



"BEST PRACTICE"

CORPORATE GOVERNANCE NEWSLETTER

The speech outlined below was delivered by Michael O'Sullivan at a Corporate Governance conference in late June 2001. It is included in this newsletter for our information.

"The future impact of shareholder activism on board decision making"

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President

INTRODUCTION

I am delighted to have this opportunity to introduce the Australian Council of Superannuation Investors, and to discuss with you some of our ideas about the impact of active shareholders on Corporate Governance.

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Our Council was formed in March this year by fourteen Super Funds together with the Conference of Major Superannuation Funds,

Industry Fund Services and the Australian Institute of Superannuation Trustees.

Our primary role will be to provide research and information to our member superannuation funds on corporate governance issues. Our members see it as important that they have a source of independent research, and independently evaluated information to assist them in framing and implementing their corporate governance policies.

We are a non profit organisation, supported entirely by our members, with no commercial linkages to any other group or company.

We expect to carry out some research ourselves, but most of it will be conducted by universities and research institutes, whom we will commission. In every case their independence and standing will be a key criteria in our decision to invite them to perform research on our behalf.

THE ROLE OF SUPERANNUATION TRUSTEES

It is important to remember that Superannuation Funds are

conducted by independent Trustee Boards. Trustee Boards must be composed of an equal number of employer and employee representatives.

Thus any long term corporate governance approach, founded on becoming active and engaged shareholders, must reflect a balanced and bipartisan consensus between the two interests who come together on trustee boards.

Equally, trustees are obliged by statute and trust law to act exclusively in the interests of the beneficiaries – the fund members.

The legal position of trustees in relation to the exercise of their voting rights is evolving and becoming clearer.

Under company law in Australia, voting is optional for any shareholder. Trustees, however, must pay attention to the Superannuation Industry (Supervision) Act 1993 – the "SIS Legislation" which creates rights and duties, and Trust Law, including the fiduciary duties which are central to their role.

In the US, Pension Fund trustees are obliged to ensure their proxies are voted on issues which might affect the value of the investment.

In Australia, the current minimalist view is that trustees are obliged to consider whether to vote their

shares. If that decision is yes, then the trustees must consider how they will vote on issues.

In practice Super Funds outsource investment to investment managers – so it becomes the investment manager's decision as to whether and how shares will be voted.

At the least, that leaves trustees with a duty to monitor the voting record of their investment managers.

It would be fair to say that Superannuation Trustees up until now, have not paid attention to voting their shares, nor have they paid attention to corporate governance as an area with which they must acquaint themselves. Obviously there are exceptions, but superannuation is something of a sleeping giant, about to awaken.

THINGS ARE CHANGING

Around the world, Pension Funds are becoming more and more active in corporate governance. Australian Funds, seeing these developments, are being drawn towards activism.

There is an International Corporate Governance Network in which pension funds are active participants.

Corporate Governance is seen as a development issue in building strong international financial architecture— especially following the crisis in Mexico, Brazil, Russia and the Asian Financial Crisis. The World Bank and the IMF are devoting resources to building corporate governance, in order that developing countries may attract investment.

In Australia major company failures have highlighted corporate governance.

The flight from Defined Benefit Funds to Defined Contribution Funds has made shareholder value

much more visible and vital to Super Fund members.

Australians are very heavily invested in Superannuation. Today the figure is around \$500 billion, with very high levels of growth in the funds.

The Minister for Financial Services Mr Hockey has called on Institutional Investors, including Super funds to “not only ensure that fund management members get a good return on their investments... but also have a responsibility to be good corporate citizens and good share holders. And funds managers and trustees have a responsibility in particular to make boards accountable for the decisions they make on behalf of shareholders.

...It is not enough for funds managers to be lazy at annual general meetings. Fund managers have to exercise their votes on behalf of their members in the best interests of the company and if the board and directors are not acting in the best interests of the company or make decisions that they should be held accountable for, it is not good enough for funds managers to run away and not face up to the tough tasks of holding those directors accountable for their decisions”.

The leader of the Opposition, Mr Beazley, announcing the Labor Party's policy for the forthcoming election issued a warning that unless there was a considerable improvement in the percentage of share voting, a Labor Government would consider making the voting of shares by institutional investors mandatory.

There are many other factors at work to stimulate activism – the last one I want to mention is the rise and rise of Socially Responsible Investment (SRI). SRI offers Funds choices about selective investment. One basis for selection is Corporate Governance – how does the company behave socially,

environmentally and as an employer?

The marketing of SRI products is raising awareness of what is at stake, and will continue to focus Trustees on the responsibilities of corporate citizenship. Funds are offering and will offer SRI investment choices to members, broadening the understanding of the members, and thus imposing greater accountability on trustees.

CORPORATE GOVERNANCE ISSUES

The collapse of HIH and OneTel have been a setback for those who have argued that preoccupation with corporate governance had or would lead to public companies taking their eye off the ball.

Mr Stan Wallis, a most senior figure among directors of Australian public companies argued last year in the Corporate Governance Oration, for the Centre for Corporate Public Affairs, in favour of small, entrepreneurial boards, dominated by executives or quasi executives.

He also referred to a Boston Consulting Group's study which looked into how boards performed overseas and whether governance principles mattered.

According to Wallis, Boston Consulting Group's research was conclusive stating that “our analysis showed no correlation between things demanded by corporate governance purists (such as an independent board) and shareholder returns”.

Whilst we agree there needs to be a review of corporate governance provisions, we do not support dismantling existing corporate governance structures including those that have emerged as part of the Federal Government's Corporate Law Economic Reform Program.

The Blair Government in the UK is taking a constructive approach on these issues. It is currently undertaking a far reaching review of Corporate Law Structures for the new Century. The Treasury-commissioned March 2001 review of institutional investment in the UK by Paul Myners is the most thorough and comprehensive report on the subject for a generation. Its potential importance for improving the quality of investment decision taking, and ensuring that corporate management are properly accountable to their real owners, the 20 million or so individual and beneficial shareholders, is clear.

In our opinion the objectives of wealth generation and competitiveness need not be inconsistent with corporate governance objectives of transparency, proper disclosure and a consistency undertaken by management. Therefore we subscribe to the view that a review of corporate governance framework must be conducive towards promoting:

- an inclusive approach to directors' duties which requires directors to have regard to all the relationships on which the company depends and to the long, as well as the short term implications of their actions, with a view to achieving company success for the benefit of shareholders as a whole; and
- wider public accountability: this is to be achieved principally through improved company reporting, which will require the publication of a broad operating and financial review which explains the company's performance, strategy and relationships (eg, with employees, customer and suppliers as well as the wider community).

Some of the issues highlighted in the HIH collapse were:

- allegations by the Chairman that the principal board was unaware of the state of the affairs in areas governed by the boards of subsidiary companies, which he said were dominated by Executive Directors; and
- allegations that the audit committee comprised directors deriving from the firm carrying out the audits.

In the OneTel case, two directors who represented major investors claimed to have been profoundly misled as to the cash position of the company.

Our view is this:

- that public companies are social institutions, with manifestly important responsibilities to shareholders, clients, suppliers, employees, and in the community in which they work;
- shareholders put directors in place to safeguard all of these interests and responsibilities on their behalf; and
- the failure of HIH has demonstrated the community effect – taxpayers may be asked to shoulder more than \$2 billion to mitigate the effects of the collapse.

We believe it is beyond argument that shareholders must be vigilant and active. Large investors have a unique role:

- they can engage the company throughout the year; and
- they can use their proxies to ensure that the directors act as they should.

Voting against board proposals at an AGM after the fact is less effective than constructive engagement. But

engagement will not be constructive unless the ultimate threat of sponsoring or defeating directors and resolutions is real.

IFSA sought to refute claims of low levels of activism through a study of activism of Fund Managers. In summary it found that there were higher levels of activism than suggested by other studies through a combination of activities including "behind the scenes" engagement with Corporate Boards on specific issues and exercise of proxy votes.

The IFSA study says that it's members manage about 23% of the capitalisation of the Australian share market, and that 69% of the shares are routinely used to vote or engage with the companies. Another 27% are sometimes used to engage or vote.

Other studies, undertaken by Melbourne University and CGI have found that in those companies without a widely held shareholder base (this meaning no major non-institutional shareholders) proxy instructions for 1999 director-election resolutions represented on average 41% of total voting capital, compared to 39% in the 1998 year. This compared to UK 50% of total voting capital being exercised and in the US 80% of total voting capital being exercised.

Melbourne University's Centre for Corporate Law and Securities Regulation examined proxy voting returns for director election resolutions and controversial resolutions at 59 large listed Australian companies' annual general meetings.

It found that only 41% of proxy votes of total voting capital were exercised in the companies surveyed.

In "widely held" companies (defined as companies where a single non-institutional shareholders did not hold more than 20 per cent

of shares), the levels of proxy votes were even lower at 35%.

The report said that given institutional shareholders now held between 45 and 50 per cent of Australian equities "trustees of superannuation or investment funds... should for their own protection, take a close interest in their manager's performance on proxy voting.

This therefore implies that there is not a frequent exercise of their right to vote and raises a further issue as to "whether they meet their obligation to consider whether to vote or not.

Notwithstanding the results of the IFSA study, there is a perception that the Australian experience follows a tradition of inactivity of fund managers, pension funds and institutional investors in UK corporations with regard to exercising their voting power or even providing back room influence to effect change at the corporate level.

ACSI'S IMMEDIATE FOCUS

Our Council has a committee which will select and supervise the issues to be researched.

The issues we are looking at immediately include:

- to build on a study we already have of the composition of boards, including multiple directorships, non executive directorships, and independent directors. In relation to director independence we will use the IFSA Guidance Note No. 2.00. Which sets out criteria for genuine independence in addition we will correlate these results to committee memberships including nomination and remuneration committees. We will also take account of superannuation or retirement plans for non

executive directors to quantify them as a basis for measuring independence of action;

- to analyse CEO remuneration movements within a comparative group – ie, within ASX Industry classifications. Here we will look at, fixed cash remuneration, bonuses, share options and other non cash remuneration within the ASX classifications, and link it to performance using various performance measures;
- to analyse CEO remuneration and benchmark it against company performance;
- to analyse Board and Committee independence – including the role and genuineness of the independent non executive directors, looking at related party transactions, transparency and disclosure;
- to review the adequacy of current disclosure practices regarding share option arrangements, including the appropriateness of the hurdles which trigger these packages, benchmarking actual disclosure and the hurdles for share options against best practice in comparable companies;
- develop a framework to support effective proxy voting practices. This will look at contractual arrangements between Funds, Investment Managers and Custodians. It will also look at proxy voting services which will be required to enable trustees to give effect to policies of corporate governance; and
- review the practice of dual listing as a means of achieving company mergers. This will include the effect on shareholder franchise, and

looking at changes which may be needed in the corporate law.

CONCLUSION

Superannuation Trustees already have onerous responsibilities. There is no doubt that interest and activism investors is growing and will grow in the future.

Our task will be to make it possible for Trustees to play the role they wish to play as institutional shareholders.

We expect Australian Superannuation Funds to take their place in the international movement towards better corporate governance.

We understand that good corporate governance by itself does not lead every company to make the best business decisions, it is no safeguard for example, to a mining company against falling world mineral prices, but it does represent the best means of insuring against reckless and imprudent company behaviour. Despite what some may say is an unfinished debate, we think good corporate governance and good performance are organically linked.

So we have no choice but to take these emerging responsibilities seriously, and to meet them as we have met all of the other issues involved in protecting our members interests.

CORPORATE GOVERNANCE - COMPANY SECRETARIES

Nigel Bond
IFS Fairley

Corporate governance has jumped to the forefront of political discussion with the spectacular failures of HIH, One-Tel and Harris Scarfe. The regulators including the Australian Securities and Investments Commission ("ASIC"), the

Australian Stock Exchange ("ASX") and the Australian Prudential Regulatory Authority ("APRA") are under scrutiny as are the various company auditors, the allegation being they have failed to adequately supervise corporate governance.

While the regulators and auditors clearly have a role to play in improving the standards of corporate governance, as with most things, compliance begins at home. With regard to corporations, compliance begins specifically with the Company Secretary.

Role of the Company Secretary

The Australian Standard Classification of Occupations ("ASCO") produced by the Australian Bureau of Statistics provides that a Company Secretary is responsible for administering and reviewing corporate compliance, specifically:

"advising the corporations Board concerning compliance with the Corporations Law, Stock Exchange and listing rules and other relevant legislation and corporate practice."

You might well ask why look at the ASCO definition, why not refer to the Corporations Act or the ASX Listing Rules? The answer is simple, while the Corporations Act requires that a public company appoint a secretary, it does not specify the duties of who may be a company secretary or how the position of secretary differs from that of a director.

Indeed there are no more onerous requirements on becoming a company secretary than a company director and yet the company secretary is charged with the task of ensuring company compliance with the Corporations Law, Stock Exchange Listing rules and other legislation.

In a regime where financial service licensees must satisfy onerous educational and experience criteria and are subject to direct supervision by ASIC, the chief compliance officer is simply required to be over the age of 18, surely an oversight.

How can these standards be improved?

The simplest option is to improve the standard of those individuals currently acting as company secretaries and to better define the scope of their obligations.

First, it is necessary to define the role company secretaries are expected to play in corporate governance. Secondly, Company Boards should be made aware of their responsibility to appoint suitably qualified company secretaries. In particular, emphasis should be placed on ensuring company secretaries have access to training, support and professional advice.

Initial steps may include requiring professional memberships which provide an infrastructure of experienced professionals for those newly charged with the responsibility. Potential bodies include the Chartered Secretaries Association. By ensuring that company secretaries meet minimum training requirements, have access to the relevant corporate documents and sufficient support from the board, the necessary compliance culture will develop.

Compliance begins at home

If we, as shareholders and directors, appoint inadequately trained individuals, with minimal resources, support, access and remuneration to the crucial position of chief compliance officer, then we are not only partly to blame for corporate failures but should expect more.

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This newsletter is correct to the best of our knowledge and belief at the time of going to press. It is, however, written as a general guide so it is recommended that specific professional advice is sought before any action is taken