

6 August 2018

ASX Corporate Governance Council  
c/o ASX Limited  
PO Box H224  
Australia Square NSW 1215  
Attention: Mavis Tan

Via email: [mavis.tan@asx.com.au](mailto:mavis.tan@asx.com.au)

Dear Mavis,

**Re: Submission to the consultation draft of the fourth edition of the *Principles and Recommendations***

Regnan was established to investigate and address underappreciated sources of risk and value for long term shareholders in Australian companies. Its research is used by institutional investors making investment decisions, and also used in a program aimed at advocating for improved governance and risk management, both in direct conversations with S&P/ASX200 companies and via other channels.

In this capacity, Regnan has been a close observer of governance practice since 2007, and prior to that as BT Governance Advisory Services since 2001. During this time, we have witnessed significant progress among Australian listed entities. The ASX Corporate Governance Council's *Principles and Recommendations* ("the Principles") have been a significant driver of these improvements.

We welcome the periodic review of the Principles as a means by which investors can communicate contemporary governance expectations to listed entities.

## Supporting an informed market

Under an "if not, why not?" framework, the Principles support market functioning via their utility as an information resource for listed entities. As a central reference point, they are an efficient means by which listed entities can be informed about shareholder expectations. In turn, this improves efficiency for shareholders, who can be certain that any governance variations by listed entities result from informed consideration of the issues rather than merely from lack of awareness of shareholder perspectives. The Principles support both listed entities and investors to make more informed decisions as a result.

We see it as part of directors' duties to determine whether their entity is better served by adopting governance Recommendations expressed within the Principles (including to streamline

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communication with investors) or by establishing and explaining alternative arrangements suited to the organisation's circumstances. We see it as inappropriate for directors to relinquish responsibility for this determination.

Much of the material within the draft goes beyond Regnan's expectations, both in form (level of detail) and in the nature of the content that is specified, but we see no reason to restrict the material to universally observed (or even to universally achievable) corporate governance features. The Principles can carry extensive information about the shareholder context within which listed entities need to make choices about governance design and disclosure<sup>1</sup> *provided that* they are structured in ways that allow users to *clearly distinguish* requirements, recommendations and other material provided for information.

## The role of the Principles and each component part

The effectiveness of an expansive approach in supporting an informed market relies on widespread understanding and acceptance of the Principles as an informative resource, and not quasi-regulation. Based on extensive observations of corporate practice and investor commentary during more than a decade, we note that *very many* users of the Principles misunderstand this objective.

We strongly advocate that the Principles be drafted in a manner which provides additional support to users to appreciate the demarcation between each Principle's component parts. These include:

### ▲ Requirements

This involves confirmation by a listed entity of whether it has responded to a shareholder expectation expressed by each of *the Principles* (whether by adopting a Recommendation or by another means, disclosed as part of the requirements). We consider the objective of this component to be *standardisation of disclosure* – enabling shareholders to more efficiently evaluate listed entity governance strength, with reference to priority areas of agency risk identified by each Principle.

### ▲ Recommendations

Recommendations should propose arrangements widely recognised by shareholders as constituting an acceptable response to their priorities outlined in the Principles, *presented descriptively to companies for their information*;

### ▲ Other statements

The objective of additional material should be to ensure listed entities are fully supported in understanding shareholders' perspectives about these areas of priority, and able to make

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<sup>1</sup> We see it as axiomatic that Council-approved Principles will ultimately reflect expectations of shareholders, if there is appropriate shareholder representation on the Council.

informed governance design and/or disclosure choices accordingly. Accompanying material should include a robust rationale for each Principle/Recommendation, illustrative material and external resources to which users may also refer.

## Meeting the needs of contemporary users

Since the first edition of the Principles was published, there has been a significant increase in the ease with which larger and more established listed entities are able to discover, address and negotiate shareholder expectations (e.g. through investor resources devoted to corporate engagement). We therefore see smaller entities and newer market entrants as the principal audience for the Principles. Given resource constraints for these groups, it is critical to avoid any misunderstanding of the distinction between requirements, recommendations, and supporting material.

In light of the above, we suggest more effective signalling/further reinforcement of the objectives of the Principles and component parts. In particular, we propose clearer demarcation of requirements, recommendations, and supporting material. The Principles' content, language, document structure and format could better reinforce this, including through streamlining peripheral, redundant or duplicative material. For example:

- ▲ We see the overlap of emphasis on social licence to operate across Principle 3 and Recommendation 7.4 as hindering understanding of their *distinct* foci. If inclusion in both is warranted (see below) the approach in each case should be targeted to the objective of the Principle under which it is included.
- ▲ In its current form, the mention of legal requirements under Recommendation 3.4 (Have a policy on corruption and bribery) is unlikely to add new information to listed entities' understanding. If legal requirements are germane to the rationale for this Recommendation, they warrant more serious treatment; if not, this reference dilutes focus and diminishes clarity.
- ▲ We view the use of the word "should" variously across Principles, Recommendations and explanatory material as unhelpful to demarcating requirements from Recommendations and other material.
- ▲ Design and formatting could further support demarcation of expectations versus supporting material.

Our more detailed comments on some of the draft Principles, Recommendations and other material are made in the context of all of the above.

## Principle 7 Recognise and manage risk

Regnan encourages the Council to consider whether the extended form of Principle 7 fully captures the objective of the Principle, its headline form, and the Recommendations which flow from it. Tighter correspondence of these elements will more effectively clarify expectations for users.

### Recommendation 7.4

We welcome the continuing focus under Recommendation 7.4 on environmental and social risks. Our observations from continuing review of, and extensive engagement with, S&P/ASX companies indicate that guidance in relation to shareholders' expectations regarding these issues continues to be necessary, even for many larger listed entities.

However, the current framing of this Recommendation is insufficiently targeted to the objective of effective governance over *risk to the listed entity*.<sup>2</sup>

Commentary under Recommendation 7.4 focuses only on risks to the listed entity *arising from its own impact* on the natural environment, social groups, or in contravention of community standards. Many environmental and social risks to listed entities are not (or not substantially) attributable to the listed entity's actions.<sup>3</sup> This recommendation (and associated glossary entries) need to expand to encompass these risks.

Similarly, international standards for sustainability reporting do not universally address the impact of environmental and social issues *on the entity* or require that these be addressed from a risk (versus corporate responsibility) perspective. We consequently believe it is misleading to propose that a sustainability report complying with international standards (including some of those mentioned) will necessarily support a requirement that listed entities recognise and manage risk.

The expanded framing that we advocate is already implicit in the reference to climate change in the current draft. Specifically, it is apparent in the examples of how this risk can play out; recognition that listed entities can be exposed to this risk regardless of involvement in fossil fuels extraction or use; and in the Council's encouragement of reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosures.

We view it as necessary to provide a more substantial definition of "material exposure" within the body of the section, for instance referencing the capacity of environmental and social risk exposures to influence the decisions of shareholders.

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<sup>2</sup> Principle 3 as currently drafted may be better suited to addressing the impact of the listed entity on the natural environment, social groups or in contravention of community standards.

<sup>3</sup> For example, physical exposure to frequency of extreme weather events due to climate change.

### Comments on Principle 3

We welcome the focus of Principle 3 on the need for listed entities to be responsive to the ethical expectations of the community. This supplements the expectation that listed entities “act lawfully” with a reference point that is less susceptible to corporate influence (on legislation) and consequently is likely to facilitate greater shareholder confidence during periods when public confidence in institutions is diminished.

We note that Principle 3 contrasts with Principle 7 whose focus is the appropriate handling of and disclosure about *risk to the listed entity*. This contrast could be strengthened by expressing ethical expectations independent of a risk-based framing in Principle 3. We strongly support explanatory material informing companies about the value of “social licence to operate” and note abundant evidence of corporate inattention to social licence causing poor commercial and shareholder outcomes. However, we see this as potentially better addressed within Principle 7. We are concerned that the draft does not present a rationale or other material in support of Principle 3’s call to act in a “socially responsible manner” (i.e. observe a community-based standard of ethical behaviour). We encourage the Council to address this.

Regnan believes any reference to a community standard needs to clarify which community standard(s) are appropriate (for instance the community in which the company is listed versus the one in which it operates).

### Streamlining Principle 3

The draft phrasing of Principle 3 carries an implication that culture is *the* means by which listed entities ensure they act “lawfully, ethically, and in a socially responsible manner”.

Organisational culture is an important contextual cue for decision-makers, and a proper subject for Board and investor diligence. Accordingly, Regnan has been engaging company directors and executives on their oversight of culture since for many years. However, this phrasing of Principle 3 inappropriately elevates culture over other means (e.g. compliance processes) by which listed entities should impel conduct that is lawful, ethical and meets community expectations; and should suppress conduct which is not. Reference to culture may be better confined to a Recommendation under Principle 3.

For similar reasons, we do not support the Recommendation (3.1) that listed entities *express* core values. The primary vectors for communicating ethical standards within organisations are organisational structures, frameworks for decision-making and accountability (e.g. policies, incentives, provisions of codes of conduct, etc.) and prevailing behavioural norms (culture). While values statements may be useful components of these controls elements, we see little advantage in encouraging corporate investment in rhetorical positions that are independent of mechanisms for accountability.

We see the active phrasing of Principle 3 (“instil...” versus “act...”) as enhancing guidance for readers, and note that further clarity would be achieved within the text of Principle 3 (and potentially other Principles) by clarifying *who* is responsible for taking this, and other, recommended action. For example, “The Board should...” may be appropriate framing for Principle 3, given the stated Council objective of directing “tone from the top” via this Principle.

### **Observations on recommendations 3.2 – 3.4**

We welcome the focus of recommendations 3.2 – 3.4 on concrete activity to secure lawful, ethical behaviour in line with community expectations and welcome the inclusion of recommendations that that the Board be informed of material breaches of Policies and Codes described in 3.2 – 3.4.

We suggest reordering to place proposed Recommendation 3.3 (whistleblower) last, to avoid any inadvertent misapprehension that bribery and corruption matters lie beyond its purview. We are concerned that no case has been presented for a standalone policy on anti-bribery and corruption (as opposed to, for instance, coverage of these matters within a broader code of conduct).

We propose that box 3.2 (suggested Code of Conduct) include a provision requiring employees (and any others to whom a Code applies) report instances of violations of the Code. Whistleblower policies can address impediments to reporting concerns, but do not provide for *a responsibility* to do so, therefore we view this as a material omission.

We note evidence of escalating shareholder interest in/concern about listed entities exercising (legal) influence via political channels, including via means that do not involve direct payments. We believe a stronger statement of expectation with respect to accountability for lobbying and political influence is required, and direct the Council’s attention to the International Corporate Governance Network’s published Guidance on Political Lobbying and Donations for more detailed proposals.

### **Principle 8**

The core function of executive remuneration is (as stated in the longer form of the Principle) attracting and retaining talent for value creation. Remuneration plays a supporting role in shaping executives’ priorities and behaviour. We believe greater emphasis on the core function is warranted within the commentary, to balance the extensive attention in the Recommendations paid to achieving alignment with broader shareholder expectations.

Regnan sees considered remuneration arrangements that support executives’ roles in sustained value creation as likely to resolve many of shareholder concerns that currently underpin some of the Recommendations.

#### Principle 4

Investors must be able to rely on the accuracy of information provided as part of ASX Listing Rule 4.10.3. All disclosures made in association with the Principles (whether on a website, annual report or elsewhere) should be supported by the same sign-off, assurance and accountability arrangements as other market disclosures.

#### Principle 1

We note that concerns surrounding director overcommitments are of a different nature and are likely to warrant consideration of different solutions than those concerning director conflicts. We recommend that these two aspects be separately addressed within Principle 1.

Regnan fully supports the Council's recognition of diversity as a source of improved decision-making capacity and views associated recommendations on diversity as appropriate to address in *Principle 2* (Structure the Board to add value). We see significant opportunity to improve the alignment of Recommendations and supporting material with the Principle (whether retained in Principle 1 or shifted to Principle 2) via greater emphasis on and more direct attention to cognitive diversity.

#### Thank you

We congratulate the Council on the consultation draft, which evidences considerable ambition to address contemporary interests and concerns of shareholders. We hope our feedback proves useful as you finalise the fourth edition.

Should you wish to clarify or further discuss anything in Regnan's submission, please don't hesitate to contact me on [pauline.vamos@regnan.com](mailto:pauline.vamos@regnan.com). Further, we have focused our feedback on a limited range of issues and would be more than happy to engage further beyond the contents of this submission.

Yours sincerely



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Regnan