Business
Council of
Australia

BUSINESS COUNCIL OF AUSTRALIA

Supplementary Submission to the
Parliamentary Joint Committee on
Corporations and Financial Services

on the

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

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1 INTRODUCTION

The Business Council of Australia would like to take the opportunity to make a short supplementary submission to the Parliamentary Joint Committee on Corporations and Financial Services as part of its inquiry into the Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill (**CLERP 9**).

This submission supplements the Business Council's original submission, which responded to the Federal Government's Bill. The purpose of this submission is to respond to amendments to that Bill that have been proposed by the non-government parties.

The Business Council has an overall concern that we are seeing an increasing tendency to respond to every misjudgment, mistake and mismanagement in the corporate sector with new regulatory requirements and increasingly interventionist regulatory powers. This trend can be seen across the political spectrum and across all levels of government. The Business Council recognises the community and political concern that can be generated by these issues, but seriously questions whether further regulation is always the best answer. We are also concerned that many superficially attractive regulatory proposals may in fact not achieve their stated objectives and may have unintended and adverse consequences.

This trend towards regulatory 'quick fixes' runs the real risk of reversing the economic gains that Australia has made from two decades of regulatory reform and deregulation. Australia's current economic prosperity is the result of hard decisions made in the 1980s and 1990s to free up the corporate sector, enabling it to be innovative, dynamic and internationally competitive. Adding new regulation for every misjudgment, mistake or instance of mismanagement will progressive undermine those gains. This is of particular concern where that regulation is highly detailed and prescriptive, directing Boards and management on how to run public companies.

Finally, the Business Council is concerned that much of this re-regulation is being driven by isolated instances of corporate behaviour or failure, without regard to the fact that the cost of new regulation is born by all corporations.

2 ALP PROPOSED AMENDMENTS

The Business Council would like to take the opportunity to respond to a number of amendments to the CLERP 9 Bill proposed by the ALP[1].

As an overall issue, the Business Council is concerned that a number of the ALP proposed amendments would make mandatory elements of the ASX Corporate Governance Council *Best Practice Principles and Recommendations*. The rationale presented for this is that "[i]n Labor's view, if it is good enough for the Australian Stock Exchange, it should be a requirement in the law. What is wrong with legislating for it?[2]

This approach fails to recognise that prescribing certain practices is not the best means of ensuring better corporate governance. Mr Justice Owen, in his report on HIH, stated that[3]

> *"I think that any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature, corporate governance is not something where one size fits all."*

The approach taken by the ASX Corporate Governance Council recognises that while, in general, certain governance practices may be desirable, it cannot be assumed that they should be the preferred approach in all circumstances. Companies should therefore have the ability to adopt alternative governance practices suitable to their situations, provided they give adequate explanations of why they have adopted those practices and how those practices achieve the objectives of good corporate governance.

Mandating particular approaches to corporate governance also risks setting those practices in concrete, stifling the evolution of Australian corporate governance and the ability of larger corporations to keep in step with international developments. Companies need flexibility to respond to changing expectations in the market and from the community. Improving upon current practices should not be discouraged merely because the improvements are inconsistent with a particular approach adopted at a particular point in time.

Finally, mandating particular corporate governance practices may unwittingly encourage a superficial or 'tick the box' approach to governance, with companies focussing more on satisfying the standard than on looking at the governance objective that underlies that standard.

2.1 Remuneration Report

The ALP has proposed a number of amendments to the Bill covering executive remuneration. For example, the ALP has proposed that as part of the remuneration report, companies be required to disclose:

- the board's policy on the duration of contracts, notice periods and termination payments;

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1 ALP proposed amendments taken from ALP Policy Paper, "Labor's Approach to CLERP 9 – *Cracking Down on Corporate Greed*", October 2003, and from the speeches of the Hon. Simon Crean MP and Mr David Cox MP in the House of Representatives debate on the CLERP 9 Bill (Hansard, 16 February 2004).

2 Hansard, House of Representatives, 16 February 2004, 24822, *per* the Hon. Simon Crean MP.

3 Report of the HIH Royal Commission, para 6.1.2.

- the board's policy on performance conditions;
- the value of options granted and exercised and of those that have lapsed unexercised;
- the board's policy on equity value protection schemes; and
- graphs plotting shareholder return for the previous 5 financial years.

With the exception of the last point, this level of disclosure is already covered by the ASX Corporate Governance Council *Best Practice Principles and Recommendations* and encouraged by the Executive Remuneration Best Practice Principles and Guide issued by the Business Council. For example, the ASX guidelines recommend that companies disclose their remuneration policies, including fixed, performance-based and equity-based remuneration and agreed termination payments. Companies that fail to do that need to disclose their reasons for not doing so.

The Business Council is concerned, however, with the final point, that graphs plotting shareholder return for the previous 5 financial years be included in the remuneration report. We recognise that this is currently a requirement of the UK Directors' Remuneration Report Regulations. While this proposal superficially seems reasonable, it pre-supposes there is or should be a simple and direct link between past performance and current remuneration. This says nothing about the company's current strategy or the complexity and challenge of delivering future growth in shareholder returns. Such a proposal only serves to encourage a short term view, by punishing those companies that are making hard investment decisions now for greater growth in shareholder wealth in future. The Business Council supports the premise that remuneration must be tied to performance and that this link must be transparent. We do not believe, however, that the addition of a graph of past performance adds anything to the more general requirements and may be misleading.

2.2 Non-Recourse Loans

The ALP has proposed an outright prohibition on non-recourse loans to Directors and management.

The Business Council believes that all non-recourse loans to Directors and management should be disclosed. However, the Council does not support an absolute prohibition as there may be circumstances where a non-resource loan is an appropriate part of an overall remuneration package. For example, a struggling company may wish to attract a highly successful executive in an attempt to save the company from collapse. Through the use of a non-recourse loan to buy shares, the executive can be rewarded if she or he is successful, but will not be personally penalised if, despite the executive's best efforts, the company is beyond saving.

Given the possible legitimate use of non-recourse loans, the Business Council supports full disclosure over outright prohibition.

2.3 Directors' Remuneration

The ALP has proposed an outright prohibition on the payment of options, bonus payments and retirement benefits to non-executive directors (other than statutory superannuation).

Again, the Business Council opposes an outright prohibition as there are instances when such payments may be legitimate. For example, many small start up companies rely on the payment of options to Directors to attract experienced Directors to their companies. These companies are often in a weak cash position and the payment of substantial Directors' fees would be a significant cost to the company. By their nature, however, a major asset of these companies is their future potential, which they can draw upon to remunerate Directors through options.

The Business Council also notes that few major corporations now offer options, bonus payments or retirement benefits to non-executive directors. The ASX Corporate Governance Council *Best Practice Principles and Recommendations* also state that non-executive Directors should not receive options or bonus payments, nor retirement benefits other than statutory superannuation.

Where the payment of options, bonus payments or retirement benefits to non-executive directors (other than statutory superannuation) are made, they should be fully disclosed.

2.4 Multiple Chairs

The ALP has proposes an amendment to require a non-binding resolution of shareholders on the appointment of a director as chair where the director is already chair of another company (applying only to companies within the ASX All Ordinaries Index).

The Business Council understands that the ALP proposal is based on a similar requirement in the United Kingdom. The UK *Combined Code on Corporate Governance* (as revised in June 2003) states that "[n]o individual should be appointed to a second chairmanship of a FTSE 100 company"[4], noting that this is not a prohibition, but that compliance or otherwise with this provision need only be reported for the year in which the appointment is made.

In the UK, the requirement is limited to the top 100 companies on the Financial Times Stock Exchange (FTSE). The ALP proposal would apply the measure to the top 500 firms on the Australian Stock Exchange. It is also important to note that the market capitalisation of the companies at the lower end of the FTSE 100 is around £2 billion (A$ 5 billion). In Australia, only the top 38 companies have a market capitalisation of this size or larger. The ALP proposal is therefore significantly more extensive than the UK requirement and covers 99% of the Australian market by capitalisation.

2.5 Directors' Relationships

The ALP proposes amending the CLERP 9 Bill to require directors, when standing for election, to disclose

- all relationships between the candidate and the company; and
- any relationships between the candidate and the directors of the company.

The Business Council understands that the first dot point, disclosure of the relationship of the candidate to the company, is already normal practice. The second dot point, proposing the disclosure of "any relationships between the candidate and the directors of the company" is vague and would therefore make compliance difficult. In particular, it is not clear what is intended by the term "relationship". Would this cover just financial or commercial

4 United Kingdom, *Combined Code on Corporate Governance*, June 2003, at A.4.3.

relationships between the candidate and directors, professional relationships (such as the fact that the candidate is on another Board with one of the Directors), former professional relationships (such as the candidate and a Director having previously been employed by the same firm) or even personal relationships (such as membership of the same sporting club or church). There is clearly a very wide range of potential relationships covered by the proposed amendment, and there appears to be no link to whether these relationships are material to the interests of the company or its shareholders. The Business Council's view is that any material relationships will already by covered by the requirements to disclose potential conflicts of interest and therefore this additional vague requirement is unnecessary.

2.6 Board Committees

The ALP proposal to require companies within the ASX All Ordinaries Index to establish an appropriately composed remuneration committee and nomination committee, as well as audit committee, is a further example of mandating particular corporate governance practices which may be desirable, but cannot be assumed to be appropriate in all cases. At the very least, companies should have the option of constituting the whole Board as a remuneration or nomination committee. This will avoid problems for smaller companies with smaller numbers of Directors.

2.7 Doubling Sanctions

The ALP has proposed a doubling of the current penalties for serious breaches of the Corporations Act from 5 years to 10 years and an increase to five years for many offences that now only carry two year penalties. No justification has been offered as to why this increase in penalty is needed and what effect it is expected to have, particularly as it cannot be assumed that greater penalties are effective as greater deterrents. While the Business Council is not opposed to increasing penalties *per se* (and supported the increase of civil penalties from $200,000 to $1 million in the CLERP 9 Bill), it is important to ensure that the penalties under the Corporations Act remain in step with comparable offences under other Acts.

2.8 Analyst Briefings

The ALP proposes an amendment requiring:

- written disclosure in analyst reports of any interest of the analyst; and
- companies to disclose information provided during briefings to analysts.

The Business Council supports the first dot point, noting that a similar requirement should apply to the media and other commentators, but has concerns with the second point. It appears that the amendment would require companies to disclose the fact that a briefing has taken place and the information exchanged at that meeting. This places a much greater burden on companies that the current requirement of not disclosing material information at briefings that is not already available to the market. In effect, the ALP amendment appears to require release of detailed minutes or transcripts of all communications with analysts. This is a prescriptive and costly requirement that would be imposed for no clear benefit. It is also not clear what concern the ALP amendment is seeking to address and whether this concern is valid.

2.9 Alternative Accounting Practices

The ALP has proposed an amendment to require auditors to report to shareholders and the audit committee on any alternative treatments of financial information that have been discussed with management, the ramifications of the use of such alternative treatments and the treatment preferred by the auditor. The Business Council does not oppose auditors being required to report to the audit committee on alternative treatments, while noting that it is within the power of the audit committee to require such information and therefore legislative backing is not required. The Business Council is concerned, however, with the proposal to make internal deliberations over alternative treatments publicly available (the effect of requiring alternative treatments to be reported to shareholders).

This requirement is likely to stifle discussion between companies and their audit advisors on appropriate treatments of financial information, when both parties know that such information will need to be released publicly. Releasing information on the ramifications of the use of alternative treatments would potentially require the company to release a number of alternative financial accounts, which may result in confusion and misinformation in the market. Finally, where an auditor is dissatisfied with the treatment adopted by the company, they would already be required to qualify their assessment of the accounts.

3 DEMOCRAT PROPOSED AMENDMENTS

The Australian Democrats have proposed a number of amendments, particularly focussed on executive remuneration. A number of these are similar to amendments put forward by the ALP and have therefore been discussed above. For example, the Democrats have proposed an amendment requiring remuneration disclosure to include all options, 'golden hellos' and 'golden goodbyes', and to be fully expensed. The Business Council's response to this proposal is given in Part 2.1 above.

3.1 Expanded Disclosure

The Democrats have proposed amending the CLERP 9 Bill to require disclosure of remunerations for all executives (not just the top 5 to 10) whose full packages are in excess of $1 million.

The Business Council set out its concerns with the disclosure of individuals' remuneration in its original submission to the Parliamentary Joint Committee. In particular, the Council noted that[5]

> *The Business Council is concerned that the disclosure of individual executives' remuneration has unintended consequences, which will be exacerbated by increasing the number of executives covered. There is strong anecdotal evidence to suggest that the disclosure of individual executives' remuneration leads to a 'ratcheting up' of salaries, as an executive can see how much peers and colleagues within the company, and its competitors, earn.*
>
> *Disclosure can also lead to executive remuneration being adjusted upward so that it falls within the top quartile of remuneration paid across comparable companies. Companies are wary of being seen to underpay their executives, or employ executives that are apparently only good enough to warrant remuneration at lower levels, compared with their competitors.*

The Business Council went on to argue that these issues could be overcome through adopting better approaches to the disclosure of executive remuneration:[6]

> *The Business Council accepts disclosure of the remuneration of the senior most executives, however, it believes alternative means of disclosure that do not result in 'ratcheting' nor conflict with privacy principles need to be considered.*
>
> *The principle behind disclosure is that it allows shareholders the opportunity to judge whether the remuneration of the company's executives is consistent with the performance of the company and to compare remuneration with that of peers and competitors.*
>
> *This objective could be achieved through disclosing the total, combined remuneration of the top executives. In effect, the company would be disclosing the average remuneration of its top managers, providing a valid means of*

5 Business Council of Australia, Submission to the Submission to the Parliamentary Joint Committee on Corporations and Financial Services on the Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill, 17 November 2003, p 11.

6 Ibid., pp 11-12.

comparing remuneration and performance, without disclosing the remuneration of named individuals. Shareholders have the opportunity at the annual general meeting to question the Board on how total remuneration relates to the company's performance.

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

Extending the remuneration disclosure requirement to all executives earning over $1 million will only exacerbate the unintended consequences from disclosure of individual remuneration. The stated policy intentions of broadening the disclosure would be better achieved by disclosing the combined total remuneration of senior executives.

3.2 Ratification of Remuneration

The Democrats have proposed amending the CLERP 9 Bill to require all executive contracts to be approved by shareholders within 12 months of negotiation, if those contracts include remuneration in excess of 20 times average male earnings (that is, currently approximately $1 million). The amendment would also require 33% of all the shareholding register able to vote to have voted for them.

The Business Council is strongly opposed to this proposal and believes it would be unworkable in practice.

In effect, the Democrat amendment would mean that executive remuneration contracts were subject to ratification by shareholders, presumably at the annual general meeting. Until such ratification, there would be considerable uncertainty over the executive's remuneration and tenure. The following example illustrates the practical difficulties the proposed amendment would cause.

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

A successful executive working for a rival firm (Company B) is identified and selected as the most appropriate candidate for the position. The executive agrees to take the position and terms of employment are negotiated. The executive's current remuneration is over $1 million, as is the value of the remuneration offered by Company A. The contract is therefore subject to ratification by Company A's shareholders.

This places the executive in a difficult position. Once it becomes know that she is considering a move to Company A, her career at Company B is finished. If her contract with Company A is voted down, however, she is left in limbo.

To offset this risk, the executive demands an up front payment in return for her agreement to enter into the employment contract with Company A. The payment will need to be considerable, as the executive is potentially risking her successful career. Company A is now faced with an additional cost in employing an executive from outside of the company. In addition, if the shareholders vote against the executive's contract, Company A will lose both the new executive, and the up front payment.

The Business Council maintains its view that, if there is sufficient shareholder interest, shareholders are able to discuss executive remuneration, and place resolutions on the agenda, at the company's annual general meeting.

3.3 Fines for Non-Disclosure

The Democrats have proposed amending the CLERP 9 Bill so that failure to disclose and expense executive remuneration would result in an automatic ASIC fine against the company equivalent to the total package for the executive(s) concerned.

The Business Council strongly opposes such a Draconian measure. Under this proposal, companies could receive fines of millions of dollars for minor and technical breaches of the Corporations Act. A company that makes a minor miscalculation on the expensing of an executive's options, or adopts a legitimate alternative expensing methodology to one accepted by ASIC, and based on that calculation, does not disclose that executive's remuneration, would automatically be liable to an ASIC fine. In addition, fines are presumably also intended where disclosure is held to be inaccurate or incomplete, greatly increasing the risk of serious fines for minor and technical breaches.

The Business Council also notes that such a fine against the company penalises the company's shareholders. Any such fine against individuals, however, would amount to forfeiture of a year's remuneration for what could be little more than a technical breach of the Corporations Act.

The Business Council is strongly of the view that any breaches of the requirements of the Corporations Act should be pursued through the courts.

4 CONTACT DETAILS

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