



Australian Council of Super Investors Inc.

# CORPORATE CITIZENSHIP NEWSLETTER SPECIAL CONFERENCE EDITION

July 2006 : Issue No.25

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- Independent Non-Executive Directors on tightly held company boards.
- Where the responsibility lies in the investment food chain to promote the management of environmental, social and governance issues.
- The complex considerations that go in to designing and reviewing remuneration reports.
- Australian and US class action experiences and

any current conference would not be complete without a discussion about AWB, James Hardie and News Corp.

## THE GOVERNANCE "UNDISCUSSABLES"

The conference commenced with a very dramatic opening from Leon Gettler Chief Business Writer, "The Age" and was most ably facilitated by Bob Welsh, Chief Executive, Vic Super. In his presentation Leon drew upon his recent book "Avoiding Board Hubris – Organisations Behaving Badly – Australian Wheat Board and Others – A Greek Tragedy in Corporate Pathology". He started his presentation in an imaginative way by quoting the following poem written by Mike Carlton in the spirit of Banjo Patterson.

*I'd written him a letter which I had, for want of better  
Knowledge, sent to where I met him at the  
wheat board, years ago.*

*He was chairman when I knew him, so I sent  
the letter to him  
Just on spec, to make the point that "Howard  
doesn't want to know".*

*And an email came directed, not entirely  
unexpected,  
(And I think the same was written in some  
Middle Eastern bar)  
'Twas his CEO who wrote it, and verbatim I  
will quote it,  
"Trevor Flugge's gone to Baghdad and we  
don't know where he are.*

## The 5<sup>th</sup> ACSI Annual Conference 16<sup>th</sup> June 2006

### BRIDGING THE EXPECTATIONS GAP!

Shareholders increasingly expect more from company Boards on how they should protect their interests. Boards assume that they know what shareholders want or should want from the company and its Directors. The aim of ACSI's fifth annual conference 'Bridging the Expectations Gap!' was to challenge participants attending to open debate and bridge the expectations gap. The feedback from our best attended conference suggests that ACSI achieved that aim.

Both attendees and those who were unable to attend the ACSI conference will find the following record of the key outcomes from the conference, a valuable source of information about -

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*But when he left Australia, he was going to meet with Alia,  
A trucking mob in Jordan, who were keen to grease the wheels.  
For 10 per cent commission, they could swing Saddam's permission  
To get our wheat accepted: it's the mother of all deals.*

*But I guarantee, Prime Minister, that there's nothing at all sinister:  
The chaps at DFAT told us that the sums looked quite okay.  
When you're selling wheat in billions, what's a quick 300 million?  
If it keeps the Nationals happy it's a tiny price to pay."*

*Sitting here at Kirribilli, I've been thinking, willy nilly  
That it's somehow reminiscent of the children overboard,  
But I can handle Rudd and Beazley as I always do, quite easily,  
By endlessly protesting that there's nothing untoward.*

*I'll tell Bush next time I meet him at the White House, where I greet him,  
That I'm sure he'll understand about the wheat board's quid pro quo:  
He'll forgive this minor error in the global war on terror  
When I look him in the eye and tell him Howard didn't know.*

Leon, explained that AWB had eleven directors and two classes of shareholders, 'A' class shareholders and 'B' class shareholders - 'A' class shareholders were the growers. They had no economic interest in the company but they elected nine board members, the 'B' class shareholders whose investment was at risk elected two. In his opinion this corporate governance structure encouraged the AWB money debacle that was used to prop-up the regime of Saddam Hussein.

In light of the collapses of Enron and HIH Leon asked why these patterns keep occurring to which he referred to Prof. Adjouris of Harvard University, who discusses the notion of corporate "undiscussables".

"Undiscussables" are the issues inside organisations that people just don't want to talk about. It can relate to certain agendas of people, unethical and, minor cases that people don't talk about it. Leon believes that every organisation is replete with undiscussable. As Adjouris pointed out the undiscussability is undiscussable which means you can't talk about why you can't talk about it and you can't talk about what you can't talk about."

Leon identified six signs of a company potentially in trouble. He suggested that companies could exhibit these features -

1. Excessive layers of management. The greater number of layers could mean that bad news may not filter through – undiscussables. Every organisation in a globalised economy has a network of experts including lawyers, accountants, auditors, IT professionals and so on. Corporations end up with so many experts and inevitably issues fall through the cracks because it becomes someone else's problem, someone else's department and again Leon used NAB as an example. No one took responsibility – both collectively or individually until it was too late;
2. The leadership team inside the organisation jump from strategy to strategy. In this situation they can't clarify where they're coming from, where they're heading to;
3. A deeply delusional mindset inside the organisations leadership. Their view of the world is completely out of whack with reality, with respect to opportunities, risks and directions;

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4. Fragmentation inside the organisation where different components don't talk to each other, it's a highly atomised structure where cliques can sabotage each other, get in each other's way, impede progress;
5. The organisational leadership is completely unaware of its fragmenting and delusional state; and
6. The organisation has difficulty dealing with the markets, investors, employees and suppliers.

Leon suggested that if you get three or more of the problems listed above you've got a potential "cot case".

The nature of Leon's talk evolved around the term "hubris" which is a Greek word (excessive pride and arrogance). When he started writing about corporate failures he was struck by how these developments evolved like a Greek tragedy. So he developed from these warning signs six forms of corporate pathology which are briefly discussed further below.

### Corporate Pathology

1. Myopia - "...where people don't want to see the bleeding obvious" - every organisation has a level of myopia where people deliberately ignore weaknesses and sites examples include NAB and Enron.
2. Bureaucratic organisation - bureaucracy is used to cover-up and hide what's actually going on. In his view one of the most striking examples of how bureaucracy can stultify came with the Siev X disaster - the worst maritime disaster in Australian history, more than 300 people, men, women, children drowned. The Navy and Air force knew they [boat of asylum seekers] were coming but they didn't do anything because they weren't 'tasked' to do the

job - it was bureaucracy getting in the way.

3. Charismatic organisation - "...when charismatic leaders are appointed to run companies we see the share price go up. Peter Smedley at Mayne hadn't even put his feet under the desk ... and we all know what happened there."
4. Paranoid organisation - Two examples provided were Microsoft in its war against the Department of Justice and British Airways in their campaign against Virgin about extra gates at Gatwick British Airways..."teams of people who were [illegally] analysing Virgin's routes and getting data which ultimately resulted in a defamation payout."
5. Over-politicised organisation - One of the best examples of over-politicisation in organisations that Leon has come across was in the 9/11 commission report which found that the CIA and the FBI didn't share key information.
6. Depressive organisation. - The example provided here was Pacific Dunlop.

Leon concluded by noting that there are various ways to fix these problems. Solutions are not easy. At the outset what needs to be done is to address the undiscussable issues.

"... every organisation lives and dies on the strength of those [systems and] linkages [inside them]- every organisation's like a village, a community. So I'll leave you with an old Sufi saying and it goes like this. You understand one and because you understand one you think you understand two because one and one is two but the most important thing to understand is a meaning of 'and'."

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### INDEPENDENT DIRECTORS IN THE SPOTLIGHT

Erik Mather, Head of BT Governance Advisory Service did an exceptional job of facilitating an interesting discussion with -

- **Geoff Ashton, Chairman, Leighton Holdings (a company where 53% of the votes are held by one institution) and Director STA Super and**
- **Elizabeth Nosworthy, Deputy Chairman, Babcock & Brown Limited (where the executives not only hold a substantial amount of the shareholding but they also 'own' the intellectual property, in relation to the enterprise operating in the investment banking sector).**

Erik opened the session by reminding delegates that the ACSI guidelines first issued in March 2003 and revised last year in August recommend that corporations should promote and support the role of independent and skilled non-executive directors who are engaged with the company and can exercise independence of judgment.

An independent non-executive director is expected to make decisions on the merits of the subject before the board and not be affected by other extraneous considerations or influences.

Before handing over to the two prominent panellists Erik noted (not without a twinkle in his eye) that it wasn't possible to talk about independence in tightly held companies without referring to the contribution that Jim Kennedy, Director of Qantas and the Stock Exchange made in August 2004. In doing so he quoted from report in The Australian Financial Review "I could give you a good example of independence, I have an Italian gardener called Vince, he's a great guy, never been on a board, he speaks reasonable English, he's a bloody good

gardener and he would be absolutely independent".

### Dichotomy of skills and interaction of the board

Geoff set the scene by explaining that a skilful set of arrangements is needed in the board environment. You are asking a group of people to, on the one hand bring to the table their experience, their skills and their perspectives on a range of matters and to be involved with independent thought in that area, whilst at the same time they have a great need to work in a collegiate environment with their fellow board members. He suggested that the success of these exchanges is often determined by the maturity around the table and the skill of the chairman in being able to draw out the varying views, and to bring the rest of that group to a conclusion and a consensus view. The skills are based on shared visions of working together and having a clear view of what everybody's trying to achieve.

From Elizabeth's perspective she would not join a board unless it's very clear that the management and the rest of the board respect the value of independent directors. In her view, independence doesn't mean that you have a different point of view from everybody on every single issue and you hold that point of view no matter what and you register your objection at every meeting. What it means is having a robust and enquiring mind, being willing to raise difficult issues, not taking for granted what management tells you, aggressively questioning but still maintaining the necessary courtesies in the room. So that by the end of the day if management provide a proposal, no matter how good the proposal, is they know that if they've missed something or left something out, somebody in the board's going to question it.

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### Structures and Procedures

It is very important particularly in tightly held boards that there are structures and arrangements and processes in place that the board follows to ensure that there is no domination of a single shareholder or shareholder groups.

As Geoff explained these structures (including committees) and procedures will differ depending upon the type of tightly held company –

1. One that's run by an individual;
2. Those that have a parent with whom they trade. There are examples of this in the oil industry;
3. There are companies where the dominant shareholder doesn't trade with the company and Leightons is a case in point, and
4. Where you have a significant government ownership.

Geoff did note with some caution that notwithstanding appropriate committees being in place comprised of independent directors "it doesn't remove the ultimate situation where the major shareholder could at any AGM remove any of the directors who are up for nomination." The point he raises is whether tightly held companies are appropriately priced given the inherent risks with such structures.

### Strategy follows culture; it isn't the other way round

Culture has to start in the boardroom and with the CEO who sets a standard that the rest of the company can see. Often the core values are heavily influenced by the CEO, the board participates but in the day to day running of an entity the CEO is responsible. It is the CEO and the senior management team that really influence the core values

about how that organisation goes about its business. As such Geoff believes that it is incumbent on investors such as superannuation trustees to engage with directors and chairman and focus on how a board (which is representing the shareholders) goes about its business of monitoring the performance of the organisation and the management team on behalf of the shareholders. Its about understanding the processes that are in place across the organisation and how the board deals with issues such as, remuneration, strategic decisions in the company, what influence do major shareholders have on tightly held companies and what is the role of the independent directors. Elizabeth agreed that there was room for more engagement.

To have a good culture in a corporation people can't be afraid of making mistakes. Between the board and the CEO and the senior management there has to be a culture where the CEO can come along and say, that we identified this strategy, we've gone along the path and I have to tell you that either we made a mistake and we just got on the wrong tram or in implementing it and it hasn't worked out as well as it should and there are reasons why. There needs to be a discussion about, what happened, why it happened, what were our processes, what can we learn from this, how can we ensure that we don't do that again and then how can we fix the mistake that we've made? If you don't have that relationship in the boardroom and you don't encourage your CEO to have that relationship then the CEO will not have that relationship with their staff. Elizabeth put it another way **"You can be a learning organisation or you can be an organisation, which is a terrified organisation where the CEO roams the corridor, and people shrink into their offices and hide behind cupboards in case he catches their eye."**

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Our panel were unable to suggest examples of how investors could learn about the culture inside companies through disclosure. However, investors were offered to think about whether the company “walks the talk” by knowing people in the company and by listening to what they say in terms of the way they talk. For example by talking to senior executives and listening to what they say can illustrate what their relationship is with their CEO and you might hear from the CEO what his relationship with the board is.

In concluding the session Geoff noted that “...its not about absolutes, its about exercising business judgement and as Elizabeth said you have the debate and in the end its about understanding the risks and the benefits in any sort of situation or proposal and the board forming a collective view that they understand the risks and believe its in the best interest of shareholders. In her view that’s what shareholders are banking on when they elect a board of directors, they’re making this assessment overall that the experiences and skill sets around that board table are capable of making sound mature business decisions and judgements on their behalf and they won’t always be right.” Elizabeth correctly pointed out and added “...there’s got to be some trust in this.”

**WHAT REALLY HAPPENED AT JAMES HARDIE – IT’S A CLASS THING!**

Ros McKay, Research and Policy Officer for ACSI facilitated this topical session about James Hardie, which is back in the headlines again following a recent taxation ruling with regard to its compensation arrangements for asbestos victims.

Asbestos House is a monumental history of James Hardie Industry and the 107year relationship it had with the most useful and unfortunately deadly substance. ACSI encourages anyone who is moved by Gideon’s presentation to read ‘Asbestos House’.

**In response to the overwhelming feedback to both Gideon’s presentation skills and the content of his session, outlined below is the complete transcript from Gideon’s presentation.<sup>1</sup>**

“The Hardie story is unusual in the annals of Australian Corporate scandal. We’ve always tended in this country to manufacture commercial villains with a certain roguish swagger - Bonds, Skases, Adlers, Rivkins. The dramatised personae of Hardie and their professional minions were nothing of the kind. Hardie was the .... of respectability, the company is the bluest of chips, the directors were the pick of the bunch, by the objective financial means that matter chiefly to investors the executives were the best and the brightest. We learn more I think from this case about corporate morality and human frailty than those of isolated spivs and ratbags whom we’re at to deplore and distance ourselves from as unrepresentative.

... Hardie’s involvement with asbestos spans a century, basically 70 years in and 30 years trying to get out. So while the provocation for my book “Asbestos House” is the events of the last five years, it’s also an attempt to understand their context. Now the book will tell you in detail, what occurred, the dates, places, people and laws relevant - I’m going to try and tell you today what I think happened in substance with a long view. Now I sit with some circumspection, I think a reasonable person could look at the same sequence of events and draw different conclusions, in fact both Hardie and the ACTU do, but this as they say in post modernity is my truth. I realised that on the day that Keith Windschuttle joined the ABC board that’s an unfashionable view but I’ll enjoy the latitude to express it while I can. Anyway, first some history.

James Hardie himself was a Scottish immigrant from Linlithgow, his partner Andrew Reid was a younger and more

<sup>1</sup> Any errors or omissions are ACSI’s not the presenters.

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energetic man who joined him and eventually bought him out in 1912. It was Hardie himself who introduced asbestos cement as an import to Australia in 1903 but it was Reid who had the idea of manufacturing as an import substitute in 1915 and it is the Reid family that has benefited most richly from the wages of asbestos in Australia. En passant it might be contemplated exactly what the implications are of attaching a persons name to a corporation. Do people feel differently towards James Hardie because it sounds like (to borrow Emerson's description of an institution) the length and shadow of one man? Is there something none-the-less deluding about this in that the mans connection with the company expired 94 years ago and also protective of the interests of the family that has been its driving force for much of that period. I wonder how perceptions of this story might have been different had James Hardie been called Ascor or John Reid & Co?

Asbestos is a fibrous silicate, it is immensely strong, it forms a very strong bond with Portland cement and water and sand to produce fibre cement. Fibre cement became hugely popular especially after World War II when housing demand was acute and building materials generally scarce. Unlike CSR, the company, rather than the concept, Hardie was a genuine one substance corporation – it was called James Hardie Asbestos, its HQ was Asbestos House. It was far more comparable to the big integrated asbestos combines overseas, Turner & Newall in the UK, Johns-Manville in the US and Cape Asbestos in South Africa – in fact it was closely linked with them all. It had for many years a large shareholding in Cape, it had close technical links with Johns-Manville and Turner & Newall and was involved in joint ventures with both in particular it was a big shareholder in Canadian asbestos mines associated with Turner's.

So we're dealing with a company that throughout its history has been avowedly a member of a major international industry and that's important, because for much of the 20<sup>th</sup> century, asbestos fell into the category of (to borrow Donald Rumsfeld's formulation) a known unknown - being known to be dangerous to an unknown degree.

Its instructive in fact to review the epidemiology of asbestos, it was fragmentary but it only ever pointed one way. The first death from asbestos was, in which asbestos was implicated, was 1903, the condition asbestosis was first diagnosed in 1924, in 1930 the British home office investigated the industry and produced regulations to curb some of its more egregious excesses however the industry were able to stave off legislation that might seriously have had inhibited them. In fact the industry has a shameful history not unlike the tobacco industry of intimidation and disinformation.

The first cases of compensation appeared in the US but when they did so, Johns-Manville and its industrial contemporaries bought them out. The industry sponsored medical research to prove that asbestos was not poisonous then buried it when it achieved inconvenient results. In fact the objective of the industry's research was never to lay bare the dangers of asbestos it was to arrive at agreed safety minimums permitting the industry to proceed with least disruption.

A common criticism of James Hardie in the last five years is that it has based its behaviour on minimums of legal compliance. In fact this criticism can be made over a much longer period. Hardie manufactured legal products in accordance with government regulations which it sold to consumers eager for them but one aspect of asbestos related disease that was widely understood from its very earliest days was that it lay latent in the human body for periods of a decade or more. This made the existence of a known/unknown exceptionally dangerous because it made it possible for

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action to be deferred almost indefinitely and for such responses as there were to be tokenistic, provisional, temporary and insubstantial. And in that period the industry seized on anything that resembled certainty while preserving their economic interests. In particular in 1938 an American industrial chemist, Waldemar Dreessen proclaimed what the claim known as the 'Dreessen Standard'. In the absence of anything else it became gospel. He found that incidents of pneumoconiosis tailed off in workers exposed to less than five million parts per cubic foot of asbestos fibre. It was as dodgy as all hell but in the absence of anything else it worked.

In fact five million parts per cubic foot is also the density when dust becomes visible so the industry hued to the idea that what you couldn't see, couldn't hurt you. In fact, no one ever really achieved the Dreessen Standard on a regular basis but providing they could advertise it as an objective in view they were satisfied.

Now the reaction to less convenient research was different. Richard Doll was invited by Turner & Newall to investigate a link between asbestos and lung cancer but when he proved it the company tried to stop the papers publication.

In the second half of the 1950's a South African Doctor called Chris Wagner found there was a high incidence of a rare and terrible cancer called Mesothelioma among miners of Crocidolite, a particular kind of asbestos. Again the industry did its best to prevent the dissemination of Wagner's work but in fact it got here anyway.

The first Australian case of Mesothelioma was diagnosed in the early 1960's. So by the early 1960's you therefore had strong links with asbestosis, lung cancer and mesothelioma. Now analysing Hardie's response to this is complicated and in fact it's germane to the previous discussion on governance.

The interesting thing about studying Hardie over time is that the locus of power was always changing, something that, when it comes to matters of corporate governance we're often insensitive to. Hardie had been a private company until the early 1950's with a powerful chieftain in Andrew Reid. Towards the end of his life, also in 1938, the executive began to fill the power vacuum, a group of old executives with the company from its inception - Chisholm Cameron, Stewart D'Arrietta and George Sutton. Andrew Reid then had two sons, Thyne & Jock, they both became chairman - Thyne was an interventionist chairman, Jock was not. After the war the company CEO, Jonah Adamson herded the old executives on to an executive committee and wielded power more unilaterally. But, he came to be rivalled by the family heir John Reid who was the grandson of the founder. When Adamson left in 1971, Reid installed a cats paw called Ted Heath. So whose responsibility asbestos was, was unclear.

In fact the process of legal discovery over the last twenty five years while its unearthed considerable quantities of Hardie documentation and internal correspondence concerning the dust and it's perils, when its considered as a proportion of the quantum of documentation that an industrial company of Hardie's size would produce in the normal run of events, the bulk of this material fades in significance. Now there are two possible explanations for this, in fact I think both apply - (1) what Clayton Utz euphemistically calls document retention, (2) indifference.

Now there were certain individuals in Hardie who took dust and disease very seriously indeed but they were always isolated. For the most part the board and senior managers seem to have been untroubled, for it was always a problem whose consideration could be deferred. That's problematic. Presumption of innocence might be a fundamental tenant of the law for persons but because epidemiological evidence is seldom total or even entirely

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unambiguous it is supremely ill suited to judgments concerning toxic substances. And in the case of asbestos there was always the possibility that it might be decades before the precise degree of the harm it was wreaking was known. Hardie employees and consumers in the 1950's, 60's and 70's therefore were essentially the unwitting subjects of a medical experiment – the answers to which lay a generation away.

**One reflection of mine after reviewing the evidence is that malpractice is not always an act of volition. It is a question also of what you do not say, do not do, choose to avoid or choose to ignore. Often it's the case that one imagines oneself to be preserving the status quo by not making a decision. Hardie provides an object lesson that this is not the case.** The tragedy is that asbestos turned out not to be irreplaceable, Hardie investigated asbestos substitutes as early as the 1940's because of the world fibre shortage and then first reduced the amount of asbestos in its fibre cement in the late 1950's. But by choosing not to pursue asbestos substitutes until the 1980's, Hardie's deepened its own eventual plight.

[The] [q]uestion I'm often asked about Hardie's is when should it have known that it had a problem. In my mind it should have been obvious from 1965 that there was a problem. That was when the annals of the New York Academy of Sciences published a large work of epidemiological called the "Biological Effects of Asbestos". We know that Hardie read it, we know that they were concerned about it. It was the beginning of efforts in the US and UK which chipped away at the Dreessen Standard and over the next decade it would be agreed that there was no safe standard for Crocidolite and then for another kind of asbestos called Amosite. Hardie's response however was to try and contain the problem, they borrowed a health program from Johns-Manville but its efficacy in Australia was limited. In a progressive illness with long latency your workers current health is a guide only to how you were doing,

not how you are doing. And it offered in fact the delusion that they were doing something.

The 70 years of being in asbestos began winding up around the mid 1970's when David McFarlane became CEO. It was a multi-fold process, some operations were moved offshore, the company changed its name and the name of its HQ. It revived its experiments with asbestos substitutes, it undertook a major diversification by buying Reid Consolidated Industries, it changed its board and its management. The result however was only partly successful, for much of the 1980's in fact Hardie drifted hopelessly, strategically lost and managerially inert. Not until the company appointed CSR's Dr Keith Barton as CEO did Hardie guarantee it would find a future. In the 1990's as you would know its embryonic American building products business proved perfectly positioned to profit from a housing boom.

Then three things happened which prepared the way for what's happened in the last five years. First there was a legal case, or there were legal developments. Funny thing is that if you'd ask someone to name an evil asbestos company, even five years ago, chances are that it would have been CSR.

Hardies had remained successfully out of the public eye settling cases on terms of confidentiality courting no publicity. Then as the market for compensation got hotter Hardie took a tougher line, it fought some cases to verdict which it mostly lost. But what it won was the Putt [v James Hardie Coy] case an action aimed at penetrating the corporate veil. The claim was upheld by the DDT (the Dust Diseases Tribunal) but overturned on appeal and that made Hardie confident that it could manoeuvre its way out of its asbestos liabilities which it did in two ways – by setting up the Medical Research and Compensation Foundation and re-domiciling itself to the Netherlands.

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The other two things I think were subtler. First there was the top to bottom clearout of management that Keith Barton viewed as necessary for cultural change to flourish, that entailed another step in the company's separation from its past. And the third is there began to be a steady seepage of executive power from Australia to the US which was steadily becoming the overwhelming contributor to group earnings. The US of course is a country rather too familiar with asbestos as a corporate liability. The company began to fall in line with American capital market expectations - this was lost on most Australian shareholders, institutions and private alike and certainly on potential tort claimants. Again I return to perception, the issue of perception raised earlier. James Hardie has a steady Hibernian Presbyterian ring but behind the corporate facade almost everything about the company and its business and management changed during the 1990's.

Hardies conceived two restructuring plans in order to accommodate its American growth that also dealt with its asbestos liabilities - projects Chelsea and Green. Chelsea designed on Barton's watch was flexible but not final, it involved the operating entities selling 15% of itself to offshore investors and the holding company gradually selling down it's interest to fund those liabilities. But the market tanked when the IPO was about to take place and the plant never found out. Project Green which was agreed in Keith Barton's successor Peter McDonald's rein was ambitious but decisive. It involved a closed end fund based on the net assets of the former asbestos producing subsidiaries, propped up as we found out later by some pretty ropery actuarial calculations.

It may just be coincidence but I think the two plans are analogist to their chief executives and their locales. Barton has in his business lifetime kept pretty conservative company and in Australia had a least a vestigial connection to the company's origins. McDonald who was the first Hardie CEO

based in the US seems to have been temperamentally drawn to total solutions, to complete. He was thoroughly assimilated into the culture of a far away country where almost all asbestos companies have sort the sanctuary of bankruptcy to avoid paying plaintiffs - I need not serve course to the US system is pretty Darwinian.

Over the last thirty years, US\$70 billion has been spent on asbestos litigations and more than seventy companies have been driven into bankruptcy. That's something I think the corporate socially responsible need to grapple with - whose standards are we imposing? What if Macquarie Bank instead of buying the Beaconsfield Mine had acquired a Chinese coal mine? There are 5,000 deaths in Chinese coal mines every year, the day before Todd & Brant were exhumed, 27 miners died in a blast at a privately owned coal mine in North West China. Whose standards would have applied in an Australian owned Chinese coal mine? If Hardies I think had attempted the transactions, which became the subject of the Jackson enquiry in the United States, no one would have turned a hair - that's just the way they do business there.

**In Asbestos House I present some conjectures about the planning and execution of these projects and I outline what I feel were the failures of the board to ask the right questions of management to provide the right information.** In the end the decisions I think also bespeak something of the company's connectedness to its past. In the draft of one board paper, Peter McDonald summed up there is no silver bullet solution available, the asbestos position is not one created by the current management or board but it is here and needs to be dealt with. He described the decision as a beauty contest between warthogs and the decision is which option is least ugly. The board evidently backed the wrong warthog but the key phrase I think is 'not created by the current management or board'. No one seems to have grappled with the

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ramifications of the failure of the foundation that they were creating, despite their cognisance that it was a possibility beyond a general sense that if their public affairs department couldn't spin it they could always rely on the corporate veil.

One group that you don't often hear mentioned in corporate socially responsible spatches also begs for comment – advisors. The board culture at Hardie placed heavy reliance on advisors yet these same advisors had spent three years and longer on projects Chelsea and Green, they stood to achieve large fees by their consummation and they were now so close to the company as to be almost indistinguishable from corporate officers. They were present to both give the board frank and fearless advice and to assist management in its aim of executing the deal. It's worth asking whether in the circumstances it was possible for them to do both. In fact to my mind the James Hardie board needed advice on its own advisors. Economists describe a phenomenon called regulatory capture where regulators come to identify with the interests of those they are regulating rather than those they are protecting. I think there's a similar phenomenon called advisory capture where advisors grow so close to the executive they know as to obscure their duties to directors.

Whatever the case the three crucial board meetings at James Hardie were all conducive to unanimity of thought and while unanimity can be a powerful and productive force it's also indicative of conformity and inhibition. In fact it surprised me to hear Elizabeth Nosworthy say that she thought if she was, if there were five directors who thought one way and she was the sixth that she was probably wrong. I think that's a ticket to corporate disaster. In Peter Drucker's memoirs, *Adventures of a Bystander*, he describes how Alfred Sloan the master manager at General Motors always deferred any decision on which he and his colleagues found themselves in absolute agreement. He would say there's something

we haven't thought of, think up some questions then come back and ask them. For such a disposition here however there was no time, insufficient information and inadequate information.

In my interviews with Greg Combet he declared the James Hardie affair to be a class thing and I think it's an observation not without force. The individuals involved in the creation of the Medical Research and Compensation Foundation behaved as those in social groups with shared backgrounds and shared assumptions are inclined to do. Taking cues from one another and tending to place weight on and to overlook the same matters. Above all, not one of them speculated about the human consequences as opposed to the corporate consequences of getting the transaction wrong. This failure of the corporate imagination was to my mind an outcome of the acutely rarefied version of reality in which modern business exists. The James Hardie case is by no means the only evidence of that phenomenon but is an extreme and deadly one."

### WHO'S RESPONSIBLE FOR SUSTAINABLE BUSINESS PRACTICES?

Tim Hughes, Chief Investment Officer, Catholic Superannuation Fund presided over a lively and informative debate from our well respected panel members comprising -

GARRIE LETTE - Principal, Mercer Investment Consulting;  
AMANDA MCCLUSKEY - Manager Sustainability, Portfolio Partners Ltd;  
NATALIE TOOHEY - Director Government, Industry and Community, Relations, Foster's Group, and  
GARRY WEAVER - Executive Chair, Industry Fund Services

**While the title of the session was changed the substance had not. The aim of this session was about identifying whose responsibility it is to encourage sustainable business practices.**

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**To do this the session followed things through the investment management food chain, from superannuation fund trustees, to their consultants the fund managers and finally to a representative of a company in which superannuation funds invest.**

Tim commenced the session by reminding participants not to underestimate the growth of the superannuation industry. Australian's now have \$900 billion approx. invested in superannuation. Which is likely to be more than the total market cap of the ASX 300 companies. It's slightly larger than Australia's annual GDP and it's four times the size of the Commonwealth Government Budget. Superannuation funds are now big players in the Australian economy and they have time horizons that might be very much longer than those of most of the agents and representatives who look after some of our interests. So do superannuation funds trustees and their representatives have a direct role to play in some of these environmental, social and governance issues or to put it another way, can we afford not to be involved? With that Tim handed over to the Garry Weaven.

### **Garry Weaven's Maxims**

Garry opened the discussion by considering why superannuation investors should act to influence corporate behaviour or even distinguish between different corporations (in terms of their environmental or sustainable or socially responsible performance) when they are making investment decisions. When considering this issue Garry offered three maxims:

#### Maxim 1

Allowing for the sexist language of the day, Voltaire said, "Every man is guilty of the good he didn't do". The bottom line in his view is that if you're going to be a large and growing owner, you need to be a responsible owner.

In his view there is no decent empirical evidence to suggest that taking account of environmental sustainability and social responsibility matters will result in diminished investment returns. Therefore, if there is no evidence to that effect then superannuation investors are faced with a very simple choice – do you actually take an ethical stance or not, do you take a responsible stance as owners or don't you?

#### Maxim 2

"Conventional wisdom only adds value to the unwise" a statement Garry attributed to himself. Garry argued that if we simply stick to traditional or currently fashionable means of analysis and investment decision making then it will be virtually impossible to outperform markets over meaningful timeframes. Superannuation funds and in particular the rapidly growing industry funds which aren't constrained by liquidity requirements, have a particularly privileged opportunity to take a longer term view in investment decision making.

#### Maxim 3

"People in glasshouses shouldn't throw stones." (This maxim speaks for itself and is attributed to 'anonymous').

### **The Mercer ESG Survey of Fund Managers**

Garrie Lette overviewed where the fund management community were with regard to corporate governance and broader environmental and social issues. His comments were based on a global research project commenced in the UK, which Mercer has been running for the last year or so, the work in Australia having been essentially completed.

The aim of the project was to assess manager's practices regarding voting and engagement on environmental, corporate governance and social (ESG) issues and finally the integration of ESG analysis into

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mainstream investment decision making. The findings provided both relative and absolute assessments of managers – relative in the sense that at the top end of the spectrum, if a manager is doing better in these areas than all of its peers they've got to be awarded top marks for that. But at the bottom end of the analysis a more absolute judgment was made, as there are some managers whose performance in these areas isn't adequate in light of Mercer's and their clients expectations. Mercer's analysis has been survey based (initially at least) and as such is subjective.

### Voting

In terms of results so far - formal voting in corporate governance policies are effectively universal through the industry. Mercer did receive one or two responses saying that a fund manager doesn't vote and they didn't have a voting policy. But that sort of attitude only applies to a very small minority. Reporting of voting to clients is patchy, is rarely routine, more commonly managers will state that they'll make their voting records available to clients upon request. However, surprisingly the survey found that one manager said that a written report of voting performance or voting behaviour couldn't be provided even if it were requested.

### Engagement

On the engagement side with companies most managers claim to be engaging with them, however formal policies on engagement are less common. Generally the approaches on engagement are adhoc and as such there's no process or attempt to measure success on any widespread basis. Collaborative engagement is fairly uncommon. The organisation and process through which engagement is undertaken varies but frequently it's left to the individual analyst responsible for the stock to decide the issues to be raised and to decide if any

follow up is necessary and as such it is not particularly well co-ordinated.

### Mainstreaming ESG into investment decisions

Again the results here are patchy. The good news is that where specialist SRI/ESG teams exist within funds management organisations they are increasingly being integrated into the mainstream teams and their input is being embraced. The broad conclusion that can be drawn is that in most cases there is no systematic process existing within funds managers to identify and assess the ESG factors that are important.

Generally there's no specialist skill in ESG, either in-house or externally purchased and training of existing staff to allow them to analyse the ESG issues is adhoc at best.

### Size does matter

Mercer has found that there is some positive relationship between the size of the organisation/funds under management and the apparent effort, which is being made in relation to ESG. However, having said that there are some smaller managers, which are actually doing well.

### Cross border comparisons

It is not easy to make cross border comparisons. However, the feeling is that Australia is probably a little bit behind the UK, but probably a fair way ahead of the US in these areas. A lot of US managers still basically don't want to know about these issues.

There is also some anecdotal feedback from managers that clients really haven't driven them in this area which perhaps suggests that some managers haven't recognised that ESG is about is protecting or promoting long-term share market performance.

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Finally, the Mercer survey has found that where managers are doing well, frequently there's been a passionate individual who's really got the effort kick started, now that individual in some cases has been at the top of the organisation, however, sometimes the impetus has come from a passive individuals somewhere in the middle ranks.

### Sustainability a mainstream investment issue

Amanda McCluskey then followed Garrie's presentation with the following three key messages -<sup>2</sup>

1. Sustainability is a mainstream investment issue;
2. It is reasonable to expect your fund managers to be considering sustainability; and
3. There are a number of actions that super trustees and executives can do to ensure sustainability risks and opportunities are managed over the long-term.

#### 1. Sustainability is a mainstream investment issue

To understand 'mainstreaming sustainability' it is useful to understand what it is not. Mainstreaming sustainability does not mean Socially Responsible Investments (SRI) or ethical investment. SRI and ethical investment strategies typically 'screen in' or 'screen out' companies or sectors because of their activities or the nature of their business. SRI and ethical investment strategies do not look to understand what implications sustainability issues will have on companies' financial performance.

If an investor is posed with the question "what are you doing to mainstream sustainability?" they are asking "what are you doing to: consider, understand, and manage the impact sustainability has on your portfolios

performance?" not "are you screening out companies that are unethical?"

Amanda put forward the media sector as an example of how sustainability analysis can provide insight to potential risk and opportunities. The media sector can have up to 75% of its value as intangible or unexplained value, that is, value that is not explained by the value of its assets or products produced.

By undertaking analysis of the sustainability issues for the media sector an analyst quickly discovers the value is generated from human capital and intellectual property, something that is not typically captured in the financial statements. By then reviewing how the different media companies manage human capital and intellectual capital an analyst can find the best longer-term investment opportunities.

#### 2. It is reasonable to expect your fund manager to be considering sustainability issues

In her view because sustainability is a mainstream investment issue, superannuation trustees can quite reasonably expect their fund managers to be considering sustainability issues when making investment decisions.

Amanda referred to Origin Energy (Origin) as an example of a company that has a number of hidden risks arising from sustainability issues but by undertaking sustainability analysis an investor will find that Origin has turned potential risk into an investment opportunity. Being an energy company, carbon and climate change risks are the most immediate sustainability risk faced by the Origin.

Origin has done significant work understanding the long-term risks and opportunities arising from climate change and, as a result; they are one of the more active companies in carbon trading, they

<sup>2</sup> Portfolio Partners, Extracts from 'Portfolio Partners – mainstreaming sustainability' based on Amanda McCluskey's presentation at the ACSI Conference.

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have invested significantly in 'new solar' technologies and consider carbon and climate change issues when making acquisitions. These actions have helped hedge Origin's long-term carbon and climate change risk.

Given 45% of Origin's earnings before interest and tax (EBIT) is from the retail component of the business, reputation management is an important component of its long-term positioning. Being one of the leading providers of Green Power, Origin is well positioned to manage any reputation risks and potential loss of market share resulting from consumers increasing understanding of climate change issues.

Being a significant employer, Origin has good performance in human capital management reducing turn over in call centres over time.

Therefore, by undertaking the sustainability analysis, clear long-term investment opportunities become clear.

### 3. What can super trustees do to ensure sustainability issues are considered?

The first thing superannuation fund trustees can do to mainstream the consideration of sustainability issues is to ask their underlying fund managers and new managers what they are doing to consider, understand and manage sustainability issues. If the manager says they are not, the next question is why? If they say yes, the next question is how? A superannuation fund will soon be able to ascertain which managers have the skills and understanding to manage the issues.

Superannuation funds can also take a longer-term view when they are appointing managers moving to rolling 3 or 5 years as opposed to the typical rolling 12 months performance measurement.

Amanda concluded that in her view sustainability is now firmly a mainstream investment issue with real and tangible

impacts on company performance. Fund Managers that are systematically considering sustainability issues will outperform over time as they are better equipped to find the hidden value and hidden risks associated with sustainability issues.

Trustees can therefore quite reasonably question and expect their fund managers to have a process for considering sustainability issues and there are a number of ways they can do this with minimal upfront outlays. Simply questioning their fund managers approach to the issues will be the most effective and efficient way to take the first step to ensure long term consideration of sustainability risks.

### **The end of the food chain**

Natalie Toohey rounded up the introductory component of this session by sharing Foster's Groups views on sustainability.

#### Foster's philosophy

Foster's manages long term risks and tries to capture long term opportunities to ensure it's sustainable as a business. As such it's not necessarily environmental sustainability or social sustainability or giving cheques to charities. Foster's job is to continue to be around as a company and to be profitable into the very long term.

The relevance of sustainability to the business from Foster's point of view is about aligning what you do with what you say you do and stress testing those standards at intervals to ensure that they continue to be relevant from a stakeholder point of view.

Natalie then shared some concrete examples of the sorts of things that Foster's has been doing over the last 12 months, which include -

- instituting a 24 hour customer information complaint line
- putting in place changes to its glass production that has decreased markedly

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the number of glass and bottle complaints

- up weighting sparkling bottles to reduce potential for injury which was undertaken in collaboration with retail partners
- boosting the quality of consumer information on labelling giving about alcohol content to encourage people to drink responsibly
- ongoing decreases in our greenhouse gas omissions and in water usage across its production sites

### A personal plea!

Occasionally a truly long-term view requires Fosters' to take some short term hits and that can include hits that appear on the balance sheet or hits that require a significant capital investment. The example provided was what Foster's has done in terms of water efficiency in new sites over the last couple of years. This is where encouragement from owners is very useful. In her three years at Foster's she regretted to say that she was only aware of ever having fielded one question from a shareholder on Foster's long-term risk management sustainability profile.

Natalie noted that the general public, community, government, and her view everybody else in the universe are deeply interested in sustainability issues but the people that actually own the business don't really seem to care.

In her view there's a huge a largely untapped role for shareholders to really accelerate that process and get the full benefit of a proper long-term view.

### **What are the barriers to increasing engagement on ESG matters?**

Perception was put forward as one of the biggest barriers in terms of what superannuation trustees are interested in beyond receiving six monthly performance figures.

In terms of trustees there is a whole range of reasons why their focus on ESG matters has been slow to develop. One clear reason is that industry and public sector funds themselves and representative trustees superannuation is a relatively new phenomenon and they're feeling their way on these issues.

It also must be remembered that historically most superannuation money was invested through trusts. In a pooled trust structure each individual super fund is one of many unit holders in that trust so the unit fund manager in that environment has all of the say on issues impacting on the trust. But in the emerging world of individual mandates, wholesale mandates with individual groups, individual trustees it is the trustee that is paying the piper. Now a fund manager is really going to make sure that they make money for themselves so they have to get the signal from the person paying them. Then it comes down to the signals from the person paying them and if the signal is always short-term performance, then fund managers will behave accordingly.

If trustees who control ultimately the appointment of fund managers and the direction of asset allocation and even asset selection in some cases, take the issue seriously they will pay what it takes to have the job done by whoever they choose to do it. Because, as one panel member pointed out if trustees don't lead on these issues it is inevitable that left to their own devices, management board clubs won't necessarily act in the best interests of anyone.

Another barrier is the way that companies are reporting on sustainability. Some criticisms were raised about the quality of reporting by companies. What is needed is bare bones meaningful reporting from companies about what they are doing, what their targets are, and this is where we're going.

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It was also suggested that companies need to start understanding for themselves whether there's a dollars and cents value proposition in managing and reporting on ESG matters. If so how they're going to exploit it and how they're going to communicate that to their owners and to the broader community. However, it was noted that it would take some time for that sort of clarity to start really filtering in and for companies to integrate this exercise into their mainstream business practice.

It was acknowledged that there was no suggestions that trustees should micro manage the companies in which they invest, however trustees are in the position to engage effectively on these issues whether individually or collectively through organisations such as ACSI.

The message to fund managers and trustees was that ESG should be accepted as being worthwhile in itself, in its own end as a responsible citizen and as a responsible owner and as representatives of wholesale fund management arrangements. The question that was left for the audience to consider was as individuals do we only react, only behave according to what will maximise your economic position?

The key message from the panel was that there's nothing revolutionary about saying to superannuation fund trustees and fund managers that they should take steps to ensure reasonable, ethical, environmentally sustainable, socially responsible factors into account by corporations.

### VARIOUS STAKEHOLDER VIEWS ON REMUNERATION REPORTS

**Martin Lawrence, – Lead Analyst, ISS Proxy Australia explained that the intention of this session is to consider whether remuneration reports are hitting the mark or are they missing a beat?** Martin explained that we were fortunate to have the following

experienced reviewers, writers, designers and advisers on remuneration reports as panel members for this session - who look at remuneration issues and remunerations reports

PRU BENNETT – Principal, Corporate Governance International  
GAIL BERGMAN – Governance and Corporate Culture Leader, Ernst and Young  
ANDY DE WOLF – Partner, Executive Remuneration Services, Deloitte  
JOHN EGAN – Chairman, Egan Associates

#### Voting Statistics on Remuneration Reports

Pru Bennett kicked started the panels presentations. She noted at the outset that in her view there is one key issue that shareholders and in particular trustees should be concerned about and that was the issue of missing votes. ACSI is actively engaging with a number of relevant parties to ensure that the issue of missing votes is resolved.

Pru then provided the following examples of poor structures in remuneration reports:

- retirement benefits for non-executive directors;
- interest free limited recourse loans for executives;
- performance periods for long term incentives of less than three years;
- rewards for achieving below medium performance;
- consulting fees paid to non-executive directors;
- no relative performance hurdle;
- unchallenging performance hurdles;
- too much discretion to the board regarding the performance hurdle; and
- loans to non-executive directors

The major departures from best practice she noted were:

- no or non disclosure of performance hurdles;
- a pure share price performance hurdle;

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- non disclosure of remuneration package; and
- non disclosure of the valuation of the options being issued.

All other members of the panel universally supported one view expressed by Pru that shareholders should not apply a cookie-cutter approach when assessing remuneration issues. Each company is different; some performance hurdles suit some companies and some industries but not others.

In concluding her presentation Pru noted that in her view the remuneration report has increased disclosure significantly and it has been a great benefit to shareholders. For corporates the message was to provide an adequate and logical explanation for any structure that falls outside accepted remuneration guidelines.

### **Companies should remunerate fairly and responsibly**

Gail Bergmann reminded the audience that under the 10 ASX principles of good corporate governance, Principal 9 focuses on remuneration and says that companies should remunerate fairly and responsibly. However, it is not always easy to quantify what is fair and reasonable. Is a policy of always linking pay to performance fair and reasonable and hence represent good corporate governance practice? How does this then apply to company's in a turnaround position where they potentially need to pay for improvement in performance or turnaround situation.

In order for any remuneration policy to represent sound governance practice it does need to be fit for purpose i.e. taking into account the needs of the three main stakeholders in a remuneration arrangement; (1) the company as represented by the board, (2) the shareholders and (3) the executives themselves. In order for remuneration policy to work it needs to take

into account the needs of those legitimate stakeholders and as Gail argued taking into account the needs of stakeholders is in itself a principle of good corporate governance as espoused by the ASX.

She also stressed the importance of engaging and communicating with all stakeholders in developing good remuneration practices. By way of example, if a company has remuneration practices that are different to its peers, possibly even out of line with general market practice then it's important that companies communicate that and give shareholders the information with which to judge the remuneration policies and practises of the organisation.

In summary Gail noted that in order to meet the principle of good corporate governance, fit for purpose, and consulting with the stakeholders there is a need to communicate in a way that tells the company's unique story and not being reigned in by the need to meet the legal requirements of the remuneration report.

### **The Challenges for Remuneration Advisers**

John Egan took the audience through the challenges that a remuneration advisor faces.

#### Global Tensions

Shareholders like the company to secure talented, competitive but not excessive remuneration and for equity rights to be strongly performance tensioned and the company should meet the market not lead the globe. The tensions have arisen where there's been a perception that companies have sold the story that they need to be competitive globally in terms of remuneration when none of their people come from anywhere other than these shores and they've never been tapped on the shoulder to go and lead a world top 100 company.



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From the board's perspective, remuneration policy must enable a company to attract and retain appropriate talent, performance expectations need to be stretching however attainable. Occasionally they find shareholder groups and investors asserting that the performance criteria set for a company as being too low, whereas from the company or the boards perspective, they represent quite challenging hurdles in the circumstances which are known fully to the board.

Management have a view that reward should reflect the risk that they take, expected tenure, the prospect of failure or sector volatility, and executive contribution to value creation. However, what John observes is that over the last decade, management are becoming risk averse on the one hand and wanting to be paid more year on year on the other. He quite appropriately commented that it's quite a challenge for boards and sometimes perplexing for shareholders.

### Performance Expectations

The other question he observes, is whether our best companies be expected to continuously achieve top quartile shareholder return growth? Is it realistic to expect that earnings will increase on a compounding basis by 10 or 15% continuously?

That then leads on to the issue of re-testing performance hurdles. John was of the view that shareholders were against re-testing. In his view by not allowing re-testing you're really saying if you train for years for the Olympic Games and you don't get the gold medal, then give up. It also assumes that there's no volatility by sector or any other factor in the marketplace. ACSI's stated policy position on re-testing however is that "Where performance conditions or hurdles have not been met at the vesting date, the ability to 're-test' the hurdle on a future date or dates is now an unacceptable aspect of

corporate governance in some countries. ACSI is generally opposed to re-testing, but is prepared to assess each proposal on a case by case basis." From an practical perspective ACSI will general accept up to four re-tests when considering the issue as part of an incentive grant or the remuneration report of a company and would prefer that shareholders are given an opportunity to re-consider these grants and there underlying hurdles more frequently rather than re-testing.

### Issues Going Forward

From John's perspective one of the issues moving forward that a lot of company's are struggling with are concerns about short term incentives and the level of reward under short term incentives and the increased exposure to criticism of payments under those incentive plans. John himself admitted that many of those plans are not good plans and John thought as a consequence there could well be a shift to total annual remuneration without an annual incentive being much higher and long term incentives being based on the underlying value created in the corporation rather than the volatility of the company's performance in the marketplace and in his judgement that wouldn't necessarily represent a bad thing.

He concluded his remarks by providing the following food for thought - Is there a conflict between funds manager's expectations that management's accomplishment for continuous improvement? Is there a misalignment between this continuous ranking of funds managers and the way in which they're rewarded and how mum's and dad's are the beneficiary superannuants who are looking for sustainable returns over a very long period of time?

### **A Comparison of UK and AUS Remuneration Reports**

Martin then handed over to Andy de Wolf who provided a comparison of experience



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with the introduction of in UK and Australian of the non-binding vote on remuneration reports. Andy's views are based on his experience in the UK at the time when the share market was quite volatile; there was a great deal of government pressure in terms of "fat cat" pay and a lot of media coverage on such issues.

### Voting

On the one hand in Australia he believes that we have a very passive investor community who generally consider if investments performing why would they use the vote, right the way through to the more aggressive investors who work quite strongly in terms of looking at fund managers policies, looking at the way the proxy advisors are recommending.

In the UK you have some institutional investors saying that they will use their vote no matter what and then on the other side you have investors waiting to use their votes on a number of companies.

### Disclosure in remuneration reports

Andy mentioned a couple of main differences in particular, in the UK companies are better at disclosing the story behind the remuneration arrangements i.e. actually articulating what their strategy is about, why they've chosen particular incentive arrangements and why that in concept creates shareholder value.

Glaxo Smith Klein set a precedent in terms of the non-binding vote on remuneration reports in the UK. As such in the UK there is more consultation with institutional shareholders with the proxy advisors particularly if there's re-designs. So when it comes to actually producing the remuneration report at the end of the year effectively the institution investors have already seen and have already approved quite a lot of it because they've been used

as a sounding board for a number of the positions taken in the remuneration arrangements. This is an area likely to increase in interest in Australia.

With the introduction of guidelines and in order to avoid further regulation of disclosure of remuneration, companies in the UK have stepped up the levels of disclosure transparency and the linkages between performance and pay. However, the linkage between pay and performance still needs quite a lot of work.

In Andy's view in the UK the pressure is now moving away from disclosure and starting to focus on the quantum of pay.

### **NEWS CORP AND DELAWARE LAW**

Phil Spathis, Executive Officer of ACSI facilitated this session noting the ACSI has had a few good reasons to become better acquainted with the laws of Delaware recently. In October 2004 superannuation funds from across the world campaigned for improved investor protection provisions to apply to News Corporation as it moved to reincorporate from Australia to Delaware. Part of the package of improvements included an agreement with News Corporation was that it would adopt a board policy to refer any poison pill that was to apply beyond one year to shareholders for approval.

As a result of reaching agreement with News Corp on this and other matters, ACSI agreed to support News Corp's move to Delaware. Not long after its reincorporation, John Malone's Liberty Media increased its stake in News Corp to 17.1%. In early November 2004 the News Corp board instituted a poison pill that would effectively dilute Malone's shareholdings should he acquire an additional 1% of News Corp shares. Nine months later on August 11<sup>th</sup> 2005, buried somewhere in a single paragraph on page 81 of News Corp's performance report was a reference to a board decision to unilaterally

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extend the poison pill for an additional two more years. There was of course no reference to the agreed board policy that gave shareholders a vote in these circumstances. When pressed at the news conference about this Rupert Murdoch said "yes we had a policy but we decided to change it". News Corp had therefore breached its agreement with superannuation funds.

It became pretty clear that there was no recourse to enforce our agreement in the Australian jurisdiction given that the company had moved across to Delaware. Hence, the fortuitous Introduction from the International Corporate Governance network friends to Stuart Grant, a partner of law firm Grant & Eisenhofer based in Delaware who convinced us that there was merit in taking an action in a Court of Chancery in Delaware. After many teleconferences and meetings, twelve Australian and International based superannuation funds representing half a trillion dollars filed a complaint in the Delaware Court of Chancery seeking that the decision to extend the pill be ruled invalid and alleging that News Corp had breached its contract with its shareholders.

As such it was Phil's great pleasure to be able to introduce the attorneys who spear-headed News Corp case in the Delaware Court of Chancery, Stuart Grant and Megan McIntyre from Grant & Eisenhofer.

**In this session Stuart explained how the Delaware jurisdiction actually works and operates for shareholders, boards and directors. This is particularly relevant for Australian superannuation funds given that the majority of companies that form part of our US equity investments are in fact domiciled in Delaware. Megan then discussed the significance of the News Corp case.**

The focus of Stuart's presentation was on the concept of the gatekeeper.

The US is the epitome of capitalism and when talking about capitalism reference is made to one overriding premise and that is that people will do what's in their own self interest which usually entails greed and risk and sometimes being risk averse we have set-up this system of gatekeepers. So for example if I put my hand in the cookie jar, the question is what's the penalty if I get caught and what's the likelihood of me getting caught.

Instead of being able to control management directly the US relies upon the gatekeepers because the gatekeepers whether they be directors, compensation (comp) committees, audit committees, the auditors themselves, the bankers, the investment bankers, underwriters. However, they benefit from working for the corporation, but those benefits aren't anywhere near as great as inside management.

By placing that responsibility on the gatekeepers that they need to control the CEO because we can't put in place a system. We put a burden on the gatekeeper to monitor the CEO because it is assumed, CEO's and inside management can't run the corporation effectively by themselves. They need the boards of directors with the outside directors, they need the outside consultants and the auditors. They also need to raise capital, so therefore they also need the investment banks and the commercial banks. In order to function in the corporate world, one needs all of these external sources. By turning to these external sources they decide whether it's worth their while to assist management in their activities. If they can raise the bar and say it's not worth for them working with the CEO's, then inside management are stopped from undertaking the activity that we choose not to have them do – this is the premise behind, the entire American system.

The question then becomes how do we put this pressure on the gatekeepers to fulfil this role? When News Corp took an action that was unacceptable to investors, litigation was

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pursued, not only against News Corp but also to its directors for being personally responsible. When there is massive frauds that have taken place in the US (the WorldComs, the Tycos, the Enrons) have they not only tried to hold those who are the primary wrong-doers responsible, they've tried to hold the auditors, banks and outside directors who should have stepped up to the plate.

People do question whether litigation drive up costs? The answer is yes it does. Doesn't it chase people away from wanting to participate in these activities? Again yes it does, but that's exactly how the system works by raising the cost on those who help participate. It forces them to keep in line, those who can do the wrongdoing.

Engagement in the US isn't as active as it is in Europe because in the US they don't have as much direct contact. Shareholders don't have the ability to vote on remuneration policies, to vote out directors but what they do have the ability to put pressure on the behaviour of others, to control the behaviour of CEO's.

The US system provides the complete inability to control corporate America running a muck and yet the ability to put litigation exposure, to put financial threats on those who are in control or advise the controllers is highly evident.

### News Corporation case

Megan McIntyre then discussed the significance of the News Corporation case for Delaware law.

Delaware law is what governs the relationships between directors and shareholders and other corporate constituents. Delaware has specialised court known as the Court of Chancery that hears all of the corporate governance related cases and even those US companies that are not incorporated in Delaware that is

because the other States look to Delaware law.

Delaware is therefore at the forefront of defining the relationships and the rights and responsibilities of directors and shareholders in a Delaware corporation. The law is in part statutory but a large part also develops through cases. As a consequence the law is constantly changing and Delaware has, historically had a reputation of being somewhat management friendly but in recent years there's been an increasing willingness of institutional investors to step forward and really play an active role in litigation and the courts have been receptive to that. As a result institutional investors have been able to create some movement and some change and have achieved some really very significant results in terms of shareholder rights.

Delaware has historically been very deferential to boards of directors. In terms of the News Corporation case the court ruled in our favour and said that "the shareholders are the ultimate holders of power in a Delaware corporation and whatever power the board derives from the shareholders their purpose is to guide the board in deciding what's in the shareholders best interest when there's an absence of any expressed direction from the shareholders. But when the shareholders want to step forward and say we want to have the right to vote ourselves then the board has to give way to the shareholders". **This has been very significant in Delaware because this was the first time a court had ever really recognised that the shareholders were the supreme holders of power and the board was really the agent of the shareholders.** In this case not only didn't News Corp not get the decision reversed but they actually got it somewhat reaffirmed by the Court of Chancery.

The result of all of this is really a very significant development in Delaware law. **Not only will this establish an important**

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**precedent for future court cases but it strengthens the power of the shareholders.** If you want to engage with a corporate board and are asking for corporate governance reforms the boards have to take notice that the shareholders are the ultimate holders of corporate power and that shareholders do have the ability, to get together collectively and make some decisions and vote in some reforms.

The other area where will have particular relevance is in the area of shareholder resolutions. In the US a shareholder can put a proposed resolution on the ballot for the company's annual meeting and the company has to include it on its proxy materials, as long as it doesn't fall into one of certain enumerated categories of excluded types of proposals, and one of the excluded categories is a proposal whose adoption would violate Delaware law or the law of the State of incorporation. In the past where shareholders have proposed bylaws, for example, that any adoption of a poison pill requires approval by the shareholders, the corporations haven't included the proposal in the proxy material because it would violate Delaware law. However, going forward shareholders potentially will have more rights in this area because of the News Corporation decision.

Megan concluded by commending those funds that took part in the News Corporation case as it does take courage to step forward and become a plaintiff in a case.

The key take out from News Corp illustrates that by acting collectively or even individually through litigation in the US system you can accomplish something that's important not only for your particular dispute that you're dealing with, but also for the development of the law and for shareholder rights that will benefit you and other shareholders into the future.

### WHEN EXPECTATIONS HAVEN'T BEEN MET – THE LAST LINE OF DEFENCE

Paul Allen, General Manager, LUCRF facilitated the last session for the day. In this session we heard from -

**JAMES COX** – Brainerd Currie Professor of Law, Duke University School of Law and  
**BERNARD MURPHY** – Managing Director, Maurice Blackburn Cashman

**about the opportunities and risks for institutional investors and their fiduciary duties when considering taking part in class action both in Australia and the US.**

James (Jim) Cox was the penultimate speaker at the conference. Jim in what we learned was his usual jovial manner commenced his presentation by clarifying that he didn't have an accent but the rest of the Australian audience certainly did.

The focus of Jim's presentation was on the results of a study about securities class actions. The cornerstone of class actions reform was in December 1995 when US Congress passed the law called the Private Securities Litigation Reform Act (PSLRA). It's distinctive in many features first of all it's the first act that was ever passed just to identify procedures of law just for securities class actions not for class actions generally. Secondly it was the only President Clinton veto, that was ever overwritten by the Congress.

The cornerstones of the PSLRA was two twin requirements that abandoned the notice pleading requirements so that now to have a class action survive you have to allege the violations that have occurred with a strong inference of facts set forth with a great deal of particularity. The PSLRA also introduced the concept of proportionate liability so at the end of the day the trier of fact is supposed to determine that you are 10% culpable for the misdeeds that occurred with the idea that your liability would then be

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capped at 10% of whatever the losses were that flowing from that. Since the introduction of the PSLRA there has been a steadily constant increase in the number of cases that are filed in the Federal Courts.

The study also found that of 118 securities class action settlements, 70% of the institutions that have losses suffered in these class actions never present the paperwork to claim their fair share of the settlement hence why the original study in this area was called "Leaving money on the table", the paper which was the focuses of Jim's presentation talks about letting billions slip through your hands. If you do a quick back of the envelope calculation the average mean loss suffered by the approvable claims that could have been submitted is US \$850 thousand. Provided below is a list from Jim of reasons as to why those billions have not been collected.

### Avoid sleeping with the enemy

One explanation for this is what is called 'avoid sleeping with the enemy' these are individuals who manage funds that frequently identify very closely with the management of the company who are the targets of the securities class actions and so their cultural leanings are more toward the managers of those corporations.

### Rolling Stone Gathers No Moss

'Rolling stone gathers no moss', certain kinds of financial institutions change their advisors and they change their custodians regularly. The normal time period for a class action that is from the time the lie is told until the truth comes out is somewhere in the nature of about two years and then the length of time it takes after the truth comes out to when the settlement occurs is sometimes usually about two and a half years. So it is easy to imagine that if you just bought your shares as an institution in the middle of the fraud interval and then you didn't get a notice settlement until three and a half years later that during that period of time you may have changed

your advisor or your custodian at least once if not a couple of times.

### Voting with their feet

This is somewhat analogist to sleeping with the enemy. Jim then provided an explanation of this by way of example shared with him at a function "... I manage a pension fund that has US\$3.5 billion under management, and I get evaluated by picking stocks and managing risk and so what do I care if I leave US\$500,000 on the table every year, that's not what goes into calculating whether I'm performing very well or not. I get paid upon my benchmarks of the funds performance vis a vis Lipper (a reuter service) or some other service."

This to Jim's mind is about leaving money on the table that could have gone into your fund and be put to use in the future and the present value.

### Who's on first

An organisation may have appointed somebody to keep track of the settlements and that's part of their job description but not their exclusive job description. There's many other things that go on and individuals do not monitor that person's behaviour – perhaps their job changes, or other portions of their job become more demanding and there's a crowding out effect and that which does not get measured, does not get managed.

Since writing the paper, work has been being undertaken with the US SEC to take a leadership position about:

- There being no centralised location for giving notice of a settled securities class action.
- Standardising the form that claims administrators use.
- Allowing electronic searches of the SEC filings system database which collects

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information about funds trading and practises.

- Encouraging institutions to ask custodians and advisors what procedures they're following. In terms of third party law firms, Jim suggested funds in these situations ask them - will you represent us in any and all situations and will you do that in a way that's really consistent with our fiduciary obligations, which is to recover any money that our beneficiaries have suffered so that it goes into the fund and works for our pensioners and not just pick and choose the ones that's useful for you.

### Lead Plaintiff Provisions

Jim then discussed a provision that was introduced in the Private Securities Litigation Reform Act on December of 1995 in relation to lead plaintiffs i.e. that class actions generally are understood to be lawyer driven (at least in the United States). In the US they're lawyer driven because they're based on a contingency fee arrangement. The cost of bringing law suits in America is lower because they have this rule instead of the loser pay rule. Therefore if you lose a class action you're not going to pay for the defence's attorney's fees and in the US they also have to allow for the contingency fees in the aggregation of claims.

In 1995 a procedure was introduced to give notice to all members of the class and inviting them to step forward and become the lead plaintiff. And the court is then in charge with selecting the plaintiff with the largest financial stake (in the securities class), that is the claimant with the largest loss who partitions become the lead plaintiff.

### **Why aren't institutional investors in Australia more active participants' class actions?**

Bernard Murphy took to the stage and noted with some interest that Jim's paper indicates that in 2004 shareholder class actions in the US generated US\$5.45 billion worth of cash, to be distributed to the victims, and only 28% of

institutional shareholders ever picked it up. Similar research is not available in Australia but anecdotally Bernard suggested that the percentage in Australia would be a lot lower.

So the question that arises is - why institutional investors in Australia are not more active participants in these sorts of cases? One of the reasons has been that class actions in general appear to still be a matter for debate and for their proponents they're an effective means of providing access to justice. However, for the opponents they represent one more step towards an American style litigation culture, which does not appear to be welcome in Australia.

The purpose of Bernard's presentation was to provide an overview of the public policy issues underpinning shareholder class actions, looking at the duties and discretions of superannuation trustees as participants in shareholder class actions and the practicalities of those involvements.

The first class action in Australia was in relation to Mr King v GIO who'd suffered a loss of \$3,000. This case clearly illustrates the cost barrier to litigation which can occur in the absence a class action. The legal costs spent in opposing the case was \$30m approx. As a consequence 22,000 shareholders (not many institutions) shared in \$97m. Following the start of the class action, an ASIC prosecution was undertaken and was concluded several years after the action finished.

The case related to a situation where in the course of a takeover bid from AMP the GIO directors in reliance upon a \$200m profit forecast for the next six month period strongly advised all their shareholders not to accept an offer. Six months later instead of making a \$200m profit, GIO had lost \$760m.

The second public policy issue is the operation of the share market. 55% of Australians own shares, largely through occupational superannuation. Laws are in

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place that require a properly informed market, and class actions provide a procedure for the victims to access those laws. Those laws have no life, absent a class action procedure because shareholders can't afford to sue companies for their misconduct, for misleading behaviour or breach of the continuous disclosure regime absent a class action regime. If ASIC does prosecute somebody (and they can really only pick out the most high profile cases), then the corporation's are penalised however, there is no compensation for the victims.

Another public policy concern is that class actions try to second-guess business judgements. In Bernard's view, there's never been a case in Australia where anyone's recovered any money for misleading and deceptive conduct without a strong case and the business judgement rule and the Corporations Act provides a safe for directors in terms of the decisions they've made. Nor do shareholders class actions penalise corporations for forecasts, which with the benefit hindsight proved to be wrong.

### Fear of Litigation Explosion

In responding to this issue Bernard noted that there's no empirical evidence to suggest there's going to be any form of litigation explosion. In the last ten years in Australia there have been nine of class actions cases, in the same period in the US, there's been 2352 even allowing for the difference in population, it's 18 times more likely in the US.

Bernard then argued that due to the following reasons we won't see an American style litigation explosion in Australia.

1. **Cost.** These cases are really expensive to run and no plaintiff lawyer or litigation fund will spend the millions of dollars necessary to conduct one of these cases unless there's a reasonable certainty of recovery - there's just no incentive to pursue a merit-less claim.

2. **Costs follow the event rule.** This means that the unsuccessful litigant pays the other sides costs. This is very different to the situation in America because where contingent fees apply.

3. **A less litigious culture,** the absence of jury trials and the absence of contingency fees.

### Funding Litigation

One issue that is changing the litigation landscape is the increasing availability of litigation funding over the last few years.

The first way is through a lawyer handling the case on a no win/no charge basis, there aren't that many lawyers who'll do that and there's not much competition for this sort of work.

The second way of doing it is with a private litigation funder and the biggest one is IMF which is a publicly listed company. IMF raises money on the stock market like any public company and they meet the costs of the plaintiffs and the class members and they also indemnify the plaintiff against adverse costs.

### Considerations for Trustees

In determining whether Trustees should participate in the shareholder class action the trustees overarching duty is to preserve the value of the property held on trust and in the case *Re Brogden* Lord Justice Fry said: "...a trustee undoubtedly has a discretion as to the mode and manner and very often as to the time at which or at which he should carry his duty into effect but his discretion is never an absolute one - it is always limited by the dominant duty, the guiding duty of recovering, securing and duly applying the trust fund and no trustee can claim and right or discretion which does not agree with that paramount obligation." Scott on Trusts put it slightly differently: "...a trustee's under a duty to the beneficiaries to take reasonable steps to realise on claims he holds in trust. If he fails

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to take such steps as are reasonable he is subject to a surcharge for such loss as results from his failure to act.”

Bernard highlighted the following as being relevant in determining whether trustees should participate in class actions –

1. **Good cause of action** and whether the proceedings would be fruitless. In exercising their discretion trustees need to perform some form of due diligence. Trustees are not obliged to rely simply on the advice of the lawyers for the plaintiff but nor are they obliged to disregard it. If trustees don't want to engage their own lawyers to conduct a due diligence, Bernard suggested they have them interrogate your lawyer.
2. **The cost of bringing the claim** and any exposure the risk of adverse costs. If trustees are not the lead plaintiff they don't have any risk, if as a trustee you are the lead you do. However, trustees can insure that risk and get indemnified through a litigation funder, so Bernard argued that exposure to costs should not be a disincentive.
3. **Administrative time and expense** associated with being involved. The nature of the procedure is that it is the lead plaintiff that has to prove the case, it's the lead that's exposed to discovery, it's the lead that's interrogated – in America it's the lead which is deposed. Australia doesn't have depositions. Initially what is required is the details of the share purchases and share sales in the "fraud period" or the "class period" – so in the period when the misleading conduct is said to have been operative. Bernard suggested that it isn't very complicated and often completed by use of a questionnaire.
4. **Materiality of loss.** Bernard suggested that while whether the loss is material is a consideration, in circumstances where the costs are going to be met by litigation funder or only paid on success to a no win/no charge lawyer where there's no

exposure to the risk of adverse costs, the time and internal expense is minimal in his view the materiality test is misused.

### Arguments against taking part

One argument that Bernard hears about not taking part in class actions is the expression of the view that monies received in damages only reduce shareholder value. Shareholder class actions are commonly against the defendants as directors, the auditors and the advisors – they draw their money from a pool outside the company, which is usually drawn from some insurance company. In his view settlements don't reduce shareholder value.

Bernard also referred to a recent a US analysis of the impact of settlements in shareholder class actions which indicated the share value sometimes increases on the announcement of a settlement which may be because the share market regains confidence that the company will comply with proper corporate governance and the law.

To his mind the biggest concern is about being exposed as having lost money. Bernard suggested that to give this consideration any weight might suggest that trustee's are putting its own business interests before the interests of the beneficiaries.

Bernard concluded his session by noted that It is important that trustees have a proper understanding of the basis upon which they perform their duties and exercise their discretion regarding participation on these cases. Increasingly, trustees will be called upon to make a decision to determine whether to be involved. The paramount consideration as with any consideration by trustees, has to be the interests of the beneficiaries and as long as you keep that as the guiding principle in his view trustees are unlikely to fall foul of proper compliance with the law

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As one participant correctly pointed out during question time we cannot ignore the fact that superannuation funds have been and are invested in pooled funds and as such further work needs to be conducted in the area of encouraging pooled fund managers to take part in these actions.

### CLOSING REMARKS FROM PHIL SPATHIS

"It is my pleasure to make a few closing remarks.

We all share an individual and collective responsibility to bridge what we call the "expectations gap" in corporate governance between boards and investors.

Addressing compliance requirements, is a basic competency we should expect of boards.

There are limitations here.

What good is box ticking, if a board and its directors don't have the right values and competencies, to drive company performance in the best long- term interests of all its shareholders.

Superannuation funds invest billions of dollars in Australian listed companies and are therefore entitled to have high expectations about the incentives and controls Boards should have in place, in order to mitigate the risks of failure and collapse.

If we don't care about governance, then who will?

We should care about:

- Promoting independently minded non-executive directors who have the skills, capacity and strength to challenge the "group think" on a board and apply their scrutiny in the interests of all shareholders;

We should care about:

- Whether executive incentives reward high performance and not mediocrity or even worse failure;

We should care about:

- How companies manage their non-financial risks arising out of their activities that could damage their reputation and position in the community;

Boards and executives will be less inclined to commit the sins of arrogance and myopia as discussed by Leon Gettler, when they know that shareholders are more closely observing how they manage potential or actual conflicts of interest.

In this regard, as trustees and fund managers, we also need to ensure that we practise what we are asking company directors to do, and remain committed to honouring the traditional standards of fiduciary duties.

Failure to do so could also mean, in the face of future losses or scandals, that trustees are on the receiving end of members' legal action of the type discussed by Bernard Murphy.

A failure to demand the rights of ownership, as well as a failure to honour our responsibilities of fiduciary ownership, will mean that we too bear a heavy responsibility for what may still be wrong and right in governance and investments in Australia.

In tangible terms, for our part, this should mean that we are voting all of our shares all of the time.

We have made much progress in this regard. But this is only a start.

It also means that we talk to companies, to convey our ongoing expectations, beyond the limited issues that are presented for



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shareholder approval at annual general meetings.

Only this way, can trustees as investors be properly regarded as owners rather than renters of company shares.

There is a lot to be done but the challenge is not insurmountable.

I hope that the conference today has provided you with much food for thought on these issues.

Today's conference would not have been possible without the help and assistance of a number of people.

I would like to thank Chris Dardoumbas who has once again has made sure that every aspect of the conference has ran seamlessly. Your efforts have been appreciated by all of us.

It is always a great privilege to work with our research officer, Ros Mckay, who has once again applied her tireless efforts to make this conference a success. So I thank you Ros for your every efforts.

I would also like to thank Bob Welsh, Amanda Mcluskey, Martin Lawrence, Erik Mather, Tim Hughes and Paula Allen who as facilitators put a lot of work into bringing the sessions together.

Thanks goes to Fiona Reynolds for her input during the planning stage of the conference.

I would also like to thank Michael O'Sullivan, whose wisdom and guidance keeps us focussed.

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- Anthony Lieberman of Future Digital Image for our printing and graphic requirements;
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- And the staff of Audio Visual Dynamics;

Thanks to Jane Alister and Hang Mai from IFS for organisational support today.

And of course I would like to thank all you for your attendance and participation."

It was then Phil's pleasure to draw ACSI's fifth Annual Conference to a close.

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