15 November 2013

Ms M Tan
Australian Securities Exchange Limited
Exchange Centre
20 Bridge Street
SYDNEY NSW 2000

Via email: mavis.tan@asx.com.au

Dear Ms Tan

ASX Corporate Governance Council Corporate Governance Principles and Recommendations (third edition) and Listing Rules changes

I refer to ASX Corporate Governance Council's and the ASX's Consultation Papers relating to proposed changes to the third edition of the "Principles & Recommendations" and the "ASX Listing Rules", "the "Guidelines". Our Submission is a combined submission on the Guidelines.

ISS welcomes the opportunity to comment on the Guidelines. Our detailed comment on both documents is attached. In general, ISS supports many of the proposals contained in the draft revised Guidelines.

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Submission Outline

Institutional Shareholder Services Inc. (ISS) is pleased to submit the following observations on the proposed ASX Corporate Governance Council (ASX CGC)[1] changes to the third edition of the "Principles & Recommendations" and the "ASX Listing Rules", "the "Guidelines". Our Submission is a combined submission on the Guidelines. It is a commentary aimed to assist all concerned with better corporate governance practices by highlighting key matters of interest in the proposed changes to the Guidelines. Our Submission is based on our extensive local and global experience and expertise in corporate governance[2].

Submission focus

Our Submission will address some but not all the recommended changes. Although all the recommended changes are important and will significantly continue to generally improve corporate governance practice, we have selected some key areas, Principles 2, 7 and 8, as the focus of our Submission due to their greater impact on reporting requirements. Overall, listed issuers will face greater reporting under the proposed changes to the Guidelines. The changes will affect annual reports for financial years beginning on or after 1 July 2014.

ISS generally supports the structural changes to the Guidelines in that continuous improvement benefits market integrity by enhancing transparency and therefore the confidence of all market participants, for example by not distinguishing trusts and externally managed issuers from the requirements of the Guidelines. ISS will not comment on compliance with the new Guidelines in terms of possible unintended consequences and or the potential for undue compliance burdens; nor on the sufficiency of the level of commentary and guidance being provided by the ASX CGC; and we are not setting out to identify significant omissions and deficiencies in the Guidelines overall.

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[1] The ASX CGC was convened by the ASX in August 2002 and comprises 21 industry and shareholder bodies. It has no statutory or other constitutional basis, but it is intended to have an ongoing role in reviewing the implementation of the Guidelines and a number of other advisory functions detailed in the Corporate Law Economic Reform Proposals No 9 (CLERP 9) Discussion Paper released by the Commonwealth Government in August 2002. Participating organisations include: Association of Superannuation Funds of Australia Ltd, Australasian Investor Relations Association, Australian Council of Superannuation Investors, Australian Institute of Company Directors, Australian Institute of Superannuation Trustees, Australian Shareholders' Association, Australian Stock Exchange Limited, Business Council of Australia, Chartered Secretaries Australia, CPA Australia, Group of 100, Institute of Actuaries of Australia, Institute of Chartered Accountants in Australia, Institute of Internal Auditors Australia, International Banks and Securities Association of Australia, Investment and Financial Services Association, Law Council of Australia, National Institute of Accountants, Property Council of Australia, Securities & Derivatives Industry Association, Securities Institute of Australia.

[2] Who is ISS? ISS is a leading provider of corporate governance solutions to the global financial community, ISS issues proxy research and vote recommendations on more than 900 Australian and New Zealand companies giving institutional investors guidance around the AGM season (corporate actions, board appointments, directors' remuneration reports; and other related corporate governance matters). The ISS Australian team oversees company research and leads ISS' policy development and engages with all S&P ASX 300 issuers through their Chairs and other company representatives. The team works with some of ISS' largest custom policy clients and performs research on companies in Australia, the United Kingdom and the United States.

Some of the substantive proposed changes to the Guidelines include:

- introducing a number of new recommendations in Principle 7 with a focus on the management and monitoring of risk, including a requirement to disclose whether an entity has regard to "economic, environmental and social sustainability" (ESG) risks, and requiring the board to review the entity's risk management framework at least annually;
- introducing a new recommendation requiring listed issuers to have a remuneration clawback policy;
- expanding the categories of relationships that may indicate that a director may not be independent to include "close family ties" and a term in office of more than 9 years;
- allowing issuers to treat the reporting of their "Gender Equality Indicators" under the Workplace Gender Equality Act 2012 as satisfying their obligations to report their gender statistics under the Principles and Recommendations;
- recasting, for the benefit of smaller listed issuers, the recommendations in connection with the nomination committee, the audit committee, the (new) risk committee and the remuneration committee to permit issuers that do not have those committees to disclose that fact and other processes the issuers have adopted in respect of those matters;
- elevating a number of practices recommended in the commentary in the current 2nd edition into actual recommendations, reflecting the fact they now represent contemporary governance standards against which issuers should be required to report;
- amending the Listing Rules to provide flexibility for listed issuers to disclose their corporate governance statements on their website rather than in their annual report; and
- introducing a new Listing Rule requirement for listed issuers to lodge an "Appendix 4G" (Key to Corporate Governance Disclosures) at the time they lodge their annual report with ASX (this would replace the "Annexure C" in the current ASX Guidance Note 9).

Table 1, below sets out the focus of our submission in response the ASX CGC changes to the Guidelines. [3].

Table 1: Focus of ISS Submission

Principle	Description	Recommendation
2	Structure of the Board to add value	Box 2.1 Relationship affecting independent status; tenure
7	Recognise and manage risk	7.2 – Risk Management Review 7.3 – Audit and Risk Management functions 7.4 – Environmental, social sustainability risks disclosure
8	Remunerate fairly and responsibly	8.3 – Remuneration Claw back policy and disclosure

[3] On 31 March 2003, Australian Stock Exchange Limited (ASX) released the ASX Corporate Governance Council's (ASX CGC) Principles of Good Corporate Governance and Best Practice Recommendations (Guidelines). The Guidelines contain 10 'essential' Corporate Governance Principles (Principles) and 28 Best Practice Recommendations (recommendations). Disclosure requirements are in terms of the nature and timing of the disclosures required under ASX Listing Rule 4.10.3.

The Guidelines Statutory basis

When considering the changes being proposed to the Guidelines they must be understood in the context that, overall, there are interlinked corporate governance compliance requirements. Clearly, the aim of the Guidelines is to provide a flexible non prescriptive approach to corporate governance by focusing on disclosure of actual practice, rather than mandating a particular practice. This approach is tempered by the requirement that issuers provide an explanation and report justifications of deviations or departures from the Guidelines. The considerable pressure this puts on issuers to adopt the Guidelines should be emphasised, in that the stakeholders of a company could perceive noncompliance with the Guidelines as an adverse signal[4]. Whilst the Guidelines are a non-legislative response to corporate governance issues, at the request of the Australian Securities and Investment Commission (ASIC) and the Government, for the ASX to take a leadership role, the Guidelines are given authority by the ASX Listing Rules with legislative backing from the Corporations Act (Cth) 2001 in terms of enforcement of the operating rules (section 793C).

Whilst the ASX role on the ASX CGC is limited, it chairs and provides the secretariat function and is also represented on the ASX CGC, in its role as market supervisor, the ASX monitors and enforces corporate governance disclosure under its listing rules (Guidelines). The ASX also conducts an annual review of the corporate governance disclosures of listed issuers in their annual reports. The results of this review are released each year.

Proposed Changes to the ASX Listing Rules

Contemporaneously with the release of the consultation paper by the ASX CGC regarding changes to the Guidelines, the ASX released its own consultation paper about some changes to the Listing Rules (LR) and Guidance Note 9, which are governance-related amendments to the LR and give effect to the reforms proposed in the draft third edition of the Guidelines (see Appendix B).

Some of the more significant proposed LR changes are:

- providing flexibility for listed issuers to disclose their corporate governance statements on their website rather than in their annual report (with amendments to LR 4.10.3);

- introducing new LR 3.19B requiring an entity to disclose information about on-market securities purchases (within 5 business days after the purchase) where the entity has provided funds for the purchase of securities by or on behalf of directors or employees under an (incentive) scheme. The information to be disclosed includes the number of securities purchased, the average price, and the names of the directors or their related parties for whom securities were purchased. This rule will complement the exception in current LR 10.14 where security holder approval is not

[4] Kohler, A. G. (2005). Audit Committees in Germany – Theoretical Reasoning and Empirical Evidence. Schmalenbach Business Review, 57, 229-252.

required to permit a director or related party to acquire securities under an employee incentive scheme where the securities are to be purchased on-market;

- introducing a requirement for listed issuers to prepare and lodge an Appendix 4G at the same time as they lodge their annual reports with ASX (LR 4.7.3). The Appendix 4G builds on the existing Annexure C in ASX Guidance Note 9 as a "Key to Corporate Governance Disclosures". Issuers will complete Appendix 4G to identify whether they have or have not complied the Guidelines specifying where specific corporate governance disclosures can be located;

- enabling the information required to be included in annual reports (including the corporate governance statement) to be prepared as at the balance date or a date not more than 6 weeks before the report is given to ASX (rather than sent to shareholders) (LR 4.10). This will be of particular benefit to those issuers that prepare and lodge their annual report information with ASX at the same time as they lodge their Appendix 4E[5] information.

The Risk of Boiler-plating

While issuers may express a preference for principles-based approaches, this approach can be undermined if it appears that a certain ‘magic phrase’ is one that shareholders will accept. The risk of providing detailed rules on disclosure by way of the Act or Regulations is that issuers will follow these to the letter. Issuers will also potentially adopt phrases from the Guidelines or from shareholders’ own guidance. Such boiler-plating may not be a bad practice if it gives a true and fair view of what the company’s corporate governance practices actually are. It is poor practice when it is essentially meaningless. The task for issuers is to ensure that they describe their corporate governance policies meaningfully.

Back to the Future

Investors in Australian securities generally invest the time to review thoughtfully the corporate governance statements issued by Australian listed issuers. The ASX CGC notes that its motivation for the changes came about in 2012 in that it would be appropriate to review and update the Guidelines to incorporate the lessons of the Global Financial Crisis (GFC) and corporate governance developments in Australia and internationally since the second edition of the Guidelines were published in 2007.

Of its nature, the debate about corporate governance will not, and should not, have a final act. The release of the changes to the third edition of the Guidelines is another step. The process of implementation and further development of the changes from the third edition of the Guidelines over time will be important in ensuring that Australian issuers meet the expectations of both domestic and international audiences of all kinds.

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[5] Full Year Financial Results as per rule 4.3A. Preliminary final report for the year ended 30 June xxxx. 'Results for announcement to the market'.

Drivers to the proposed changes to the Guidelines

The last major rewrite of the Guidelines was in 2007, just as the GFC was biting (see Appendix A: Background to the Guidelines). The ASX CGC notes that overseas legislators are now facing demands for mandatory requirements to address the governance failings that allegedly led to the GFC. The ASX CGC makes no bones about the fact that the new rewrite is aimed at heading off similar demands in Australia[6].

This is particularly apparent in a new requirement that issuers disclose whether (and how) they have regard to "economic, environmental and sustainability risks". While this requirement may seem far-reaching, the ASX CGC makes the point that it is considerably less onerous than some overseas requirements, such as UK's "enlightened shareholder duty"[7] [8].

Changes have been addressed both substantively and structurally. There are a number of important structural changes to reporting on the Guidelines, including:

- the current split between governance recommendations and the guides to reporting on those recommendations has been dropped, thus providing a one-stop shop for issuers to determine what their reporting requirements are; and
- a new Listing Rule Appendix 4G (which issuers will have to lodge with their annual report) will give issuers a checklist of the Corporate Governance Guidelines disclosure requirements and will require them to indicate where they have made those disclosures.

The new Appendix 4G will be useful for both reporting issuers and anyone who has ever had to hunt through a company's annual report and website to find particular governance disclosures. It will also direct investors to information relevant to a company's compliance with a recommendation (which may not otherwise be apparent).

Key features of the new Corporate Governance Guidelines

A number of features of the new Guidelines are particularly worth noting. There is a new recommendation for the establishment of a risk committee (either standalone or part of the audit committee) or an explanation of the Board's approach to risk management. There is also a modification of director independence criteria and approach, including:

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[6] The ASX CGC adopted the same 'principles based' approach as that taken in the UK Combined Code which governs issuers listed on the London Stock Exchange. ASX listed issuers are at liberty not to comply with the recommendations, but if they do not, they must explain why not. The Guidelines were built on the belief that one size does not fit all issuers in the Australian market. This model rejected the more prescriptive approach adopted in the US by the Sarbanes-Oxley Act 2002 and in the proposed amendments to the New York Stock Exchange's listing rules which required compliance with specific practices.

[7] Gamble, A. and Kelly, G. (2001), Shareholder Value and the Stakeholder Debate in the UK. Corporate Governance: An International Review, 9:110–117.

[8] Keay, Andrew. "Tackling the issue of the corporate objective: an analysis of the United Kingdom's enlightened shareholder value approach." Sydney L. Rev. 29 (2007): 577.

- a recommendation that background checks on proposed directors be conducted;
- a statement that directors holding that office for more than nine years are no longer prima facie considered to be "independent"; and
- a recommendation that listed issuers have a program for inducting new directors and providing appropriate professional development opportunities be provided to continuing directors, and a summary of the main features of such a program be reported.

Greater emphasis on risk management

The ASX CGC says that risk management deficiencies were significant contributors to the causes and severity of the GFC. As a result, risk management assumes greater significance in the new edition of the Guidelines. The key change is a considerably expanded requirement to report on the entity's risk management. The new Guidelines recommend that issuers:

- have a standalone risk committee; or
- include risk management in the responsibilities of the audit committee; or
- if they do not have a risk committee (standalone or as part of the audit committee) disclose the processes that they use for identifying, measuring, monitoring and managing the material business risks that they face (Recommendation 7.1).

The Risk Committee also ramps up the requirements for risk management systems. At present, issuers only have to disclose whether management has designed and implemented a risk management system and whether management has given the board a report about the system's effectiveness. The new Guidelines impose a greater responsibility on the board itself. The board or a board committee should annually review the risk management framework with management, with three objectives:

- to satisfy itself that the risk management framework is sound;
- to determine whether there have been any changes in the material business risks faced by the entity; and
- to ensure that the entity is operating within the risk appetite set by the board.

The commentary to this new recommendation suggests that issuers should disclose any insights they gain from the review and any consequential changes they make to their risk management framework.

Directors

As noted above, the new Guidelines include three significant changes relating to directors.

Vetting potential directors

Perhaps the most unexpected is a recommendation that issuers should undertake "appropriate checks" before appointing a director, or putting a person up for election to the board (Recommendation 1.2(a)).

What are "appropriate checks"? According to the commentary accompanying Recommendation 1.2(a), they include checks such as:

- criminal record;
- bankruptcy;
- education; and
- character references.

While the potential benefits of undertaking such checks are obvious (and indeed many listed companies will do this as a matter of course, either directly or through recruitment agents), there is no explanation of the reasoning behind this requirement. The references to criminal records, bankruptcy and character references appear to be aimed at ensuring that directors are not "bad eggs". However, the requirement to check a potential director's education appears to go to the person's qualifications for the job – in which case, it may be expected that their relevant practical experience should also be vetted.

What is an independent director?

This has been one of the most contentious issues in corporate governance since ASX CGC first promulgated its corporate governance guidelines in 2003. In the first edition of the guidelines, it was said that an independent director was a person who, among other things, had not served on the board "for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company". This reference to the length of a director's tenure was dropped from the 2007 edition, but has made a return in the proposed new guidelines, where matters "that might cause doubts about the independence of a director, include if the director… has been a director of the entity for more than 9 years". The ASX CGC observes that nine years has been adopted as the appropriate yardstick by the UK, Singapore, South Africa and Hong Kong[9].

Of course, having served on the board for more than nine years (which equates to approximately three standard terms) does not necessarily mean that a director is not independent. However, if an entity decides that a director with more than nine years' service is still independent, it will be required to explain to members why it has reached that conclusion.

Professional development for directors

The commentary to the current Guidelines suggests that issuers should provide induction training for new directors and that existing directors "should have access to

[9] ISS' International Corporate Governance Policy 2013 Updates

continuing education to update and enhance their skills and knowledge". However, this is not a recommendation against which issuers have to report.

The proposed new guidelines go further, requiring issuers not only to report on whether they have an induction and professional development program for directors, but also to provide a summary of the main features of that program. As with the nine-year test for independent directors, the ASX CGC bases this change on developments overseas.

Principle 2: Structure of the Board to add value

The relationships which may affect the independence of directors are proposed to be expanded and will include service on the board for more than nine years.

Under the proposed recommendation 2.1(b), if a director has an interest or relationship of the type described in the revised Box 2.1, but the board is of the opinion that it does not compromise the independence of that director, the listed entity should disclose the nature of the interest or relationship in question and provide an explanation of why the board is of that opinion.

Proposed Box 2.1 states that a director should be characterised and described as an independent director "only if he or she is free from any interest, position, association or relationship that might influence, or reasonably be perceived to influence, his or her capacity to bring an independent judgement to bear on issues before the board..." The concept of independence is based on the existing commentary concerning independence.

Proposed Box 2.1 then lists examples of interests, positions, associations and relationships that might cause doubts about the independence of a director. Proposed amendments to the relationships referred to in the existing Box 2.1 include:

- expanding the references to "a material supplier or customer of the entity or any of its related issuers, or an officer of, or otherwise associated directly or indirectly with, such a supplier or customer" to cover previous relationships going back 3 years;
- elevating "close family ties" (which was previously contained as guidance in commentary); and
- including service on the board for more than 9 years.

The criteria above determining whether a director should be considered "independent" have been amended. Notably, service on the board for more than 9 years[10] is now expressly listed as an indicator that a director may not be independent. This brings the issue of independence versus experience into further focus but importantly does not mandate a negative independence conclusion simply because of the passing of time. This proposed recommendation has been amended to include a statement that directors holding office for more than nine years are no longer prima facie considered to be "independent". If an entity decides that a director with more than nine years' service is still independent, it will be required to explain to

10"Zombie Boards: Board Tenure and Firm Performance". Paper presented at the American Accounting Association Anaheim, CA August 3 to 7, 2013. Huang, Sterling." Available at SSRN 2302917 (2013).

members why it has reached that conclusion. This recommendation might be regarded as somewhat controversial given that since the Second Edition, the guidelines have not been prescriptive about length of service being a matter impairing independence, despite earlier moves in other jurisdictions[11]. A length of service criterion was deliberately omitted when the Second Edition was adopted.

Apart from consistency with other jurisdictions, there does not appear to be a compelling reason for this proposed change[12].

Proposed Box 2.1 then states that in each case, the materiality of the interest, position or relationship needs to be assessed to determine whether it might interfere or might reasonably be seen to interfere with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally. In practice, this is generally how many listed companies have tended to approach their analysis of independence.

> As a matter of policy, ISS considers director independence and tenure on a case by case basis, on an individual director basis, such as the value a founder brings to the board or a director with special skills, irrespective of independence and or tenure. However, we strictly apply a policy of overall board independence in terms of board composition being a majority independent board in terms of the election or re-election of non-independent directors, including all committes. As with many features of contemporary corporate governance practices, the matter of independence is not easily determined simply by applying a number.
>
> Irrespective of the deliberations on determining independence, shareholders at ASX-listed companies would benefit from the increased transparency, to be gained, that debates on independence brings to a board. Any increase in disclosure on this element of governance, as contemplated under Recommendation Box 2.1, is welcome.

Principle 7: Risk Management Oversight to include ESG

The board and the senior management of some Australian listed companies have a statutory duty to develop, implement, oversee and report on an effective system of risk management. As discussed further in this section, those issuers regulated by ASIC and APRA in the financial services sector must comply with mandatory risk management oversight. The changes made to Principle 7: *Recognise and Manage*

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11 Ryan Jr, Harley E., and Roy A. Wiggins III. "Who is in whose pocket? Director compensation, board independence, and barriers to effective monitoring." Journal of Financial Economics 73.3 (2004): 497-524.

12 While a more prescriptive approach was rejected, the Guidelines were developed against the background of developments in the US, the release of the Higgs and Smith Reports in the UK and similar work in other countries, as well as updated standards issued by many of the member bodies of the ASX CGC and consideration of information about the various corporate collapses which generated concentrated public attention on corporate governance issues at the time of the first edition.

Risk places a greater emphasis on reporting and disclosing the effectiveness of risk management across the broader range of issuers and risks, and not just credit, market and operational risks.

Previously, the focus of the Guidelines on the risks surrounding financial reporting (see Appendix B: Risk Management Background)[13]. The scope of risks has been broadened by adopting the concept of material business risks. The ASX CGC (2008) defines these as “the most significant areas of uncertainty or exposure, at a whole-of- company level that could have an adverse impact on the achievement of company objectives”. Examples of external environmental factors impacting a company’s risk profile include industrial sector outlook, market competition, industrial relations, foreign exchange, interest rates and commodity prices and changes in government policy and regulation. Internal environmental factors include occupational health and safety, environmental impact, consumer protection/trade practices, financial controls and reporting, technology reliability, production capacity and people and skills (ASX CGC, 2008). Hence, there is clarification that material business risks involve financial and non-financial risks.

The scope of the obligations contained in the Principles (2007) is extended considerably under the ASX Listing Rules. The ASX listing rules are contractually binding between the ASX and listed issuers and are enforceable under sections 793C and 11O1BN of the Corporations Act (Commonwealth of Australia, 2001). The Corporations Act also imposes a number of further requirements on a company’s management with respect to the risk management of financial reporting. Under section 295A of the Act, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), or person’s acting in these roles, must provide the directors of the company a written declaration attesting to the integrity of the financial reporting process. Issuers must also be aware of their obligations under section 299A to include in the directors’ report information required to make an informed assessment of issuers’ operations, financial position, business strategies and prospects for future financial years.

Three ASX listing rules covering mandatory requirements are applicable to an entity’s risk management practices. The prevailing rule is ASX listing rule 4.10.3 which requires issuers to disclose in a Corporate Governance Statement in the annual report the extent to which the company has followed the Principles. Issuers are required to explain their different governance practices with respect to the ASX CGC’s recommendations. ASX listing rule 12.7 directs the top 500 listed companies in the Standard and Poor’s Top 500 to have an audit committee and those in the Top 300 to have an audit committee in accordance with Principle 4.3 Guidelines for Principle 4 include the audit committee’s responsibility to review the risk management and internal control systems.

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[13] Earlier Changes to Principle 7: Recognise and Manage Risk: the 2003 version of the Principles was updated in 2007 reducing the number of principles from ten to eight and the number of recommendations from twenty-eight to twenty-six to remove regulatory overlap with the Corporations Act (2001) and the accounting standards. The board and management’s responsibilities for risk oversight, management and disclosure were more clearly defined in the second edition, the Guidelines (2007). A key change was the expansion of the scope of Principle 7: Recognise and Manage Risk to reflect the heightened concern and increasing expectations of stakeholders with regard to risk management (ASX CGC, 2008).

ASX listing rule 3.1 is a continuous disclosure provision requiring timely disclosure of any information that could have a material impact on the valuation of the company's securities. Therefore, ASX listed companies have an obligation to make an announcement to the securities market in relation to some or all their material business risks and/or changes to those risks, where the risk or change is likely to have a material impact on the price or value of a company's securities. In addition, further support for this rule is provided in section 674 of the Corporations Act which imposes statutory liability for its breach in certain circumstances under civil (s. 1317) and criminal (s. 1311) provisions.

International Aspects

International governance regulations reflect that the concepts of corporate governance, internal control and risk management are inter-dependent[14] [15]. The 1992 Cadbury Report in the United Kingdom (U.K.) was one of the first policy initiatives legitimatising the widening of organisational control practices to encompass risk management and corporate governance issues[16] [17]. Cadbury (1992) resulted in the first release of the Combined Code on Corporate Governance in the U.K in 1998.

Previously, the primary focus of risk management guidelines had been internal controls over financial reporting. The inclusion of enterprise wide risk management into the governance spectrum was endorsed further following the Turnbull Report in 1999. This report resulted in the publication of guidance for directors on the Combined Code extending requirements beyond the financial sphere to include broader business risks, explicitly linking internal control over financial reporting to risk management[18].

Compliance to Risk Managements Disclosure

An academic study, using a sample comprising the S&P ASX-300 listed companies, as at 30 June 2010 assessed their Risk Management disclosures in their annual reports for fiscal year 2010, to Principle 7 (according to the major risk disclosure categories specified in Principle 7)[19]. The findings were that there was a widespread divergence in disclosure practices and low conformance with Principle 7 recommendations. The results suggest that the disclosures practices are weak and not meeting the needs of regulators and stakeholders to risk management disclosure in Australian Listed companies. The results of the study also identified that the extent of the overall very low disclosure is less than 20 percent of issuers made disclosures of any type of the 31 risk themes identified in the principle.

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[14]Spira, L. F., & Page, M. J. (2003). Risk Management: The Reinvention of Internal Control and the Changing Role of Internal Audit. *Accounting, Auditing & Accountability Journal, 16*(4), 640-661.
[15]Woods, M. (2009). A contingency theory perspective on the risk management control system. *Management Accounting Research, 20*(1), 69-81.
[16]Bhimani, A. (2009). Risk management, corporate governance and management accounting: Emerging interdependencies. *Management Accounting Research, 20*(1), 2-5.
[17]Maclean, M. (1999). Corporate Governance in France and the UK: Long-Term Perspectives on Contemporary Institutional Arrangements. *Business History, 41*(1), 88-116.
[18]Arena, M., Arnaboldi, M., & Azzone, G. (2010). The organizational dynamics of Enterprise Risk Management. *Accounting, Organizations and Society; also at n 9 above Spira et al*
[19]*An analysis of risk management disclosures by Australian publicly listed companies,* A. Ma S. Buckby G. Gallery Queensland University of Technology, May 2012

Furthermore, less than 40 percent of issuers made disclosures on a further 8 of the 31 risk themes. Overall only 4 themes were identified as having moderate, high or very high disclosure levels. The theme "occupational health and safety" and "changes in regulatory environment", were identified as having a very high level of disclosure and "reputation risk" and "insurance risk" were assessed as having moderate disclose levels. In contrast departures from Recommendations 7.1, 7.2, 7.3 or 7.4" (ASX CGC, 2007, p. 35) was also particularly low with only 4 percent of issuers reporting any departures.

> These results cast doubt on the effectiveness of Principle 7 of the Guidelines in achieving full disclosure of Risk Management information in ASX listed companies and the self-reporting principles associated with corporate governance disclosures.

Outsourcing Risk Management

A survey questionnaire sent to ASX listed companies requesting information about their risk management function for the financial year ending 2009 achieved a sample of 271 issuers. Results suggest 46 per cent of Australian listed companies outsource risk management activities. Financial reporting, compliance and operational risks are identified as the top three categories of risk management and are the top three risk priorities.[20]

Environmental, sustainability and climate change are the least identified categories of risk management with lowest priorities given by respondents. Risk associated with human capital and the environment are the most frequently outsourced categories[21].

ESG Risk: Reporting on economic, environmental and social sustainability risks

Markets and, in turn, regulators are requiring increasing openness and accountability from listed companies. Good environmental, social and sustainability practices are rewarded by both investors and consumers. Some jurisdictions internationally have already moved to regulate corporate governance in this area. In Australia, the new Guidelines propose that listed companies specifically report on environmental, social and sustainability risks.

Market-driven environmental and sustainability reporting is already an established practice amongst the S&P/ASX 200 companies with various studies noting a significant variation between the practices of ASX 50 companies and ASX 200 companies. While 49% of ASX 200 companies were not reporting or only reporting at a basic level, in the ASX 50, all issuers provided some level of reporting on environmental risk and 26 issuers (52%) S&P/ASX 200 companies were found to have best practice reporting[22]. Now, with the developing international regulatory

[20] *The decision to internally generate or outsource risk management activities*, PhD thesis, J. Christensen School of Business, Bond University. August 2011

[21] Ibid.

[22] *ESG Reporting Guide for Australian Companies, 2012*, the Australian Council of Superannuation Investors (**ACSI**)

environment, the operator of Australia's securities exchange is following suit and more detailed environmental reporting will be expected more broadly.

The proposed reporting requirement

Proposed Recommendation 7.4 of the draft Principles and Regulations is that:

"A listed entity should disclose whether, and if so how, it has regard to economic, environmental and social sustainability risks."

The Guidelines apply to all ASX listed issuers. They are not mandatory; however issuers who do not follow the recommendations are required to explain why not. The commentary suggests that, in part, the purpose of more detailed economic, environmental and social sustainability disclosures is to allow investors to properly assess investment risk and encourages issuers to disclose the benchmarks they use to measure performance and their achievement against those benchmarks.

Existing environmental and sustainability reporting requirements apply to ASX listed issuers

> Feedback from clients at ISS cross-market roundtables has identified that clients[23] do not seem to be comfortable with any approach that could give companies incentive to seek out markets with low governance standards. Listing rules and a jurisdiction's corporate governance framework could be seen as just another arbitrage advantage point, just like tax havens or countries with lax labour and environmental laws.

The proposed Recommendation would not be the first environmental reporting requirement for Australian issuers, and given its broad nature, compared with existing disclosure requirements, for some issuers it will not significantly change their reporting practices. However, it may encourage issuers to report more widely on how they manage economic, environmental and social sustainability risk.

For issuers subject to any particular and significant environmental regulation, the Corporations Act 2001 requires the annual directors' report to disclose details of an entity's performance in relation to environmental regulation. This requirement, contained in section 299(1)(f), generally applies where a reporting entity holds an environmental licence or is otherwise subject to licence or approval conditions for the purposes of environmental regulation. Reporting for the purpose of the directors' report is expected to be more general and less technical than required for compliance reports to the environmental regulator.

A separate requirement in the Corporations Act, contained in section 1013D(1)(d)(l), is that institutions offering financial products with an investment component disclose, in the relevant Product Disclosure Statement, "the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment".

[23]Institutional Investors

ASX listing rules also require disclosure of information that would have a material effect on the price or value of an entity's securities. This generally applies to information that would influence an investor's decision to acquire or dispose of securities. In some circumstances, this may extend to environmental, social and sustainability performance information.

Examples of environmental or social factors that impact on a company's reputation (if not its financial bottom line), and consequently how its securities are treated by the market and to which disclosure requirements may apply, include:

- significant environmental incidents and how they have been dealt with;
- environmental risks (e.g. risks of pollution incidents) and the measures in place to mitigate those risks;
- the use of sustainably and ethically sourced products; or
- litigation by environmental regulators or community groups.

Generally, the more emphasis that is placed on environmental, social or sustainability performance of a company (e.g. in the company's marketing), the more rigorous the standard of expected disclosure will be. The commentary supporting Recommendation 7.4 suggests that issuers with institutional investors should make more detailed disclosures.

In practice, the more significant issuers in Australia's energy and resources market already report on environmental performance from a legal risk perspective. However, investors are calling for even greater disclosure so that they can assess investment risk.

Changing international regulatory environment

Triple bottom line reporting and corporate social responsibility have been gaining attention globally and locally over the last decade or more. The proposal to introduce Recommendation 7.4 follows international reforms around increased environmental and sustainability reporting in a manner that is integrated with other corporate reporting requirements. In 2007, legislation was introduced in the UK providing for a concept of "enlightened shareholder value"[24]. This requires directors to have regard to the longer term and to various corporate social responsibility factors including the interests of employees, suppliers, consumers and the environment. South Africa, Hong Kong, Singapore and Brazil have also already made reforms[25].

Australian Prudential Regulation Authority (APRA) regulated listed issuers and Risk Management

Together with the Guidelines, listed issuers in the financial services sector also need to meet the mandatory prudential requirements for risk management set out by

[24] Harper Ho, Virginia E. "Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide." (2010).

[25] Baskin, Jeremy. "Value, values and sustainability: Corporate responsibility in emerging market companies." *Available at SSRN 1094573* (2006).

APRA[26] and many APRA regulated listed issuers are also licensed to undertake a financial services business and so are also required to comply with Chapter 7 (Corporations Act 2001) in maintaining their financial services license which has mandatory risk management requirements.

On 9 May 2013, APRA released for consultation changes to risk management requirements that would ensure the consistent application of its risk management requirements across its regulated industries and that reflects its heightened expectations in this area.

The proposed changes[27] are to harmonise risk management requirements for authorised deposit-taking institutions (ADIs), general insurers, life insurers, single industry groups (Level 2 groups) and conglomerate groups (Level 3 groups). This proposed new approach addresses cross-industry risk management prudential standards and an updated cross-industry prudential standard on governance.

Guidelines alignment with APRA

Reflective of APRA's heightened expectations on risk management; APRA is also proposing enhancements to the existing requirements in Prudential Standard CPS 510 Governance. In particular, it is proposing that Boards of regulated institutions establish a Board Risk Committee, to which a designated Chief Risk Officer would be accountable. This is in keeping with the ASX Guidelines.

APRA has stated that its intention for harmonisation and enhancement of APRA's risk management requirements are consistent with the improvements that have been made in risk management practices, locally and globally, in response to lessons learned in the global financial crisis. The proposals are expected to take effect from 1 January 2014**.**

AISC regulated issuers and Risk Management alignment with Guidelines

Together with ASX Guidelines, listed issuers in the financial services sector also need to meet the mandatory requirement introduced by a single licensing regime: the Australian financial services licence (AFSL). An AFSL gives the right to provide financial services and imposes consistent disclosure and conduct rules. Old registration regimes, such as those for insurance brokers, were replaced by the new system. Where capital adequacy is critical, certain providers, notably Authorised Deposit Taking Institutions (ADIs), Insurers and Superannuation Funds, must also be licensed by APRA as noted above. An AFSL may apply to some or all financial services but no matter which services are provided, all licensees must abide by the

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[26]The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. APRA is funded largely by the industries that it supervises. It was established on 1 July 1998. APRA currently supervises institutions holding $4.2 trillion in assets for almost 23 million Australian depositors, policyholders and superannuation fund members.

[27]The proposed cross-industry Prudential Standard CPS 220 Risk Management (CPS 220) consolidates existing risk management standards for insurers and includes some risk management requirements for ADIs that are currently spread across a number of ADI prudential standards. The new standard will not apply in superannuation; Registrable Superannuation Entity (RSE) licensees must comply with the superannuation-specific risk management standard, effective on 1 July 2013.

same licence obligations. There is a range of explicit obligations[28] acting fairly, complying with licence conditions and the law, and maintaining adequate resources (if not also regulated by APRA), risk management systems and competence.

ISS has a policy on governance failures and will, under various circumstances, recommend a vote against members of the board for material failures of governance, stewardship, risk oversight, or fiduciary responsibilities.

Principle 8: Remunerate fairly and responsibly

The remuneration report and advisory vote were 'designed to enhance transparency and accountability in relation to decisions surrounding director and executive remuneration.' Achieving the framework principles of remunerating responsibly and fairly through the legislative measures requiring shareholders have sufficient information to monitor company remuneration (disclosure) and engage with remuneration committees to translate this broad principle into appropriate, company specific practices[29]. The new proposed Recommendation that issuers put in place a policy for the "clawback" of performance-based remuneration from senior executives in certain circumstances, such as where payment of such remuneration was not warranted or there has been a material misstatement of the entity's financial results. The proposed Recommendation also includes disclosure of the policy and any "clawbacks" made (or which should have been made) during the reporting period. The commentary for this recommendation also states that a listed entity should ensure its executive agreements conform to the "clawback" policy and facilitate recoupment of remuneration in accordance with the policy.

The ASX CGC is proposing a new recommendation 8.3 which provides that a listed entity should:

a) have a claw back policy which sets out the circumstances in which the entity can claw back performance-based remuneration from its senior executives;
b) disclose that policy or a summary of it; and
c) disclose at the end of each reporting period:

i) whether any performance-based remuneration has been clawed back; and
ii) where performance-based remuneration should have been clawed back in accordance with the policy but was not, and the reasons for not doing so.

The ASX CGC is seeking to tackle within the Guidelines the concerns that the exposure draft Corporations Legislative Amendment (Remuneration Disclosures and Other Measures) Bill 2012 (which has not passed into legislation) was seeking to

[28] Corporations Act (Cth) 2001 s912A; ASIC, Policy Statement 164: Licensing: Organisational Capacities
[29] ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations (March 2003), 51 (ASX CG Principles 2003). This was the statement extant at the time of the CLERP 9 reforms. This was substantially reworded in the second edition to recommend a clear relationship between remuneration levels and composition (structure) and performance: ASX Corporate Governance Council, Corporate Governance Principles and Recommendations (2007), 35 (ASX CG Principles 2007).

address. The ASX CGC believes that it is more effective to address those concerns in the Principles and Recommendations than to introduce legislation (particularly as the draft legislation was framed on an "if not, why not" basis). If introduced, listed issuers would – to the extent they have not already done so – be required to review their incentive plans to enable the board to claw back performance-based remuneration where appropriate.

> As a matter of policy, ISS considers a claw back policy as a potentially valuable component of any issuer's executive remuneration practices. However, as with many features of contemporary remuneration practices, the devil is in the details. One risk is for a claw back mechanism to be crafted too narrowly such that it is of limited utility to shareholders (i.e. it only would only apply in cases of material misstatements, gross negligence, etc.). In such circumstances, shareholders might question why the offence was not severe enough as to warrant dismissal of the executive. Another risk is for a claw back policy to be worded such that an issuer exposes itself to potential disputes with executives over the legitimacy of any claw back that occurs. In other words, if the (legal) costs incurred by the issuer outweigh the benefits, the claw back mechanism will be of marginal value to the issuer. In practice, performance-based remuneration is easier to claw back if the money has not actually 'gone out the doors' of the issuer. A number of ASX-listed companies have gone down this route, implementing malus provisions such that unvested deferred remuneration may be clawed back or otherwise forfeited prior to vesting. Regardless, shareholders at ASX-listed companies would stand to benefit from the proposal to increase disclosure on this element of remuneration that is contemplated under Recommendation 8.3.

Where to from here?

The amended (third edition) Principles and Recommendations will replace the existing second edition Principles and Recommendations in the first full reporting year after 1 July 2014. As noted above, the new Guidelines are proposed to apply to annual reports for financial years beginning on or after 1 July 2014. Issuers with a balance date of 30 June will be expected to comply with the new recommendations commencing with the financial year ended 30 June 2015 and issuers with a balance date of 31 December will be expected to comply commencing with the financial year ended 31 December 2015.

When reporting, issuers should bear in mind that investors and consumers are increasingly rewarding good corporate environmental, social and sustainable practices. Ultimately, the level of detail for any environment or social sustainability disclosure is not prescribed therefore the decision currently resides with the individual company.

It will be interesting to see whether Recommendation 7.4, if implemented, combined with the changing international regulatory environment, will lead to a change in market practice and more detailed environment and social sustainability reporting by a greater cross-section of issuers.

Appendix A: Background to Risk management

Risk management is a recognised business discipline with a broad supporting infrastructure in academe and professional practice. Development of a sound framework of risk oversight, risk management and internal control is fundamental to good corporate governance (ASX CGC, 2008; ASX Markets Supervision, 2009). The board and the senior management of Australian listed companies have a statutory duty to develop, implement, oversee and report on an effective system of risk management (structures, policies, and procedures and culture) to identify, assess, treat and monitor risk to support achievement of the organisation' s objectives. This is articulated in the ASX Guidelines which are given legal authority by the Corporations Act 2001 (Cth). The services required to support a company's risk management activities can be conducted in house by employees of the company, outsourced to professionals such as accounting practices or other professional consultants or by a combination of internal and external sources.

Formal recognition of risk management can be attributed to a number of factors including major financial and business scandals in the 1980's and 1990's in the U.K, for example Mirror Group, Barings Bank, Polly Peck, Maxwell Corporation (Arena et al., 2010). The first few years of this century provided a further series of high profile corporate collapses internationally (for example Enron, HIH and OneTel), events which could be partly linked to a failure to effectively manage risk (Francis and Armstrong, 2003). More recently we have seen heightened concern and focus on risk management with the advent of the current global financial crisis in 2007 (KPMG, 2010). The Organisation for Economic Co-operation and Development concluded the global financial crisis could be partly attributed to failures and weaknesses in corporate governance arrangements including lack of risk management (Kirkpatrick, 2009). Mikes (2009) observes Chief Executive Officers (CEO) are indicating one of the most importance lessons flowing from the global financial crisis is to make risk management a strategic imperative.

Internationally, regulators have made timely responses to the aforementioned events and enacted legislation and guidelines which have significantly expanded public policy in the corporate governance and risk management arena (Beasley, Clune, and Herrnanson, 2005). The Sarbanes-Oxley Act (SOX, 2002) in the United States (U.S.) and the Combined Code on Corporate Governance (Financial Reporting Council, 2003, 2008) in the U.K. contain key elements requiring public companies to incorporate effective systems of risk oversight.

Appendix B: Summary of Listing Rules Changes

Table 2, below summarises the proposed LR changes and how various LR interrelate together with the changes to the Guidelines and the proposed effective change dates.

Table 2: Listing Rules Changes

Chapter	Listing Rule: LR	Related to:	Effective change:
1	*LR 1.1 Condition 13 – disclosure compliance to the ASX Principles & Recommendations.*	*Relates to Listing Rule 4.10.3*	*1 July 2014*
3	*LR 3.16 – disclosure regarding material terms of directors and officers agreements* *New LR 3.19B – Disclosure of directors and Officers Remuneration via on market purchases of securities.*	*Relates to Listing Rule 10.14*	*1 January 2014*
4	➢ *LR 4.7 – disclosure via a new appendix to the annual report: Appendix 4G* ➢ *LR 4.10 –alternative disclosure via electronic means –company website –URL*	*Relates to Listing Rule 4.10.3*	*1 July 2014*
10	➢ *LR 10.1 – Strengthening the definition of "associate" in terms of related party transactions.* ➢ *LR 10.14 - Strengthening the definition of "associate" in terms of related party transactions in the context of acquiring securities under an employee incentive scheme.* ➢ *LR 10.16 - Strengthening the definition of "associate" in terms of related party transactions.*	*Relates to Listing Rules 10.9 and 19.12*	*1 January 2014*
12	*LR 12.7 – Removes the term "responsibility" in relation to the ASX CGC and the Audit committee.*		*1 July 2014*
14	*LR 14.11- Strengthening the definition of "of "associate" in terms of the Voting exclusion statement.*		*1 January 2014*
19	*LR 19.12- Strengthening the definition of "associate" and disclosure compliance to the ASX Principles & Recommendations.*	*Relates to Listing Rules 4.7, 4.10.3, 10.1, 10.10, 14.11.1 and 19.12.*	*1 January 2014*