. I thought that would have made you aware of the view.

Mr Magarey—I am not aware of any evidence that there is any lack of independence.

Senator CONROY—But this is about a perception.

Mr Magarey—Yes.

Senator CONROY—People are clearly indicating that there is a perception.

Mr Magarey—I agree with that.

Senator CONROY—You agree that people are possibly indicating it? I am glad, because we have a submission which says that.

Mr Magarey—In that case, all I was saying was that, if that is the perception, I cannot add to that. If they have that perception then I cannot add to that. I do not say that they do not have it. I am sorry if I expressed myself badly.

Senator CONROY—That is all right. You have successfully managed not to tell us what your view is, so you are doing okay. ASFA also suggests that at least one of the appointees should represent users of financial reports. What is your response to that?

Mr Magarey—I think there are advantages in having outside people on the board, provided they are properly qualified. There are fairly technical matters which need to be decided by the board and that is why we have accountants on the board. Under this proposal we are going to continue to have accountants on the board, but they will not be in the majority. I am quite happy with having outsiders on the board. I think it will bring extra perspective. I do not have a view on whether it should be a majority or a minority. I think it is helpful to have outside members on the board. I agree that people in that category that you have mentioned are amongst the categories of people which would be helpful.

Senator CONROY—Was the board consulted by the government or Treasury on the penalties applying to auditors in the CLERP 9 bill?

Mr Magarey—I do not think there is any change to the penalties in the CLERP 9 bill. Slightly different grounds for referral have been introduced, but the penalties have not been changed, as far as I know.

Senator CONROY—There is a liability framework. The headings to do with the liability framework mention auditor independence. It is in part 3 of schedule 1 on page 100 of the bill. That may be the point you were making.

Mr Magarey—Do you want me to look at that?

Senator CONROY—I guess that, just because there is no change, it does not necessarily mean that you do not think there should be change.

Mr Magarey—I am not aware that we were asked about whether the penalties should be changed.

Mr Coleman—We were given a copy of the bill and were asked for our comments on it.

Senator CONROY—By definition, that would have included this bit.

Mr Coleman—That is correct.

Senator CONROY—In light of the new auditor independence rules, a new liability framework has been adopted in the bill. A breach of the following sections attracts a maximum penalty for an individual of $2,750 and/or six months imprisonment: section 324CA, which establishes a general requirement for auditor independence, section 324CI, which requires a two-year cooling-off period before a member of an audit firm who was part of the audit team can join a former client, and section 324DB, which requires that auditors rotate after five years. Do you have a view on those penalties? Are they sufficient to deter? There are some serious issues there. Is $2,750 sufficient?

Mr Magarey—I must admit that, the way you put it, it does not sound like a lot.

Senator CONROY—Six months' imprisonment might—

Mr Magarey—Six months' imprisonment certainly sounds significantly more serious.

ACTING CHAIR—That is in addition to the power to suspend or deregister?

Mr Magarey—If there is a question of auditor independence, as I understand it, that would be—

Senator CONROY—It does not go to you?

Mr Magarey—It is not a ground directly to come to us, but it would be a ground for ASIC to come to us contending that it had been a breach of their duty under the act. So it could come to us. We have no power to administer financial penalties.

Senator CONROY—The reason I am asking is that you are the experts in auditor penalties at the moment. You deal with the matters at the coalface.

Mr Magarey—Yes. The professional bodies as well, of course—

Senator CONROY—And $2,750 just does not sound like much money.

Mr Magarey—No, it does not. We customarily make orders for costs which are far in excess of that.

Senator CONROY—I am sure.

Mr Magarey—We do not make financial penalty orders but we make orders for costs.

Senator CONROY—That is all the questions I have. Thank you very much. Could you come back to us as quickly as you can to answer the questions on notice about the basis on which they were suspended and the powers you exercised.

ACTING CHAIR—Thank you, Mr Magarey and Mr Coleman. You are excused.

[2.10 p.m.]

CLARE, Mr Ross William, Principal Researcher, Association of Superannuation Funds of Australia Ltd

PRAGNELL, Dr Bradley John, Principal Policy Adviser, Association of Superannuation Funds of Australia Ltd

ACTING CHAIR—Welcome. Do you wish to make an opening statement?

Dr Pragnell—The Association of Superannuation Funds of Australia welcomes this opportunity to appear before this committee on the matter of CLERP 9. ASFA has a keen interest in CLERP 9 and in corporate governance issues generally. Our members, superannuation funds, are significant shareholders in Australian listed companies. Approximately $250 billion worth of listed equities, comprising nearly one-third of the Australian market, are held by superannuation funds. This represents almost 50 per cent of the assets held by superannuation funds, which are critical in providing for the future retirement incomes of all Australians.

The need for an efficient capital market is critical for ensuring that these equities continue to perform well and that the companies to which they are attached continue to perform as well. There is a need to have an efficient capital market with financial reporting, the integrity of which is critical for the backbone of ensuring that capital markets work properly. ASFA has been very involved in recent debates regarding corporate governance. We were a member of the ASX Corporate Governance Council and have been involved in previous ASIC corporate governance round tables. We have provided submissions to this inquiry and inquiries by the OECD into their principles on corporate governance, and have been involved in other forums and round tables.

Generally we do believe that the CLERP 9 regime represents a step forward. We believe that a regulatory regime primarily based around improved disclosure, improved integrity of financial reporting and ensuring that regulators are able to act efficiently and quickly is critical in terms of ensuring the efficiency of our capital markets and, in turn, ensuring that the retirement incomes of all Australians are adequate down the road. That is the end of our opening statement. I would be more than happy to take questions.

Senator CONROY—Your submission states that as super funds hold one-third of all shares they should be represented on the FRC, and that in the US the ex legal counsel from CalPERS sits on the Public Company Accounting Oversight Board. You may not be aware of evidence that was given recently—the *Hansard* may not be available yet—where Charles Macek, the chair of the FRC, appeared and indicated support for the much smaller FRC board. He was in favour of more representation and his first campaign to achieve it was by kicking half a dozen people off the board. What role would a group like ASFA have on the FRC? What do you believe would be the advantages?

Dr Pragnell—One of the main advantages of providing that kind of input is that it is important that users of financial information, as well as producers of financial information, are involved. I have seen the recent article in *CFO* regarding the FRC, and I am well aware of Mr

Macek's comments about the FRC's size and composition. I think there are some legitimate concerns there. There are some concerns about the size of the FRC. There are some legitimate concerns about how the FRC is funded and how secretariat support services are provided to the FRC. I think they are all very legitimate issues.

However if we do have a smaller FRC, it is important that users and consumers of financial information are just as well represented as producers of financial information. At the moment, we have a bit of an imbalance towards producers and, as was noticed in that *CFO* article, a bit too much involvement from government appointees as well. I think a more independent and smaller FRC, representing consumers of information, would probably be a good thing.

Mr Clare—ASFA have a sound track record of contributing to a variety of forums. We have a history of constructive engagement. If there is a concern about some organisations taking up time or not adding to the process, the record of organisations such as ours shows that we can engage constructively and lead to efficient processes.

Senator CONROY—Your submission recommends that the CLERP 9 bill is amended to contain an obligation on the auditor to provide answers to reasonable shareholder questions within a reasonable time frame.

Dr Pragnell—Yes.

Senator CONROY—Are you concerned that, without such a positive obligation on the auditor to answer questions, the auditor may avoid answering questions?

Dr Pragnell—It did appear from our initial reading that, if there was not that positive obligation, there was a bit of a loophole: questions could be asked, but there was no obligation on the auditor to answer them. There are legitimate concerns about when and how questions are asked. If a question is provided in writing, with enough time given, and is relevant to the role of the auditor, I think there should be some obligation on the auditor to provide some response to that.

Senator CONROY—Recently, the implementation review group of the ASX Corporate Governance Council, which I think you eventually got on to—

Dr Pragnell—Yes, we did. We are on the ASX Corporate Governance Council.

Senator CONROY—You were not on the original proposed one, though, from recollection?

Dr Pragnell—We were appointed following some concerns raised about its composition.

Senator CONROY—You had similar sorts of concerns in relation to the FRC.

Dr Pragnell—Correct.

Senator CONROY—But you have not been as successful in getting appointed to that one! They have recommended that only the top 300 listed companies should be required to audit committees. Previously it was the top 500.

Dr Pragnell—Yes.

Senator CONROY—In contrast, your submission says that all listed companies should have an audit committee. Have you been dudded on the ASX Corporate Governance Council? I thought it operated reasonably on consensus. How did the implementation group slip that one pass you, or were you just really toeing the original corporate line when you did your submission?

Dr Pragnell—No. The concern that was raised in the IRC process was more whether or not the audit committee requirements of those smaller listed companies had to conform with the Corporate Governance Council best practice principles and recommendations. There was a pretty strong argument put forward that some of those requirements were maybe a bit onerous for some of those smaller listed companies. There is a difference between whether or not a listed company is required to have an audit committee and whether or not it has to have an audit committee that is required to meet the additional obligations of the ASX Corporate Governance Council. I would not say that we were dudded; we were fully informed of that decision about pushing it up to the 300. I think the IRC put forward a pretty sound case that most of those companies are actually quite small and that there were some difficulties in terms of their meeting the ASX standards.

Senator CONROY—ASFA raised a number of concerns in relation to the prospect of compulsory voting by super funds. One of those was cost. That sounds like IFSA. Have you quantified the anticipated costs?

Dr Pragnell—No.

Senator CONROY—Excellent! That was obviously considered form.

Dr Pragnell—That was an easy answer.

Senator CONROY—Have you considered how many super funds already have proxy voting procedures in place?

Dr Pragnell—Our understanding is that the majority do. The majority of funds that we have been dealing with—the larger superannuation funds—have in place or are implementing corporate governance policies and becoming more active and demanding of their investment managers regarding their proxy voting activities. Some of the data on this that I have seen coming through, which IFSA has provided, shows that we are starting to see proxy voting levels that are relatively high. Anecdotally, what we have seen—

Senator CONROY—You are not telling me everything IFSA is telling you, are you?

Dr Pragnell—Our view is that generally the larger funds are becoming far more active on this issue. We do have concerns regarding compulsory voting. Cost is obviously always going to be an issue, and I admit that we have not done any specific quantification of that. Cost is always going to be an issue.

Senator CONROY—What would the costs be for the funds that already do this—in round and single digits?

Dr Pragnell—In terms of how many basis points it would add to their investment costs, you could not quantify—

Senator CONROY—Investment costs? This is an administration issue.

Dr Pragnell—Not necessarily.

Senator CONROY—How would this be an investment cost?

Dr Pragnell—If you are asking your fund manager to be active on—

Senator CONROY—So you are saying that you would be passing on some costs, not that it would be creating your own administrative costs?

Dr Pragnell—Correct.

Senator CONROY—So when IFSA tell us that everybody is already voting, what would be the basis that they—

Dr Pragnell—Not that everyone is already voting.

Senator CONROY—They try and maintain that just about everybody is always voting; that is consistently their evidence. How could they justify passing on a new cost to you when they say they are already doing it for free?

Dr Pragnell—Whether or not they are doing it for free is something else.

Senator CONROY—Let me rephrase that: it is within their existing cost structure. According to them, they are already doing it and it is within their existing cost structure. What justification could IFSA possibility have for charging funds more?

Mr Clare—There most likely is a difference between a high incidence of voting on a voluntary basis and putting in place systems to ensure that it happens in every case.

Senator CONROY—But IFSA members tell us that they have got systems. They have to deal with hundreds and hundreds of resolutions already. They have to consider all resolutions right now; they actually have to make a decision about whether they are going to do anything or not, so by definition they all have a system right now.

Mr Clare—It comes down to the level of assurance of your systems. Different levels of assurance are needed when it is done on a voluntary basis as opposed to one where there are legal requirements and possible sanctions. I would see that as being a difference. If you had a legal obligation you would have to have a compliance program in place to ensure that it happened on top of the mechanics of voting—

Senator CONROY—Most of the fund managers I have spoken to tell me that they have got a compliance program in place now and that they deal with all these issues right now.

Mr Clare—They certainly have compliance programs in place, but we are talking about an expansion of what those programs and processes would be.

Senator CONROY—On the large fund managers, for my many sins I have attended a number of IFSA investment committee meetings and board meetings and a variety of governance meetings, and every time I go they all assure me they have got exceptionally well-oiled machines to deal with now because they are already doing it. I am glad ASFA is here defending IFSA's members. It is an unusual position for you to adopt, but I do appreciate that—

Mr Clare—We work very cooperatively with IFSA.

Senator CONROY—that has so moved you to be critical of this policy proposal!

Mr Clare—The question of cost is a fair one, and it is one which will be given further attention in the future. Looking at costs in various areas is one of my areas of activity. We have done that in the past and following your comments I am sure we will be very seriously considering a more precise quantification of what is involved.

Senator CONROY—Have you spoken to any of your members? It is only relatively recently that a number of your members have introduced it 100 per cent; the CSS/PSS is an example. They say, 'We vote 100 per cent now; the trustees have decided it is our policy.' Have they reported to you that they are paying anything more?

Dr Pragnell—Yes, they are actually. You can discuss it directly with them, but it does cost them to be more engaged—I know that.

Senator CONROY—It costs them in basis points?

Dr Pragnell—Yes, it does, particularly—

Senator CONROY—I would say that they would want to get some new fund managers.

Dr Pragnell—No. It costs them particularly when dealing with their international equities as well. In terms of having to exercise their 100 per cent policy regarding voting, it extends not just to their domestic equities but to their international equities as well. My understanding is that that is quite an expensive exercise. I am not here representing CSS/PSS, so I do not want to be putting words into their mouths. However, the view I have received from them is that they believe that by being active share owners they will be able to effectively recoup those costs by better performance of those companies in the long run. I think you will probably get much better numbers by raising that issue with them. I know that it is not without cost for them, but they view the trade-off as a benefit.

Senator CONROY—I have to say to you that, realistically, if some fund manager started charging basis points for doing their job, I would put them out to tender on the spot.

Dr Pragnell—It is not just the voting; it is the engagement as well. I think that is possibly where some of the costs are involved as well.

Senator CONROY—For receiving an instruction on a mandate? 'We want you to vote this way.' Which engagement is involved there?

Dr Pragnell—No, in terms of any engagement with listed companies regarding particular issues. Again, yes, we can have 100 per cent voting but I think the issue there—and this is probably more the key issue and our key concern—is whether we are going to end up with conscripts in terms of voting of proxies as opposed to willing and engaged share owners. I think that is more the issue. If we end up conscripting proxies, then we are going to end up with, yes, a majority of funds. Maybe there is that tail that is not doing anything at the moment, that is just going to tick the box. They are just going to give an instruction to their fund manager to always vote with the board. That is my concern. I do not want them to think of proxy voting as a compliance requirement. I want them to think of proxy voting as part of their duties as a trustee in terms of managing their investments.

Senator CONROY—I understand the principles, and I have to say I agree with your principle. Could you tell me how many resolutions moved at AGMs in the last 12 or 18 months have been defeated?

Dr Pragnell—That is not the kind of data that I would have.

Senator CONROY—Let me help you out: it is zero. Every single resolution that has been presented to a company meeting has been passed 100 per cent. It sounds as though there is a lot of box ticking going on. Two have been withdrawn; 100 per cent of the rest of them have been passed.

Dr Pragnell—I have to say that I think it has been the efforts of our members in regard to issues such as the options issue around News Corporation and around Harvey Norman.

Senator CONROY—I can see that two were withdrawn, and I have publicly congratulated both IFSA and AFSA members for taking a very proactive stance on that. The fact that you have driven Rupert Murdoch offshore as a direct consequence of denying him his options is something to be proud of, I think. He is clearly running scared from you. In regard to the other 100 per cent, it does not sound to me as though there is a lot of thought going on if every single resolution being put up at an AGM is currently being passed. It sounds very much like a tick the box approach to me, now.

Dr Pragnell—From my discussions with our members, particularly around controversial issues, around executive remuneration and around share option issues to executives and directors, there is a lot of time and energy being spent on trustee boards and on the investment committees of trustee boards looking at these issues. They are now viewing these issues as part of their fiduciary responsibility. They are looking very seriously at these issues. They are getting professional advice from various proxy voting consultants which, again, they have to pay money for in terms of getting this kind of advice on these particular issues.

Senator CONROY—They are not basis points.

Dr Pragnell—No—but, again, there is an outlay there. If you are going to contract to a group such as CGI or SIRIS to assist you in proxy voting, I am saying that they are not charities. They do not do this for free. There is a cost. The other thing I need to say is that the trustee directors that I talk to view this as one of the most important issues going forward. Part of it is that perhaps for a long period of time they may have been asleep at the wheel. Maybe that has been the case but now the penny has dropped. I think that now they do view it as part of their responsibility and are trying to take it seriously, and we—and other bodies—are trying to help them by providing all sorts of best practice guidance, training and so forth to try to assist them to do this.

Senator CONROY—Does ASFA have a position on voting? Do they have a resolution where members should vote on it?

Dr Pragnell—Yes, we have. In our *Best practice paper No. 17: active shareownership guidelines for superannuation fund trustees* we recommend that trustees seek to vote all of the time. That is a recommendation. However, our constitution does not allow us to enforce that on our members. We do not have any standard setting power, but we do recommend that our members vote all the time. We also recommend that our members seek to do that in a thoughtful manner—that they are taking in the interests of their members first and foremost, as opposed to viewing it as a straight compliance requirement.

Senator CONROY—You mentioned fiduciary duty a little earlier. You may have heard me say this before, but I am someone who feels it has probably always been the fiduciary duty of members to exercise their proxy voting power. I have long thought that by sitting back and letting companies manage themselves badly, leading to lower returns to their members, in actual fact they probably have not been as diligent in the past. I certainly agree with you that the culture has changed and I look forward to the day when they all follow the approach of CSS/PSS where they are voting 100 per cent. A bit more prodding along the way will make a difference. It is mandatory in the US to vote for pension funds.

Dr Pragnell—I would say that my reading of the US Department of Labor's guidance on this is that it is mandatory for them to consider voting and to exercise their vote in a fiduciary manner, which I think is slightly different from saying, 'Thou shalt vote.' That is my reading of the DOL guidance, and I have read that quite recently.

Senator CONROY—You have met Bob Monks, I am sure.

Dr Pragnell—No, I have not, actually.

Senator CONROY—He was the person in the US Department of Labor who actually introduced this.

Dr Pragnell—I am aware of that.

Senator CONROY—I accept that there could be some vagaries in the wording—and I am not a lawyer, thank God—but Bob certainly thinks it means everyone has got to vote.

Dr Pragnell—That is fair enough. But, again, neither am I a lawyer.

Senator CONROY—Thank God for that. There is hope for both of us.

Dr Pragnell—My reading of the US Department of Labor guidance is that it is not saying, 'Thou shalt vote.' It is saying, 'Thou shalt view your vote as part of your fiduciary obligations and you shall exercise that accordingly.'

Senator CONROY—And everybody had a look at that and felt that it means that they have got to vote all of the time.

Dr Pragnell—I know you may see the difference as subtle. I think the difference is actually reasonably—

Senator CONROY—'Semantic' is the word.

Dr Pragnell—I think it is more significant.

Senator CONROY—You could be a lawyer with an approach like that. I do not get any more insulting than that. Acting Chair, my great disappointment was missing you getting your Eco 101 lecture on Tuesday from a number of economists. I have already heard about it. I am going to read *Hansard* and I am going to try and get the tape to watch it. What percentage of trustees of super funds invest in companies directly and what percentage of trustees invest indirectly through a fund-to-fund arrangement? It is okay to take that on notice if you want to.

Mr Clare—I will have to take that on notice. We have APRA statistics that look at the use of investment managers. Like many of the APRA statistics, they are rather hard to disentangle—

Senator CONROY—Anything you can give the committee would be useful.

Mr Clare—Off the top of my head, it would be a fair proportion of each. It would be in the 40 to 60 per cent range. It depends on the fund and it can vary over time. Some funds will bring their investment activities in-house, and then they might decide to use investment managers. It is also linked to the size of funds and the level of activity. Some smaller funds may have direct holdings, and not change them much, or they may choose to use investment managers. There are also decisions about the way investment managers are used, who holds the legal title and who makes decisions about where the investments are. Some of the distinctions are somewhat arbitrary. But APRA asks the questions; they get answers and things are added up. I will do my best to disentangle that information for you.

Regarding the cost of voting, there is the odd conference paper which might have some numbers, which I will go looking for. Some of the figures for funds focus on the cost of the fund in terms of putting in place the processes and the framework for the board to make decisions. It is not just the implementation cost; they are talking about tens of thousands and sometimes scores of thousands. A number of the large funds are saying that it is perhaps not as expensive as some people think. But for a small superannuation fund—and we still have some hundreds of them—that is not an insignificant amount to do it properly. As Brad said, you can have a tick the box approach, and that may be very cheap to run but, if you want constructive engagement with an informed decision, you have to bring a whole lot in. There are strong arguments for large funds to do it, but for small funds it is a balance of time and return.

Dr Pragnell—I would like to make a comment on that. We may be using the names of CSS and PSS in vain, but I know from their processes that some of the time of their Chief Executive, Steve Gibbs, and their Chief Investment Officer, Andre Morony, is devoted to this issue. Trustees are involved, and they make payments to BT as well, in terms of this whole process. They do it right, but it costs money.

Senator CONROY—I accept that. As I said, I can understand that there would be administrative costs but, if a fund manager said to me that basis points were involved, I would not stop laughing until after the tender and until I had got a new fund manager. I will not labour that point. Any other information you are able to come back to us with would be great. IA Research has advised the committee that the CLERP 9 bill should require the disclosure of beneficial owners. You may be aware that the issue has been raised in the media in relation to the Offset Alpine case and in relation to the ownership of NAB shares, with the prospect—which now appears to be diminishing—of a special EGM to look at who owned what and how you find that out. Although you do not discuss this issue in your submission, do you have any views on whether there should be a beneficial ownership register?

Dr Pragnell—I have to say that we have not really put our minds to that issue. There are quite obviously issues for and against, but we have not discussed that within ASFA. But we are willing to take that back to the membership and see what the views are.

Senator CONROY—Schedule 10 of the bill introduces requirements in relation to the management of conflicts of interest, such as a requirement for financial services licensees to be subject to an initial licensing obligation, which requires them to have adequate arrangements for managing conflicts of interest. In addition, ASIC has released a consultation document on managing these conflicts. Are you familiar with that?

Dr Pragnell—Yes, I am.

Senator CONROY—In your view, is this general requirement for licensees to manage their conflicts of interest adequate, or are there certain types of behaviour where disclosure alone is not sufficient?

Dr Pragnell—I think it may be a slightly different issue for superannuation funds. When we saw the obligation and the ASIC policy paper, the general response I received from members was that most of it seemed relatively commonsense and straightforward. For superannuation funds, I know that as part of trustee licensing under the current Superannuation Safety Amendment Bill 2003**,** which will probably commence on 1 July this year, there are additional obligations on trustees under the fit and proper test in terms of managing their conflicts of interest. I think generally we would believe that seeking to avoid in the first instance and, if you cannot avoid, disclosing conflicts of interest are pretty critical in terms of the regulation of financial services generally.

Mr Clare—Disclosure of conflicts of interest is certainly necessary but, under existing law as it operates in regard to the superannuation fund trustees, it is not sufficient to legitimise certain behaviours. We have had a recent Queensland case where there was disclosure and withdrawal from certain transactions, the board continued, but the court held that obligations to the fund were still breached in that case.

Senator CONROY—Can you give us the details of that case?

Dr Pragnell—That is the LESF—

Mr Clare—The Queensland law—whatever—

Dr Pragnell—Law employee's superannuation—

Senator CONROY—They ripped themselves off? The lawyers got very upset? No wonder we got a favourable court judgment; lawyers were involved.

Dr Pragnell—That is a very good, very interesting decision, because I think—

Senator CONROY—George, did you lose money? You would have been in that fund originally—the Queensland legal superannuation fund, the lawyers' fund.

ACTING CHAIR—It would not involve me.

Senator CONROY—No? You would not have been a part of it? You would have had some benefits preserved in a fund like that, wouldn't you?

ACTING CHAIR—No.

Senator CONROY—You were not in that? You had your own fund?

ACTING CHAIR—Proceed to your question.

Senator CONROY—I thought you may have to declare an interest.

ACTING CHAIR—I have no interest to declare.

Senator CONROY—I was just trying to protect you there, Senator Brandis.

ACTING CHAIR—I have no interest to declare, but I remind you that you have another hour and 19 minutes before we adjourn.

Senator CONROY—My worry is that we probably do not have all the next witnesses here yet, but we are rocketing along. ASIC's original submission on the CLERP 9 policy paper said:

> ... at a fundamental level, the Act needs to prohibit certain activities of analysts where conflicts cannot be effectively managed, and disclosure of such conflicts is not sufficient to mitigate consumer or market integrity risk.

Would you share that view?

Dr Pragnell—I have to say that we have not consulted with our members on that, but I think, in terms of discussions on similar issues, that the view that I have received from the membership would probably be that we would be supportive of that kind of issue.

Senator CONROY—ASIC pointed to a couple of activities like trading by an analyst or its individual researchers in products that are the subject of a current research report within a set period or trading by an analyst or its individual researchers against a recommendation—that sort of Rivkin style approach.

Finally, ASIC's consultation document on managing conflicts of interest has been consulted on for the some months. Are you concerned that some groups may try and water down what are already considered to be a fairly soft bunch of proposals?

Dr Pragnell—I cannot say that I am aware of that, but I would think, from the response I received from the industry, that people thought that what was in the original proposals was pretty straightforward. I think that seeking to water that down might raise some concerns about what this actually seeks to achieve.

Senator CONROY—Thanks very much.

ACTING CHAIR—Thank you very much indeed, Mr Clare and Dr Pragnell.

[2.44 p.m.]

BERGER, Mr Charles, Law and Corporate Responsibility Coordinator, Australian Conservation Foundation

CHAIR—Welcome. The committee has before it your written submission. I invite you to make a brief opening statement if you choose to do so.

Mr Berger—I would be pleased to do so. Thank you. It is a privilege to address the joint committee on behalf of the Australian Conservation Foundation today. As you may know, ACF is Australia's peak national member based non-profit environmental organisation, with more than 60,000 members and supporters. ACF campaigns to protect, restore and sustain the environment and, in pursuit of this, actively engages with the corporate sector in a variety of ways to foster a sustainable Australian economy.

In my role as law and corporate responsibility coordinator, I managed ACF's recent assessment of the environmental performance of Australia's top 50 listed companies. This assessment was part of a project known as Corp Rate, which was a collaboration by the ACF, Oxfam Community Aid Abroad and the Australian Consumers' Association to investigate and assess the social, environmental and corporate governance performance of Australia's top listed companies. In doing this study I had occasion to review all of the publicly available disclosures relating to the environmental performance of the companies that we assessed. We found that there were very serious deficiencies and gaps in the quality and availability of information about environmental performance and the environmental impacts of our top corporations. Only nine of the entities that we looked at—less than 20 per cent—had a separate environmental or sustainability report. Among those nine there was a wide variation in what was reported and in the quality and quantity of the information.

Outside that group, disclosure about environmental performance was generally limited to one or two pages in the annual report, typically with very little in the way of quantitative information about emissions, resource usage and, especially, exposure to environmental risk. Usually the disclosures consisted of a brief discussion of some positive environmental initiatives that the company had undertaken, with almost no discussion of its exposures or liabilities. This is all market relevant information. You do not have to take ACF's word for it. Just last month a coalition of 13 US public pension funds, representing more than $US800 billion in assets, petitioned the SEC to enforce climate change disclosure with regard to companies listed in the United States. Those public pension funds noted that in some sectors the exposure to climate change risks represented up to 15 per cent of a company's total market capitalisation. I do not think there is any reason to think that the figures are different in Australia.

The current disclosure under section 299(1)(f) tends to be very brief, very general and of limited usefulness to investors. I have gone over one example in our submission. I will give another. As an insurance company, QBE will be—or perhaps already is—among those first and most heavily affected by extreme weather events that are caused by changing climatic conditions. There is no discussion of climate change in QBE's 2003 annual report. Its disclosure under section 299(1)(f) is one sentence. That is not to say that QBE is not in compliance with the

law; I think that it probably is. What this illustrates is that there is a large body of market relevant information about environmental risks—

ACTING CHAIR—What did their one sentence say?

Mr Berger—Their one sentence said that they are not subject to any particular environmental regulations.

ACTING CHAIR—Isn't that one sentence a standard formula that you have observed to be commonly used by companies? A lot of formulaic sentences are used in these reports, as you would well know.

Mr Berger—It is a common statement for financial companies and insurance companies—those that are not out there actually producing goods. I see that quite frequently. Even among companies that are out there digging holes in the ground or making things, the disclosures are very brief—a few paragraphs at most—and generally there is a very high level of generality. Australia is well behind international standards and developments in this area, as we have gone into in some detail in the submission.

We have often heard the argument that this is an issue that is best left to the free market, that it is still an emerging area and that if investors want this information they will just go and ask for it. My response to that is always that you could say the same thing about financial disclosures, yet those are well embedded in our regulatory structure and widely recognised as essential to the operation of our capital markets and to the trust and efficiency of those markets. It is worth noting that financial reporting requirements were fiercely resisted by business for 35 years until the first national laws were enacted in the 1930s in the United States. Regarding financial disclosures, it took a worldwide depression to finally make clear that capital markets will not work efficiently and reliably in the absence of market transparency. I ask what it will take before we understand the similar importance of sustainability reporting. Are we going to wait for a complete environmental and social meltdown analogous to the economic meltdown in the Great Depression before we require real disclosure of corporate impacts on the environment?

I will speak very briefly to our submission with respect to nominee companies in section 672. I understand that Mr Paartsch and others have already given evidence that the existing disclosure of registered shareholders is completely useless. I concur entirely in that judgment. What is currently disclosed is not a register of shareholders but a register of service companies that their shareholders happen to use, which is entirely uninteresting. There are at least three reasons why we should have information about beneficial ownership of shareholdings. The first reason is quite simply that it is market relevant even if ownership falls below the five per cent threshold. The second reason is that information about beneficial ownership is essential to ensuring compliance with the law. In this regard we are not only talking about the five per cent disclosure rule but also rules about insider trading, Foreign Investment Review Board approvals and even to some degree the war on terrorism, as has been suggested in a recent OECD report.

Finally, and most pertinently from ACF's perspective, people who are affected by Australian corporations have a right to know who they can petition when they are affected by those activities. Right now there is a total breakdown in accountability. Communities who are directly affected by environmental activities of a corporation can approach the company, the company

will tell them to take it to the board and the board will tell them they have a fiduciary duty to their shareholders. They will then go to the registered shareholders who say, 'We're not the real shareholders and we won't tell you who they are.' We are not just talking about communities in Peru and Indonesia, either. This was particularly relevant when the community directly affected by the Jabiluka mine attempted to ascertain who they should approach, who had ultimate control over the proposed activities, and they were not able to discover completely the identity of those individuals. So there is a very important issue of democracy and accountability in addition to the protection of investors.

The mechanics of disclosure is often made out to be more complicated than I think it has to be. Very simply, companies should be able to request beneficial shareholder information from registered shareholders, as they are currently able to do, and the registered shareholder should be required to give it to them, with no exceptions. If nominee companies choose to do business with Swiss banks or others who are not willing to disclose actual beneficial ownership upon request, they should do so at their peril. That concludes my opening remarks.

Senator CONROY—I want to start with the issue of beneficial ownership. You say that, even though ASX listing rules require companies to disclose in their annual reports the names of their largest shareholders, most simply disclose the nominee company, not the actual owner. You mentioned the example of Jabiluka. Is that the Rio Tinto example that you refer to in your submission or is that a separate situation?

Mr Berger—It is a separate issue.

Senator CONROY—Can you quickly tell us what your concerns were around Rio Tinto's report?

Mr Berger—Basically, when you look at the Rio Tinto report—and Rio Tinto is just an example; it is not at all unusual—and at the list of nominee companies, there is no way of knowing who the actual beneficial owners are. In other words, there is no way of knowing who the individuals or investors are who have the capability to direct votes on their shareholdings in this company. You get a list of nominees. It is duplicative. You have a number of entities listed a number of times, so it is not even the largest 20—

ACTING CHAIR—If the register of shareholders lists a number of other entities, you can search them and ultimately you will get to a natural person, won't you?

Mr Berger—I think there are two questions there. Can you be sure that you are actually getting to the ultimate natural person? In some cases you will not because they are holding their shares through a foreign entity which has chosen not to disclose that. Another question is: who has access to the shareholders register?

ACTING CHAIR—If it is a public company—or, indeed, a private company—the register of shareholders will be a searchable document.

Mr Berger—It is open to shareholders in some circumstances. It is my understanding that it is not open to the public.

ACTING CHAIR—Yes, it is.

Mr Berger—It is certainly not open to prospective investors.

ACTING CHAIR—Yes, it is. Certainly for a public company you will find that anybody on the payment of the appropriate fee can search the register.

Senator CONROY—Assuming these are real people.

Mr Berger—But it does not give you the beneficial owners.

ACTING CHAIR—No, it will not disclose trust holdings or holdings held as trustee for a third party. I accept that.

Mr Berger—That is precisely the problem.

ACTING CHAIR—But, if it is, for example, a corporation which is listed on the register of shareholdings, you can then search that corporation. As I said before, ultimately you will get to a natural person. That natural person might in turn hold his interest on a trust of some form which is not a matter of public record, but at least you would have the name of the individual of whom you could then presumably make an inquiry.

Mr Berger—But you cannot inquire of a nominee company. They will not disclose to you who they are holding shares on behalf of.

ACTING CHAIR—That is my point. But you can find who the shareholders of the nominee company are.

Mr Berger—But that tells you very little about who has the power to vote the shares.

ACTING CHAIR—That is why I drew a distinction between nominee companies and shares being held as trustee.

Senator CONROY—ASIC at the moment can issue what is called a tracing notice.

Mr Berger—ASIC can issue a tracing notice. An individual cannot issue a tracing notice.

ACTING CHAIR—It is very easy to trace through the register of shareholdings who the ultimate holders of the nominal interest are—

Senator CONROY—We are after the beneficiary, though.

ACTING CHAIR—where the nominee is holding as trustee for a third party. I accept that that may be more obscure because the trust instrument will not be a public document.

Mr Berger—That I understand is the case in the vast majority of cases where you have nominees listed as registered shareholders. You are not interested in who owns the nominee; you

are interested in who has the beneficial interest in the shares which the nominee possesses. The shareholders of the nominee have no power to affect those holdings. The nominee is simply a service provider.

Senator CONROY—AMP shareholders will not, as a rule, dictate to AMP to reveal to ACF, me or anyone else who asks them whom they are holding the funds on behalf of.

ACTING CHAIR—No, I accept that.

Senator CONROY—That is the problem. I have dealt with Rio Tinto from a slightly different angle from you. There was a resolution put out to the Rio Tinto annual general meeting concerning labour rights. It required ASIC to issue tracing notices, and the matter went to court because people did not want to disclose. Major fund managers refused to disclose who the actual beneficial owners were.

ACTING CHAIR—As they were entitled to do.

Senator CONROY—As they were entitled, and it led to quite a lot of controversy and highlighted the need for a genuine beneficial ownership list to be available so that many weeks were not wasted trying to find out who to lobby. Ultimately, the people who moved the resolution were successful in the court case and they were able to get access to the beneficial owners rather than the nominees. But beneficial ownership is not publicly available. It was available before 1996, and I think we actually conspired with you to do a bad deed. Your submission raises the issue of short-termism and it states:

... many corporate executives have little incentive to take a long-term view of corporate risks and returns.

How do we overcome that issue? For example, should executives be encouraged to hold their shares for a couple of years before selling them?

Mr Berger—It is important to keep in mind the time frame over which different investors may be looking at a company, and also the time frame that the Australian community at large would like our corporations to take into account. When you look at the large pension funds, they may be investing on a 30-year time frame. So even just holding on to shares for a couple of years would be an improvement on current practice, but it still does not get you to the very long term that is in the best interests of the very long-term investors and in the interests of Australia as a whole.

Senator CONROY—That is a dichotomy that has already evolved in the US, and has had its infancy here, between long-term investors—that is, pension funds—who want long-term, sustainable performance and short-term decisions made by management to maximise their wealth over, say, a three- to five-year period. In the US it is a clear division, which is why the pension funds are so active. It is in its infancy here, but I suspect it will grow. I think you heard the last discussion I had with ASFA, and some day they will come to the party, I promise you. Should the time frame be five years, 10 years or 20 years? How do we get the alignment right? The purpose of managers owning shares is to try to align their interests with those of their shareholders. It just seems that they have a much more short-term vision than the long-term investor.

Mr Berger—The managers are always going to have a short-term vision by virtue of the fact that the average length of employment for a CEO is about 4½ years, I think. So, at the very outside, you might be looking at 10 years. One of the issues here is simply a question of disclosure. In other words, one of the ways in which you can encourage that is to not reward them directly based on financial metrics; rather, it should be on other metrics that reflect how the company will do in the long term—for instance, the investments they are putting into research and development or into addressing long-term environmental risks such as climate change or the effects of their products. I am sure that investors in James Hardie wish that 30 years ago they had taken a closer look at the effects of the products they were producing. So if some of those incentives were built into executive compensation packages, and this is starting to happen in the United States, if the compensation packages were a mix of short- and medium-term financial metrics and long-term sustainability metrics as the basis for incentive based compensation, that would improve the long-term performance of Australian corporations.

We are not saying that that should be legislated or required, but we would like to see that information made available so that the actual criteria by which incentive based compensation is granted is publicly available so that investors looking at a company can say: 'I see they have structured their incentives properly to maximise the profitability of the company over the very long term. I am comfortable as a very long-term investor putting my money there.' If they have not, if it is all annual bonuses and short-term stock incentives, I would have thought that, as a long-term investor, you would be very hesitant to put your money there. I think it is a disclosure issue at this point more than anything else.

Senator CONROY—Earlier we discussed your concerns about what I call the 'boilerplate' disclosure—I think Senator Brandis called it 'formulaic'—that goes into 299(1)(f). Your submission raises the issue of the GRI sustainability guidelines. In your view, are they the guidelines that people should be following if they are complying with 299(1)(f)?

Mr Berger—The GRI has a lot of momentum behind it and a lot of hard business expertise and experience has gone into developing it. It is something that has had years of real-world testing; a number of Australian corporations have reported partial or full compliance with the GRI, as have a number of multinational corporations from other countries, so there is some real experience and momentum behind it. For that reason it has a fair amount of reliability, but we are less concerned with the particular standard that is adopted. There is room for disagreement and more development of that, just as there is ongoing development in financial disclosures. The Department of the Environment and Heritage has put together a modified version of those indicators for the Australian context as a set of voluntarily guidelines, and there are also other guidelines out there. The most important thing is that, in principle, companies are required to disclose quantitative indicators on some set of environmental and social criteria. In ACF's view, the critical ones are emissions, resource use and exposure to environmental risk. Whether that is done through the GRI—which we think is a very positive initiative—or in some other way is a secondary issue.

ACTING CHAIR—Thank you very much.

[3.07 p.m.]

McDONALD, Mr Robert, Global Chairman, Institute of Internal Auditors

PARKINSON, Mr Michael, ex officio Member, Institute of Internal Auditors

ACTING CHAIR—Welcome. Do you have a brief opening statement?

Mr Parkinson—We both have very brief statements.

ACTING CHAIR—Who would like to go first?

Mr Parkinson—I will. The Institute of Internal Auditors Australia welcomes the opportunity today to make a submission to the commission on certain aspects of the CLERP 9 legislation.

ACTING CHAIR—We are a committee, not a commission unfortunately.

Mr Parkinson—Representing the institute is the global Chairman of the Institute of Internal Auditors, Mr Bob McDonald, and me, past president of the Australian affiliate. It is a great achievement for an Australian to lead a global organisation, and in this respect I must recognise Mr McDonald. His paid job, although his employer may not agree, is head of internal audit of the Queensland Department of Natural Resources, Mines and Energy.

The institute was established some 60 years ago and currently has 92,000 members in 120 countries. It is the global body representing members of the internal audit profession. Whilst there is much current debate on the implementation by Australia of international financial reporting standards, the institute has had in place for many years worldwide technical standards in internal audit. Whether performing an internal audit in Australia or in Zambia, every member of the institute is obliged to apply the institute's standards in their work.

It might also be useful in my opening statement to provide a definition of internal audit. The definition developed and published by the IIA is that internal auditing is an independent, objective assurance and consulting activity designed to add value to and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management control and governance processes.

For the committee, I note that internal auditing reviews the reliability and integrity of information, compliance with policies and regulations, the safeguarding of assets, the economical and efficient use of resources and the achievement of operational goals and objectives. Internal audits encompass financial activities and operations—including systems, production, engineering, marketing and human resources. The internal audit function can be delivered by employed staff or via outsourcing to professional services firms—people like me—or to a combination of employed staff and outsourcers.

In the opinion of the institute, there are four pillars to good governance. These pillars are: one, developed and sound systems of internal accounting controls and risk management—these are obviously the responsibility of corporate management; two, a proactive audit and risk committee or committees; three, an objective, well-resourced internal audit function; and, four, an effective independent external audit.

The institute supports the external audit reforms contained in CLERP 9. The proposed legislation has an understandable strong focus on reforms to external audit, given the recommendations of the HIH Royal Commission, the Ramsay report and other parliamentary inquiries. CLERP 9, however, makes no comment on the profession of internal audit, which, as we noted a moment ago, is a pillar in the structure of good governance. The institute is of the view that either CLERP 9 or subsequent company legislation should recognise internal audit and that these recognitions should be in three forms. Firstly, there should be statutory separation of the provision of internal audit and external audit services. Currently, one organisation, say, an accounting firm, can supply internal and external audit services to the same client. The only restraints on this are the ASX Corporate Governance Council's best practice recommendations and professional independence requirements and, for those companies that are US registered, Sarbanes-Oxley requirements.

The institute contends, however, that there is never an instance where auditor independence will not be compromised, either perceived or real, if the same professional services firm provides internal audit and external audit services to the same client. These comments are made even in respect of operational internal audit services unrelated to the internal accounting controls, financial systems or financial reporting.

Our second issue is that, although the registration of external auditors is subject to needed reform in CLERP 9, there is no mention of a registration process for internal auditors or for definition outlining the nature and breadth of internal auditing. Again, drawing on the theme of the pillars of good governance, it would seem vital that internal audit be provided with a statutory registration process. The registration of internal auditors will assist in the establishment of minimum standards of qualifications and experience and support external audit reforms.

The institute has the worldwide certification 'certified internal auditor', and we would propose that this certification, which requires the passing of examinations to gain qualifications in audit experience, provide a baseline for registration. The institute recommends that all the ASX top 300 companies be required to have an internal audit function and an internal audit charter in order that there be arms and legs for the audit committee to do the work and to assist the CEO and the CFO in providing the declaration to principle 7 of the ASX Corporate Governance Council's guidelines.

This audit function could be in-house or could be outsourced. The respective heads of internal audit should be required to be registered internal auditors. Where a listed company or non-listed company has an internal audit function then the annual report of the company should outline the activities of that function, including a summary of the internal audit charter. The institute would obviously be happy to work with ASIC on a registration framework and with the Auditing and Assurance Standards Board on the codification of internal audit standards for Australia.

Our third issue and recommendation is with regard to audit committees. The institute would seek the codification of many of the ASX Corporate Governance Council best practice statements and audit committees. In fact, the institute takes those ASX statements further by seeking to have audit committees comprised solely of independent directors. Company executives may attend but only by invitation. We seek to have only the audit committees vested with a power to hire and fire the internal auditor. This procedure would allow the head of internal audit to speak and report frankly and not be beholden to the chief executive officer or the chief financial officer. Linked to the previous comment, the institute observes that the head of internal audit should have unfettered access to the chair of the audit committee, with no opportunity for the filtering of information by management, in particular the filtering of any bad news. We acknowledge, however, that the head of internal audit would have administrative reporting to the CEO and the CFO and that management input would be required to draft internal audit reports.

With regard to audit committees, we consider it essential that all ASX top 500 companies have audit and risk committees and a committee charter. Whilst this list requirement is currently included in the ASX listing rule 12.7, the institute recommends that this requirement be codified. Other listed companies, non-listed public companies and large proprietary companies should either have functioning audit committees or disclose the government's mechanism available to achieve the level of integrity of reporting had an audit committee been in place.

Lastly, on audit committees the institute takes the view that the audit committee should give documented prior approval to the contracting of non-audit services to the external auditor rather than the post-approval confirmatory process seemingly envisaged by section 300. As has been mentioned, internal audit is a pillar of good governance. With a well resourced, trained internal audit function, companies can be more efficient and effective and have the potential to uncover massive corporate governance breakdowns, as was seen in the WorldCom investigation.

Mr McDonald—I would like to provide an update on the recognition of the value of internal auditing which has recently occurred in the US. On 9 March 2004, after receiving more than 190 responses on its initial exposure draft, the Public Company Accounting Oversight Board, PCAOB—some people call it 'peekaboo', but the board members are not really impressed with that—published its auditing standard No. 2, *An audit of internal control over financial reporting performed in conjunction with an audit of financial statements*. This 250-page standard report which is required by the Sarbanes-Oxley Act of 2000 details external audit requirements for assessing the effectiveness of internal controls over financial reporting and, more importantly, expands reliance on the work of competent, independent internal auditors as part of the process. This is a major change from the first draft, which allowed for very little, if any, reliance on the work of others.

The key issue includes the recognition of the value of internal audit and its relationship to the audit committee. However, the important aspects in the standard are that the competence and independence of internal audit must meet the requirements of the Institute of Internal Auditors international standards for the professional practice of internal auditing. I believe this is going to greatly strengthen internal audit in the USA, particularly for those organisations that need to comply with Sarbanes-Oxley, because internal audit will have the opportunity to stand up and be counted, so to speak.

From talking to my external audit colleagues in the USA, I believe that the points that they will look for in determining competent internal audit will rely heavily on the certification process—that is, whether the chief audit executive is a certified internal auditor, and how many of his or her staff are certified internal auditors. Why is that important? The term 'chartered accountant' in Australia—CPAs, certified practicing accountants; AICPA in the USA—makes a public statement about a person's ability to do accounting and external auditing but says very little publicly about their competency for internal audit. CIA makes that public statement. It is the mark of excellence for internal audit. The other competency issue will be whether that audit shop has adopted the institute's standards in its methodology and manuals and whether it has undertaken a quality assurance review as required by the standards. In relation to independence, as Michael mentioned before, it will be determined in the reporting relationship. Does internal audit report to the CFO or does it report to the audit committee and the CEO? Independence is really enhanced with the reporting to the audit committee and the CEO.

I would also like to make a comment on the registration process that Michael mentioned. This was certainly considered by the Institute of Internal Auditors in the US environment but was not pursued because of the issues of federal versus state and state versus state laws in the US. With 50 states, it would be a process too cumbersome to provide a really effective registration process. For example, most states in the USA have their own certification process for company accountants and company auditors. However with only six states and the territories in Australia, and the uniform corporations law, registration is certainly an option that could work in our country.

ACTING CHAIR—Thank you.

Senator CONROY—You have outlined what you believe is the role of the internal auditor. You have alluded to this, but I would just like to tease you out on it a little bit more: how would users of financial reports benefit from a separation of the role of the internal and external auditor?

Mr Parkinson—The way I see that happening is that the reporting in the corporate governance portion of the financial report would indicate what the internal audit activity has been for the year. The scope of operation—effectively the charter of the internal auditor—would describe what the internal auditor is entitled to do and would then provide some level of comfort that the internal audit activity had covered off those things that are important in the operation of the organisation.

Mr McDonald—In a practical sense I see one of the real issues there being that internal audit has the corporate knowledge of the organisation: it knows the organisation, the reporting relationships, the people who work in there; and it has a better ability to address the risk and control issues on a daily basis rather than on an intermittent basis over the year as external audit comes and goes with its interim reporting processes.

Senator CONROY—In April, one of the governors of the US Federal Reserve, Susan Schmidt Bies, gave a speech in which she referred to the role of the internal auditor. Mr McDonald, you are probably aware of it. She said:

The Federal Reserve is very supportive of independent internal audit functions at financial services companies ... the audit committee should provide for an independent, objective, and professional internal audit process. The audit committee must set the tone for the internal audit function.

You mentioned some new developments. What requirements existed in the US in relation to internal audit prior to these new developments? Could you quickly summarise them again so that I have the whole context of what is required?

Mr McDonald—The PCAOB requirements reflect Ms Schmidt Bies's comments that organisations—in particular, audit committees—should be relying on professional, competent, independent internal audit. I guess the real difference is that, prior to Enron, WorldCom and HIH in Australia, for example, internal audit was an issue that the institute certainly knew the value of but not something that had its flag flown very well in terms of legislation, guidelines or processes in very many countries. I think the recognition now is that internal audit has been making those issues of governance risk and control for many years. We are now having the standards set as the regulators and oversight people understand that there is a real profession of internal audit that is separate to external audit and that, to get the recognition and to make it work in a real sense, it needs to be recognised by those standard setters and oversight organisations.

Senator CONROY—Has anyone in the US or anywhere else in the world picked up your suggestion that internal auditors are hired and fired directly by the audit committee rather than by the CEO? On first blush it sounds pretty radical that the CEO does not have the power to hire and fire everybody in their organisation.

Mr Parkinson—Surveys of members suggest that some companies have established themselves that way, but it has not been legislated anywhere. Some company boards have taken that right to themselves: they regard the internal auditor as being theirs.

Mr McDonald—The trend certainly indicates the change that audit committees are now hiring and firing.

Senator CONROY—Anyone in Australia? I can see a whole lot of BCA members passing out at this suggestion.

Mr Parkinson—I do not believe anyone in Australia has done it.

Mr McDonald—Not that I am aware of.

Senator CONROY—Is it just the US, the UK and South Africa?

Mr McDonald—Not the UK, South Africa. It is an issue that the institute has been talking about in a global sense. Certainly there are indicators globally that the trend is that move to a direct reporting relationship with the audit committee and with the audit committee hiring and firing—the chief audit executive, not the staff.

Senator CONROY—Just going back to Ms Bies's speech, how does the audit committee set the tone for the internal audit function?

Mr McDonald—It is about setting the independence and the reporting relationship. The audit committee basically tells internal audit, 'Go and tell us what is wrong.' I have a shorthand comment about good governance in an organisation—to ask two questions. The first is this: how quickly does the bad news get from where it occurs to where it needs to be?

Senator CONROY—I take it you do not work for NAB?

Mr McDonald—I will pass on that one. And the other question is this: when the news gets there, how filtered is it? One of the roles of internal audit is, as part of the risk assessment process, to identify with management and the audit committee the risks that should be keeping managers and audit committees awake at night, looking for effective control mechanisms. Beyond the control mechanism there is the monitoring and reporting. In a two-dimensional matrix of probability and impact, we need to make sure that there are mechanisms that watch and give early warnings for risks that are low probability but high impact—that is, if they occur, there will be a catastrophe. Internal audit can be part of that process as well.

In a sense, internal audit becomes the corporate conscience, the corporate champion for ethical behaviour, and should be the folk who stand up and tell management, 'That's against the legislation' or 'That's against the principles. You shouldn't be doing it that way. You should think about that way.' They are not acting as a telltale to the audit committee; they are telling management what should be occurring and, if it does not occur, taking it through to the audit committee. When I talk about internal audit reporting to the audit committee, I do not mean that in isolation from the CEO. Internal audit cannot be going to the audit committee without telling the organisation what is going on—unless, of course, there is a potential fraud involved or a potential issue that captures the CEO or other senior management. It really is that opportunity of risk control and reporting.

Senator CONROY—In relation to non-audit services, is it ever appropriate for a company's auditor to provide internal audit services?

Mr Parkinson—We would not believe so. The necessary creative tension between the internal and external auditor at the audit committee would not be there if one of the parties were financially dependent on the other, which would be the case if the internal services were being provided by the external auditor.

Senator CONROY—I describe it as being hard to audit your own work. Is that a fair way to describe it?

Mr Parkinson—Yes. In some cases, though, you are not auditing your own work; you are just providing bad news in an area where an organisation may not want to hear about it.

Senator CONROY—Are there any other non-audit services which a company auditor should not provide?

Mr Parkinson—The ones listed in CLERP 9 are a fairly good list. There is bookkeeping—

Senator CONROY—They are not prohibited, though, just to be disclosed. I am asking about the ones that they should not provide.

Mr Parkinson—We believe that the external auditor should be staying out of those things in much the same way as the Sarbanes-Oxley Act suggests. The great danger is that you become financially dependent on a non-audit service or that you end up auditing your own work.

Senator CONROY—We have had all of the big four companies appear before us and we have invited them to tell us what internal audit is. They take a very different view from you. That may come as a surprise to you; it may not. They felt there was very little that actually constituted internal audit. If you were to draw a line from A to B, they would be very close to A. Everything between a little bit over there and then from there to B would all be open for external work. How can you help the committee work its way through the other evidence that has been put to us—that all that stuff can be done, that there are only a couple of things, such as valuing your own work, that cannot. I have been able to get them to all agree that they should not value their own work—valuations.

Mr Parkinson—If we think about what the external auditor is there to do, which is to provide an attest in relation to the financial statements and the ongoing ability of the company, the internal auditor covers off a lot of other work. If the organisation is into triple bottom line reporting, potentially there are the two non-financial strands as well as the financial one. Anything that is operational or a risk of the organisation becomes something which is important to the internal auditor.

The danger that arises when the external auditor does some of this non-financial statement internal audit work is that, once again, it can become a very large proportion of their fee or they can be placed in a position where they can be compromised. They may find themselves tempted—I would not say that any of my colleagues would ever do it—to play down the bad news in order to retain other pieces of work.

Senator CONROY—Though you assure us that never happens. 'Trust us; that never happens!'

Mr McDonald—As to my comment about the difference between internal and external audit, traditionally external audit—as Michael said—is based primarily on the attest of the financial statements: are they providing a true and fair view of the organisation's financial operations? Internal audit, on the other hand, should be doing some of that financial assurance work and some of that work in relation to financial reporting. However, that probably represents only a very small proportion of the overall size and workload of the organisation. What about the operational risk? What about the information systems? There are very few organisations today that are not tied into at least one major information system. In an organisation with web based delivery, internal audit should have the capacity, with specialist information systems auditors, to look at the security of the organisation, the security of data, as well as the normal financial control processes of those transactions that flow into the general ledger. There is a big world beyond the financial statements within the organisation that internal audit has the ability to assist in, particularly in relation to risk. If you are not looking at the high-risk, high-impact then you are wasting your time.

Senator CONROY—Should the CEO-CFO sign-off extend to internal controls like Sarbanes-Oxley and the ASX corporate governance guidelines? You will note that they do not go as far as the CLERP 9 proposal.

Mr McDonald—I certainly believe that annual reporting should provide a statement on the internal control environment and the internal control framework for the organisation. Whether it needs to go as far as Sarbanes-Oxley for certification and signature I am not sure. We can overregulate the market sometimes and we can use a sledgehammer to crack a nutshell. For financial statements and the control environment, we need the statement, but does it need to be signed off? I am not quite sure.

Senator CONROY—Is there a difference between having a statement signed and having a statement not signed off?

Mr McDonald—The statement is part of the overall impact of the report. I guess, at the end of the day, the report is signed off, isn't it, so in that sense there is not a separate signed statement; rather it is part of the overall annual report that is signed off by the organisation.

Mr Parkinson—My understanding of the Sarbanes-Oxley requirements was that it is the controls in relation to the financial statements that have to be signed off. That is only a subset of the controls that are necessary to keep an organisation running and healthy. It would be a very brave senior manager that said all the controls in an organisation were working effectively every year. All they can work on is that they are doing their level best and they have the systems in place to keep everything healthy. I, like Bob, am not very keen on the idea of legislating the list of things that are to be signed off. I think we are much better off leaning towards principle disclosure rather than legislated checklists.

ACTING CHAIR—Thank you, Mr Parkinson and Mr McDonald; you are excused.

[3.34 p.m.]

WOLTHUIZEN, Ms Catherine Nicole, Senior Policy Officer, Financial Services, Australian Consumers Association

ACTING CHAIR—Welcome. Thank you for appearing this afternoon. Do you have an opening statement?

Ms Wolthuizen—Yes. I apologise to the committee for not having provided a submission prior to the hearing. However, the matter I am going to speak on is quite limited. Rather than canvassing the majority of issues raised in the draft legislation, I just want to focus on the requirement relating to the management of conflicts of interest by financial services licensees. This issue has not assumed a particularly central role in discussions on the CLERP 9 legislation, but it obviously has the potential to have a fairly substantial impact on the operations of financial services licensees, given the increasing importance and prevalence of conflicts of interest in that sector.

We have noticed that, as financial services become increasingly complex, the role of intermediaries—be they financial planners or investment analysts—has become increasingly important in assisting consumers to negotiate that area and make decisions which often have long-term implications and involve complex designs and features, complex products and complex decisions. This has generated strong growth in the role of intermediaries and in the number of intermediaries operating in the financial services industry. These intermediaries straddle the two trends of growing consumer demand for financial services and the dynamic growth of the financial services industry, post deregulation. At the same time, they purport to essentially serve two principles: the consumer seeking advice and assistance, and also the objectives and demands of other commercial players and interests. The conflicts of interest that these twin objectives generate raise the prospect that, in certain circumstances, the two interests that a planner or another intermediary is attempting to service will be mutually exclusive and that the need to service consumer needs will fall victim to distribution targets or other commercial imperatives.

The proposed CLERP 9 conflict management obligation sets out that licensees should have in place adequate arrangements for the management of conflicts of interest that may arise wholly or partially in relation to activities undertaken by the licensee, or a representative of the licensee, in the provision of financial services as part of the financial services business of the licensee or of the representative. The ASIC policy proposal paper, which essentially provides greater detail on how this should be implemented, indicates that, to comply with that obligation, ASIC expects licensees to control, disclose and, as needed, avoid conflicts of interest and to have measures, processes and procedures to identify conflicts of interest, assess and evaluate those conflicts and ensure that, regardless of any conflicts, the quality of the financial services they provide is not significantly compromised.

Our concern, in a nutshell, is that, for some conflicts of interest that have arisen in financial services, the focus needs to be on the avoidance requirement. I would single out three particular conflicts of interest, two of which relate to remuneration for advice services. These include:

certain forms of direct remuneration related to certain types of payments generated out of conflicts of interests—trail commissions on superannuation guarantee payments are an example of that; the kind of indirect remuneration that tends to be in the form of what are known as 'soft dollar commissions'; and, thirdly, the vested interest issues that have beset research analysts in the investment and broking firms.

In appearing before the committee today, I really wanted to focus on soft dollar commissions. We are anticipating a substantial report from ASIC over the next weeks, which will detail the nature and influence of soft dollar commissions and the extent to which disclosure may be an insufficient tool—in our view, it certainly is an insufficient tool—for effectively controlling that particular conflict of interest generated out of those sorts of payments. We recommend to the committee that the third principle expressed by ASIC—that, as needed, conflict of interests be avoided—should come into play in respect of soft dollar commissions, preferential remuneration and direct payments on arrangements such as commissions on the superannuation guarantee. I am happy to detail some of the examples of soft dollar commissions that we find particularly objectionable.

ACTING CHAIR—Would you like to table the document that you have been reading from as a submission?

Ms Wolthuizen—It is in a rough draft form.

ACTING CHAIR—Would you like to provide to the committee a revised version of the document?

Ms Wolthuizen—Yes, I would be happy to do that.

ACTING CHAIR—We will receive it as a late submission.

Senator CONROY—I want to draw you out on some of the issues you raised in your opening address. Schedule 10 of the bill introduces new requirements in relation to the management of conflicts of interest, which requires them to have adequate arrangements for managing those conflicts. In addition, as you said, ASIC have released a consultation document. In your view, is this general requirement for licensees to manage their conflicts of interest adequate or are there certain types of behaviour for which disclosure by itself is not sufficient?

Ms Wolthuizen—It seems that the focus on disclosure and the notion that you can have measures, processes and procedures to identify, evaluate and not significantly compromise the value of services would simply not be sufficient, given some of the conflicts generated. In our view, the conflicts of interest that have emerged in financial services are extremely corrosive to consumer trust in the provision of advice and financial services from many intermediaries where these sorts of arrangements exist. Given the degree to which they skew competition in this sector towards the supply side competition, where manufacturers dominate in terms of influencing the activities of financial planners and, as we have seen more recently, going out and simply buying them up and acquiring distribution networks where the control is far more direct, simply attempting to disclose some form of remuneration to a consumer is not enough.

Firstly, a consumer may not be able to appreciate the impact of that remuneration in terms of how it may adversely affect the quality of advice that is provided. Secondly, where it is so entrenched, as we now perceive, within an industry, for a consumer wanting to avoid that kind of conflict it would be very difficult to find a provider that has not engaged in it. One example that I notice today relates to share options, for example. There is one quite high profile fund manager that now remunerates its planners by providing them with share options to a value of up to $75,000 for business that they generate above a certain level. Yet the product disclosure statement, which refers to the kind of alternative remuneration it may provide its planners, describes these sorts of ancillary payments that it may pay to planners as 'seminars, client mailings, cooperative advertising, postage et cetera'. Clearly, those sorts of payments are a long way away from a share option arrangement, which is very much designed to closely tie a planner to that particular manufacturer, yet it seems that disclosure is—

Senator CONROY—That could be the first test case.

Ms Wolthuizen—I have not seen the statement of advice that the particular planners recommending that product would provide to a consumer, but describing ancillary payments which include share options as simply minor office expense support conveys a somewhat misleading impression as to the nature of remuneration provided.

Senator CONROY—We can probably have a chat with ASIC and the ACCC about issues of false and misleading conduct—certainly with ASIC. If you can put that information in your submission so that we can pursue that, that would be great.

Ms Wolthuizen—Yes, I would be happy to.

Senator CONROY—The CLERP 9 bill requires companies to manage their own conflicts of interest. In your view, how is ASIC going to be able to enforce this new requirement? What will they need to do?

Ms Wolthuizen—There is a project that we are expecting to see the results of shortly, relating to the kinds of soft dollar arrangements that are in place. The degree of depth of that report will give an indication as to how successful ASIC has been in understanding the nature of payments. Ultimately, this regime is more about disclosing to a consumer and ASIC assessing the quality of the disclosure. Another question that arises is that, even if we do get to a point where disclosure could be deemed effective and you disclose to someone, for example, that you were a participant in the luxury cruise around the South Pacific that was held by one of the major funds at the start of this year, and the consumer understood that, again, if most of your competitors are engaging in similar conduct, it does not necessarily cure that kind of behaviour or provide any kind of disincentive to that sort of behaviour.

Moreover, it still leaves that corrosion of trust that an efficient financial services market should be fostering between consumers and intermediaries and that enables a consumer who may not otherwise be able to assess and evaluate the products on the market to choose the one most appropriate to their needs. They should be able to expect non-conflicted advice from intermediaries and other licensees operating in the market. That is where I take issue with this notion that you can have processes or procedures in place around conflicts of interest such as soft-dollar commissions to ensure that the services are not significantly compromised. I simply

do not think that—whereas most of the soft-dollar commissions we are starting to see are allowed to exist—that is something that would be possible.

ACTING CHAIR—There is an argument that we heard earlier in these hearings about the point at which a conflict of interest is resolvable or able to be dealt with sufficiently by full disclosure. I think most people accept that there are some conflicts of interest which are so intractable that even full disclosure would not solve the problem. I think most people also accept that there are some conflicts of interest for which full disclosure will sufficiently avoid any embarrassment for the conflicted person. But there is this lively debate as to where you draw the line. What do you say about soft-dollar commissions? Do you think full disclosure would ever be sufficient—and, if so, in what circumstances—to deal with the conflict?

Ms Wolthuizen—No, I would probably draw the line more between direct remuneration and soft dollars falling into that kind of indirect bonus, reward or remuneration that is paid. For example, we view the kinds of trail commissions that are paid to financial planners as presenting a conflict of interest. There you have someone who is setting themselves up as a quasi-professional adviser to consumers who is paid by the manufacturers of the products that they are recommending. That is a conflict of interest that raises concerns, in our view. But we have accepted that, because the payment that comes out of that trail commission to the adviser is related to the service they provide, disclosure is one means of overcoming the problems that that conflict generates.

ACTING CHAIR—And that is the case; if there is full disclosure, there is no suggestion of dishonesty.

Ms Wolthuizen—That is right. But where you have payments that are not related to the service that is being provided but are simply made available to skew the advice—to essentially bribe the intermediary to recommend certain products over others—then it is very difficult to see how disclosure would ever be sufficient to cure that conflict.

ACTING CHAIR—Thank you.

Senator CONROY—You have just covered the other issue I had for you. You went to the heart of the issue I was going to follow up on, so I am finished.

ACTING CHAIR—Thank you, Ms Wolthuizen. You are excused.

Ms Wolthuizen—You are welcome. Thank you.

ACTING CHAIR—That concludes the public hearings of this committee's inquiry into the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003. I thank all the witnesses, I thank Hansard and the committee secretariat for their assistance, and I declare the proceedings adjourned.

Subcommittee adjourned at 3.48 p.m.