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Presentation of CGI Principal A A D Easterbrook

to the

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003

Canberra Hearing 9 March 2004

General Comments

1. **Australia's superannuation system, mandated by government, compels millions of Australians to 'lock away' a portion of their earnings each payment period to be professionally invested and managed over the long term for their ultimate retirement by professional fund managers and other major institutional investors**

   A large portion of the Australian stock market is now in the hands of those institutional investors, which are paid, or are responsible as fiduciaries, for the prudent investment management of their clients' and beneficiaries' funds

   Best practice in corporate governance has been evolved by institutional investors as the most reliable set of practices to protect and foster the long term value of their clients' and beneficiaries' funds invested in the stock market

   So government needs to listen primarily to those institutions on issues of corporate governance reform – to give those institutions the tools they ask for to do their job competently and effectively

2. **Stock markets are becoming increasingly global and the Australian market is under 2% of the world's equities markets. So, in introducing further corporate governance reform provisions into Australian corporate law:**

   - **Don't REINVENT a wheel which is already in use and appears to be working well in other major markets, especially markets with a similar governance infrastructure to our own, and**

   - **Don't REBALANCE such a wheel which is well supported by investors - for example, the UK Combined Code/Companies Act governance reforms in the UK and the Management Discussion & Analysis in the US**

3. **Give institutional investors significant dedicated representation on key market bodies – for example, the FRC and the proposed FRD**

4. **Apart from voting, institutional investors communicate with companies most effectively on governance issues 'behind the scenes' and outside (usually prior to) the AGM. The AGM is primarily the opportunity for retail investors to obtain annual accountability from boards. But even then, only a very small proportion of a listed entity's shareholder base can manage to attend the AGM.**

   So, governance reforms requiring disclosure or discussion at the AGM 'miss' the bulk of the constituency they target. Most businesses of any moment now have websites. So, as a corollary of access to public investors, a listed entity should be required to 'invest' in a website which can be used, inter alia, to provide to all its public investors convenient disclosure of key documents – for example, the notice of meeting and annual report - and record of key discussion – for example, questions by shareholders to and answers to questions by the auditor

5. **Given the very long gestation of CLERP 9, an extended transitional period before provisions become applicable is inappropriate. The market, including listed entities, has already had ample notice of intended reforms and, as a general principle, all provisions should become applicable for the main 2004 reporting season (ie for entities reporting on or after June 30 2004)**

Specific Comments

The following specific comments are on the perceived most important governance reforms in the CLERP 9 package

CGI supports the general thrust of those reforms but makes the following observations

AUDIT

1. **The two key governance protections of public investors are a rigorous, competent and independent board and a rigorous, competent and independent audit**

   It is accepted that board members of ASX-listed entities should be accountable to public investors through a triennial rotation and re-election process

   Until the 80s, the auditor of an Australian listed entity was subject to annual re-appointment by shareholder vote at the AGM (and to this day that has remained the system in the UK, whence our system originally evolved). The excesses of certain entrepreneurs, especially perceived 'auditor shopping', led to a system change in Australia which removed annual re-appointment of the auditor and substituted a more 'entrenched' system requiring ASIC approval of change of auditor

   Given the combination of the rise of institutional shareholdings and perceived deficiencies in the auditing system (especially the 'carrot and stick' pressures management can bring to bear on the auditor), it is time, through annual re-appointment of the auditor by shareholders at the AGM, to promote the independence of the auditor and to re-instate the annual accountability of the auditor to the shareholders that the auditor is supposed to serve

   Re-instatement of the annual re-appointment system will also 'mesh effectively' with the proposed fee break up disclosure solution to the issue of non-audit fees [see 3 below] – ie annual re-appointment will provide an effective sanction mechanism for shareholders if they lose confidence in the independence of the auditor, including because of the size or type of non-audit fees

2. **CGI regards a rigorous, competent and independent audit committee as the key to acquiring and thereafter maintaining a rigorous, competent and independent audit. In particular, the independent element of the board should control (ie fill chair + majority of members of) the audit committee and the committee should itself control the audit relationship, including setting and policing rules for award of non-audit fees. Those key features of an audit committee of a listed entity should be mandated**

3. **CGI has been advocating for years in its reports that each type (and quantum) of non-audit fees paid to the auditor should be disclosed. Audit firms have told us that it has been the companies (their 'clients') which have resisted disclosure of such a break up. Consequently, CGI strongly supports mandating such disclosure**

   There is, however, a 'grey area' of 'audit-related fees', which some companies classify as audit fees and others as non-audit fees. For consistency of reporting and full transparency,

CGI advocates that a third category of 'audit-related fees' should be separately disclosable – ie each type and total fees of each type should be disclosed.

4. **CGI also advocates that a listed entity which is a subsidiary of another company should be obliged to have an audit firm (and, in particular, an audit partner signatory to the audit), which is not the audit firm (and, in particular, not the audit partner signatory to the audit) of its parent company.**

   Similarly, a listed entity which is not a subsidiary of another company but has major transactions with one or more other entities should be obliged to have an audit firm (and, in particular, an audit partner signatory to the audit), which is not the audit firm (and, in particular, not the audit partner signatory to the audit) of any of those other entities

5. **Given perceived deficiencies in the auditing system (especially the 'carrot and stick' pressures management can bring to bear on the auditor), CGI regards the concept of auditors 'self-certifying" their independence as akin to students setting and marking their own exams. That certification belongs in the hands of a rigorous, competent and independent audit committee per 2 above and, in CGI's view, should be mandated accordingly**

6. **As indicated on page 1, CGI regards giving institutional investors significant dedicated representation on key market bodies – for example, the FRC and the proposed FRD – as essential**

REMUNERATION

1. **Table CGI 'Green Book' *'Guidelines for Institutions and Listed Companies'***

   These, inter alia, explain the importance of and rationale for key principles and key disclosures in the remuneration area – especially to enable institutions which are paid, or are responsible as fiduciaries, for the prudent investment management of their clients' and beneficiaries' funds to apply their skills and resources to the monitoring of the efficacy of their investee companies' remuneration policies and practices

2. **CGI, therefore, supports the extension of mandated remuneration disclosure in CLERP 9 – for example, of the essential elements of the remuneration package of a new CEO**

3. **CGI regards a rigorous, competent and independent remuneration committee as the key to a board of a listed entity handling its responsibilities with regard to remuneration policies and practices within the listed entity competently and effectively. In particular, the independent element of the board should control (ie fill chair + majority of members of) the remuneration committee and the committee should itself advise the board on, and monitor the application of, those remuneration policies and practices within the company. Those key features of a remuneration committee of a listed entity should be mandated**

4. **In line with General Comment 2 on page 2, the provisions of the UK Companies legislation with regard to the production and incorporation in the annual report of, and a 'non-binding' shareholder vote on, a directors' remuneration report should be adopted 'as is' in CLERP 9. See Director's Remuneration Report Regulations 2002 accessible via hotlink http://www.hmso.gov.uk/si/si2002/20021986.htm**

   That UK provision provides a practical and effective incentive to boards and remuneration committees of listed entities to handle their responsibilities with regard to remuneration policies and practices within the listed entity competently and effectively. The incentive is the risk of public censure by shareholders, via their rejection of the remuneration report, of the board and remuneration committee's handling of key remuneration issues. Experience to date in the UK of such non-binding votes is that such censure and rejection are very rare and, where exercised, appear to be well-chosen.

   There is no evidence that the situation will be any different in Australia – in fact, the reverse is true. Perusal of the excellent remuneration reports of the three Australia/UK DLCs (dual listed companies BHP Billiton, Brambles and Rio, which are subject to the UK Combined Code) demonstrates the wealth of useful explanation and disclosure for public, and especially institutional, shareholders in those listed entities' annual reports. That explanation and disclosure enables those institutions to apply their skills and resources effectively to the monitoring of the efficacy of their investee companies' remuneration policies and practices per 1 above.

5. **If the ASX will not promptly reinstate the two key remuneration Listing Rules which were respectively abolished and watered down in July 2000, then they should be incorporated into the Corporations Act via CLERP 9. Those key Rules were:**
   - **Adoption of new, or change to existing, equity schemes for employees/executives of a listed entity required shareholder approval by special resolution (ie 75% majority of votes cast on the resolution), and**
   - **Approval of equity grants {shares, options, performance rights etc) to board members of a listed entity also required shareholder approval by special resolution**

The former was removed from the Rules in July 2000 and the latter now requires shareholder approval by ordinary resolution (ie simple majority of votes) only

REGULATION AND SHAREHOLDER PARTICIPATION

1. **CGI supports the mandating proposed in CLERP 9 of additional information in respect of directors**

2. **CGI further advocates mandating of disclosure, in the annual report in respect of all directors and in the Notice of AGM or accompanying Explanatory Notes in respect of directors up for election/re-election, of their ages and length of service on the board. That information is material to issues of board renewal and succession planning and should be disclosed in those key documents. Well governed companies already disclose that information as a matter of best practice for the benefit of their public shareholders but a number of other companies do not**

3. **CGI also supports the need and incentives proposed in CLERP 9 for improving 'continuous disclosure', including the proposed 'on the spot' civil 'fine' system administered by ASIC**

4. **Table pending CGI report on proxy voting etc and emphasise its recommendations, including:**

    i. **Need to follow UK line on speedy introduction of electronic proxy voting**

    ii. **Need to close the Corporations Act section 251AA loophole (so that listed companies also are obliged to disclose proxy voting figures on resolutions which are 'withdrawn' by the company from shareholder vote at or before the meeting)**

    iii. **Need to police due compliance by ASX-listed companies with the reporting requirements of that section**

    iv. **Need to close the 'regulatory gap' (so that ASX-listed but foreign incorporated companies are also subject to governance protections of public investors contained in the Corporations Act, including further reforms proposed in CLERP 9), and**

    v. **Need to review whether large scale professional proxy solicitation and 'vote renting' in the Australian market should be subject to some form of regulatory oversight**