Governance Institute of Australia

T +61 2 9223 5744 **F** +61 2 9232 7174
E info@governanceinstitute.com.au
Level 10, 5 Hunter Street, Sydney NSW 2000
GPO Box 1594, Sydney NSW 2001
W governanceinstitute.com.au

15 November 2013

Kevin Lewis and Mavis Tan
ASX Limited
20 Bridge Street
SYDNEY NSW 2000

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

Dear Kevin and Mavis

Proposed changes to ASX Listing Rules and Guidance Note 9: Corporate Governance Disclosures

Governance Institute of Australia (formerly Chartered Secretaries Australia) is the only independent professional association with a sole focus on the practice of governance. We provide the best education and support for practising chartered secretaries, governance advisers and risk managers to drive responsible performance in their organisations.

Chartered secretaries have primary responsibility in listed companies to deal with the Australian Securities Exchange (ASX) and interpret and implement the listing rules. Our Members deal on a day-to-day basis with ASX and have a thorough working knowledge of the operations of the markets, the needs of investors and the listing rules, as well as compliance with the Corporations Act (the Act). Our Members also hold primary responsibility within listed companies for developing governance policies and supporting the board on all governance matters. Their familiarity with the listing rules and their practical implementation has informed the comments in this submission.

Governance Institute of Australia welcomes the opportunity to comment on the proposed changes to *ASX Listing Rules and Guidance Note 9: Corporate Governance Disclosures* (Listing Rule amendments).

Listing Rule amendments

Listing Rule 3.19B

Aligning the interests of directors, executives and shareholders
Director and executive share ownership was introduced in Australia in response to shareholder activism, which sought to ensure that the interests of directors, executives and shareholders were aligned. In the last two decades, the introduction of variable pay, both in cash and in shares and rights to acquire shares, became the favoured model to help align the interests of executives with the interests of shareholders of listed companies. Various governance guidelines issued by shareholder groups call for boards to encourage non-executive directors to invest their own capital in the company or to acquire shares from an allocation of a portion of their fees.

The purchase of on-market shares by listed entities fulfils shareholder demands that directors and executives should have 'skin in the game' without diluting the economic interests of existing security holders.

There are significant difficulties in administering the proposed listing rule, as many entities purchase a block of shares in anticipation of an award to various executives, including but not limited to the CEO. At the time of purchase it constitutes an unallocated pool of shares and it would be impossible to determine how many will be awarded to directors, including the CEO, within five business days of purchase.

Moreover, disclosure already occurs when directors are allocated shares, as listed entities are required to lodge an Appendix 3Y. Accurate information on the allocation to directors of on-market share purchases of securities is also included in the remuneration report.

To illustrate the difficulties attached to determining how many shares will be allocated to directors, the following variations are common:

- Where companies purchase the shares required for employee share plans over a period of time (for example, over a few weeks), regular notices will be required over this period. For example, if a company purchases shares over a 10-day period, then they would need to lodge several notices over that period. This may be confusing for the market, and will certainly add to the administrative burden.
- There may also be share purchases for overseas employees.
- Entities purchase for both employee-purchased shares and company-matching shares.
- The shares can be allocated with a holding lock.
- Some shares do not vest for a certain period.
- Some shares are purchased as part of a DRP.
- Sometimes there are over-purchases or under-purchases that need to be rectified.
- Share plan monthly purchases can be made over five trading days.

The consultation documents do not clarify the policy gain intended by this new disclosure requirement. Governance Institute of Australia Members struggle to find a policy rationale for a new disclosure obligation which repeats the existing listing rule disclosure obligation attached to Appendix 3Y and the existing statutory disclosure obligation attached to the remuneration report. Accountability and transparency are already provided through these mechanisms. It appears that the sole purpose would be to reveal the allocation of the pool of shares purchased on-market to employees in the entity, which information is not relevant to shareholders.

We understand that Ownership Matters is of the view that there is a ‘loophole’ in the Corporations Act in relation to the on-market purchase of shares, and have stated that shareholder approval of such purchases should be sought. It is our view that the proposed listing rule amendment is designed to counter this alleged ‘loophole’ by introducing a disclosure requirement.

Governance Institute of Australia disputes that there is any ‘loophole’ that needs addressing. The consultation document does not provide evidence of poor practice or of a problem that needs addressing or of any ‘loophole’ in the current law.

Given the very real practical issues attached to fulfilling this disclosure requirement, Governance Institute Members are of the view that alternative means of fulfilling awards to directors and executives where performance hurdles have been met will be sought, including payment in cash. Governance Institute queries whether this is in the interests of shareholders.

Moreover, we note that some listed companies currently seek shareholder approval for grants to directors, even though this is not required. The burden of the proposed new disclosure requirement is likely to stifle moves to disclosure generally as companies turn to cash-based awards.

The new listing rule requirement is part of an ongoing regulatory process that makes it increasingly difficult and cumbersome for companies to maintain share-based schemes. Given

that such schemes were originally introduced to bring alignment between director, executive and shareholder interests, by ensuring that directors and executives have 'skin in the game', and that alternative forms of remuneration will be implemented should share-based schemes become too difficult to administer, Governance Institute of Australia Members are of the view that the proposed listing rule is not in the interests of shareholders.

Governance Institute of Australia recommends that the disclosure requirement proposed in Listing Rule 3.19B be deleted. It will be extremely difficult to administer and the governance benefits have not been outlined with sufficient credence to justify its introduction or the costs of administration.

Background and history

We believe it is important to understand the history and background of the current listing rules in order to clarify that this disclosure requirement should not proceed.

When the 2nd edition of the Principles and Recommendations were issued for public consultation at the end of 2006, ASX took the opportunity to also issue a consultation paper on Listing Rule 10.14, noting that this listing rule and the then Principle 9 on remuneration (Principle 9 became Principle 8 in the 2nd edition) were linked and needed to be reviewed simultaneously. Chartered Secretaries Australia, as the Governance Institute of Australia was then called, agreed with ASX that the review was required and commended ASX for clarifying the connection.

Governance Institute of Australia Members are of the view that it is worth considering how ASX set out the issues in its 2006 consultation paper on Listing Rule 10. Accordingly, we have attached an extract from the consultation paper, covering paragraphs 97—107 on pages 21—23, as Attachment A. We have also attached the Exposure Draft of Listing Rule amendments issued in 2004, which sets out the policy rationale for Listing Rule 10.14, as Attachment B. The policy rationale clarifies that the intent of the listing rule is to ensure that shareholders of an entity are given the opportunity to approve any dilution of their holdings by the issue of securities to related parties.

Our Members responded to the 2006 consultation by noting that much of the confusion with respect to Listing Rule 10.14 had arisen as a result of proxy advisory groups seeking to use Listing Rule 10.14 as a means for shareholders to set directly some aspects of executive remuneration. We also noted that shareholders currently approve the total amount of non-executive directors' fees under Listing Rule 10.17 and that no further shareholder approval should be required where directors choose or a company requires directors to take some part of their fees in shares purchased on-market.

On this basis, we recommended that Listing Rule 10.14 should be redrafted to state more clearly that the only acquisitions of securities by directors under employee incentive schemes that require shareholder approval are those involving an issue of new shares (or, in the case of executive directors, an issue of options and/or performance rights that will ultimately result in the issue of new shares if performance hurdles are met), and not those involving the on-market purchase of existing shares. A copy of our submission is attached as Attachment C.

We also noted that companies should, of course, continue to be required to address in their remuneration reports the particulars of their share plans, including the policy behind the adoption of the share plan and the relationship between the policy and the company's performance.

ASX did not amend Listing Rule 10.14 as hoped and Ownership Matters has continued to advocate that shareholder approval of the on-market purchases of securities by or on behalf of

employees or directors should be required, even though they do not dilute the economic interest of existing security holders.

We are of the view that it is important to consider the history of the amendments to Listing Rule 10.14, because it is germane to the proposal to introduce a new disclosure requirement in Listing Rule 3.19B, requiring listed entities to disclose any securities purchased on-market by or on behalf of employees and directors. Any comment on this proposed new Listing Rule cannot be understood without historical context.

Recommendations

Our prime recommendation is that the proposed disclosure requirement in Listing Rule 3.19B be deleted.

However, should ASX decide that a disclosure requirement should proceed, Governance Institute of Australia recommends that it be amended to:

- include a starting date of 1 July 2014 — the proposed timeframe for commencing this new reporting regime is too tight (1 January 2014), particularly if its application is as broad as outlined in the Exposure Draft. This is not simply about allowing companies more time to prepare for the changes. More importantly, given that many companies run share plans from 1 July to 30 June, a 1 July 2014 start would allow companies to consider the implications of Listing Rule 3.19B when they set up their plans, rather than having to start complying with a new rule halfway through a plan
- reflect that purchases may be transacted over a period longer than five business days and that disclosure would be required at the conclusion of the purchases rather than at the time of each purchase.

Associate definition (19.12), 10.14, 10.16 and 3.19B

The definition of associate is used in multiple locations throughout the Listing Rules.

We are the view that it is not appropriate to add the 'related party' definition (as a blanket rule) every time the term 'associate' is used.

Governance Institute of Australia has prepared an analysis of the changes proposed in relation to these provisions, which is set out in Appendix A and explains the rationale for our views.

By way of summary:

- **Governance Institute agrees** that 'associate' should be defined in the Listing Rules by reference to ss 12 and 16 of the Corporations Act (rather than ss 13 and 15 to 17 of the Corporations Act)
- **Governance Institute does not agree** with the inclusion of 'related party' in the Listing Rules' definition of 'associate'
- **Governance Institute does not agree** with the substitution of the term 'related party' for the term 'associate' in Listing Rule 10.14 (and queries the equivalent change in Listing Rule 10.16), and
- **Governance Institute does not support** the introduction of new Listing Rule 3.19B (see our earlier comments); however, if it is to be introduced, the term 'related party' should be deleted and replaced with the term 'associate'.

Listing Rule 4.10(3)

Governance Institute of Australia Members approve of the proposed changes to the Principles and Recommendations and listing rules that provide for the corporate governance statement to be posted to the website, rather than included in the annual report.

Governance Institute of Australia strongly supports the requirement that oversight of the corporate governance statement continue to be a board responsibility, and recognises that it would be inappropriate to have the preparation and publication of the corporate governance statement delegated to management without such board oversight remaining in place.

However, we are of the view that Listing Rule 4.10(3) requires redrafting. The current drafting does not provide for the fact that many boards have delegated the oversight role to a relevant committee, such as a corporate governance committee.

Governance Institute of Australia recommends that the second bullet point on page 8 should be redrafted to state that the corporate governance statement must also 'state that it has been approved by the board of the entity or relevant committee of the board (in the case of a trust, the board or relevant committee of the board of the responsible entity of the trust)'.

Chairman's box: Listing Rule 14.2.3.B

Governance Institute of Australia Members realise that Listing Rule 14.2.3B — usually referred to as the 'chairman's box' — is not included in the proposed changes to the listing rules on which ASX is currently consulting. However, they are strongly of the view that it is opportune to refer to the challenges this listing rule presents, as it is hoped that those challenges can be addressed at this time.

The chairman's box is problematic. The vast majority of undirected proxies that are lodged, particularly by retail shareholders, appoint the chairman as their proxy. Their choice to appoint the chairman as their proxy to vote on their behalf is a vote of confidence in the chairman and the board, yet the chairman's box is misunderstood by many shareholders. The evidence from listed entities and their share registrars is that up to two-thirds of shareholders do not tick the box, even though they give their undirected proxies to the chairman, clearly expecting the chairman to vote them. By prohibiting the chairman from voting the undirected proxies unless the shareholder has also ticked the chairman's box, these shareholders are disenfranchised.

The *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* introduced amendments to the Act (s 250BD) prohibiting KMP and their closely related parties from voting undirected proxies on remuneration-related resolutions. The amended Act provided an exception to the prohibition on voting undirected proxies on remuneration-related resolutions to the chairman of the meeting where the shareholder expressly provided the chair with the authority to do so. However, there was an anomaly in the Act which prohibited the chairman from voting undirected proxies on the remuneration report even where there was express shareholder authorisation. This meant that while the chairman was able to exercise undirected proxies on remuneration-related resolutions (other than the remuneration report and the spill resolutions) with shareholder consent, there was no corresponding carve-out for the vote on the remuneration report or the spill resolution.

The *Corporations Amendment (Proxy Voting) Act 2012* was passed in June 2012 to clarify that the chairman of an annual general meeting (AGM) can also vote undirected proxies on the non-binding resolution to adopt the remuneration report and on a spill resolution where the shareholder provides the chairman with express authorisation to do so. That is, the Act ensured

that the chairman is able to exercise undirected proxies on all remuneration-related resolutions, including the remuneration report and the spill resolutions.

There are a number of ways in which voting forms may be drafted to effect express authorisation. Voting forms provide clear, prominent and express wording on the voting form to the effect that the shareholder authorises the chair to vote in accordance with the chairman's clearly stated voting intention, unless the shareholder indicates otherwise, or include clear, prominent and express wording on the voting form to the effect that, unless the shareholder indicates otherwise by ticking either the 'for', 'against' or 'abstain' box, the shareholder will be authorising the chair to vote in accordance with the chair's clearly stated voting intention. No matter which approach is taken, the meeting materials and voting forms provide clear statements as to how the chairman intends to vote undirected proxies.

Importantly, there has been no adverse feedback from ASIC on the voting forms used in the 2012 and AGM season and now being issued for the 2013 AGM season, which do not contain a box that shareholders must tick in order to provide express authorisation to the chairman to vote undirected proxies on remuneration-related resolutions. The outcome is that, on remuneration-related resolutions, shareholders are not being disenfranchised as they are on ASX resolutions that require a chairman's box to be ticked.

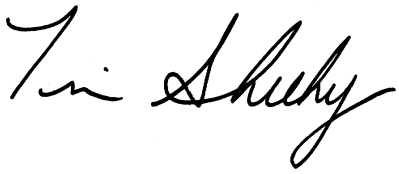
Governance Institute of Australia further notes that a signed proxy form is an authorisation. Given that voting forms already specify to shareholders that they are required either to vote for or against resolutions set out in the notice of meeting or give their undirected proxy to the chair, and also indicate how the chair will exercise undirected proxies, clarification has already been provided to shareholders wishing to appoint the chair as their proxy as to how those votes will be cast. At present, given that the majority of shareholders do not tick the chairman's box when they appoint the chair as their proxy, their capacity to exercise their voting rights is constrained.

Governance Institute of Australia recommends that ASX delete the requirement that a chairman's box appear on voting forms.

Governance Institute of Australia further recommends that listed entities be required to include words on the voting form advising how the chairman intends to exercise all undirected proxies on all resolutions so that shareholders are not in doubt as to how their undirected proxies will be voted.

We wish to meet with you to discuss our recommendations in further detail, in particular our Members' strong concern with the proposed disclosure requirement in Listing Rule 3.19B.

Kind regards



Tim Sheehy
Chief Executive

Appendix A: Analysis of proposed changes relating to associate/related party

Key: Related party/associate references highlighted in yellow

Governance Institute of Australia makes the following high level observations in relation to the terms 'associate' and 'related party' in the proposed Listing Rule changes:

- Governance Institute agrees that 'associate' should be defined in the Listing Rules by reference to ss 12 and 16 of the Corporations Act (rather than ss 13 and 15 to 17 of the Corporations Act)
- Governance Institute does not agree with the inclusion of 'related party' in the Listing Rules' definition of 'associate'
- Governance Institute does not agree with the substitution of the term 'related party' for the term 'associate' in Listing Rule 10.14 (and queries the equivalent change in Listing Rule 10.16), and
- Governance Institute does not support the introduction of new Listing Rule 3.19B (see our earlier comments); however, if it is to be introduced, the term 'related party' should be deleted and replaced with the term 'associate'

More detailed comments are set out below, including recommended changes to the proposed provisions (see middle column).

Proposed ASX amendment	Recommended provision	Reason for recommendation
LR 19.12 — Definitions		
'associate' has the meaning given in ss 12 and 16 of the Corporations Act. Section 12 is to be applied as if it was not confined to associate references occurring in Chapter 6 of the Corporations Act and on the basis that the entity is the 'designated body' for the purposes of that section. When used in relation to a director or officer of the entity or of a child entity, the term 'associate' also includes a related party of that director or officer.	*'associate'* has the meaning given in ss 12 and 16 of the Corporations Act. Section 12 is to be applied as if it was not confined to associate references occurring in Chapter 6 of the Corporations Act and on the basis that the entity is the 'designated body' for the purposes of that section. ~~When used in relation to a director or officer of the entity or of a child entity, the term 'associate' also includes a related party of that director or officer.~~	The definition of associate is used in multiple locations throughout the Listing Rules. **It is not appropriate to add the 'related party' definition (as a blanket rule) every time the term 'associate' is used.** **If the ASX has specific policy reasons for applying new obligations or restrictions on related parties of individuals (where they currently do not apply), the ASX should specify this change in the particular Listing Rule.** The term 'associate' impacts on a large number of transactions and circumstances because it

Proposed ASX amendment	Recommended provision	Reason for recommendation
		applies to every voting exclusion in LR 14.11. **By way of example:** Currently, if an individual investor buys shares in a company X, they and their associates (broadly speaking, people acting in concert with them or 'controlled' by them) cannot vote on LR 7.1 or 7.4 approval resolutions; however no such prohibition applies to their family members (unless they are 'acting in concert' or 'controlled' by them). What is the new policy reason for prohibiting family members from voting in such circumstances, particularly if they may be adult independent children or estranged family members?
LR 14.11 — Voting exclusion statement		
If a rule requires a notice of meeting to include a *voting exclusion statement, the notice of meeting must contain a statement to the following effect: The entity will disregard any votes cast on a resolution by: • the (named) person (or class of persons) excluded from voting; and • an associate of that person (or those persons). *Note: For the purposes of this rule, 'associate' has the meaning given in rule 19.12.*		The proposed revised Note to Listing Rule 14.11 will work ***provided that*** the definition of 'associate' is amended to remove the reference to 'related parties' for individuals (as recommended above). If ASX keeps the related party concept, the application of 14.11 would require careful review in each case.
LR 10.14 — Approval required to acquire securities under an employee incentive scheme		
An entity must not permit any of the following persons to acquire securities under an employee incentive scheme without the approval of holders of ordinary securities of the acquisition.	An entity must not permit any of the following persons to acquire securities under an employee incentive scheme without the approval of	This Listing Rule currently applies to associates of directors only (not related parties).

Proposed ASX amendment	Recommended provision	Reason for recommendation
The notice of meeting to obtain approval must comply with either rule 10.15 or 10.15A. This rule does not apply to securities purchased on-market under the terms of a scheme that provides for the purchase of securities by or on behalf of employees or directors or their related parties. 10.14.2 A~~n associate of the~~ related party of a director of the entity.	holders of ordinary securities of the acquisition. The notice of meeting to obtain approval must comply with either rule 10.15 or 10.15A. This rule does not apply to securities purchased on-market under the terms of a scheme that provides for the purchase of securities by or on behalf of employees or directors ~~or their related parties~~. 10.14.2 An associate ~~related party~~ of a director of the entity.	What is the new policy reason for extending this shareholder approval requirement to related parties (eg, family members that are ***not*** acting in concert with the director)? There is no specific rationale given in the 'Purpose of Amendment'. **By way of example:** The managing director's adult, independent daughter may hold a junior administrative role with a subsidiary of the listed entity and be eligible for a general employee grant of $1,000 tax exempt shares (to be issued by the company to all full-time staff). As amended, the Listing Rules would now require the listed entity to seek shareholder approval at its next AGM for such a grant (or make a one-off purchase of shares on market). The policy for this change is difficult to understand, particularly as the Corporations Act already protects against 'non-arms' length' grants to family members, requiring shareholder approval under Chapter 2E. Note: ASX already has a separate discretion under Listing Rule 10.14.3 to exercise its discretion and extend the shareholder approval requirement to such persons if the particular circumstances warrant it. An additional point is that the last sentence of the first paragraph in Listing Rule 10.14 does not reflect how grants under employee incentive schemes work in practice. The addition of the words '*or their related parties'* does not make sense, as employee incentive schemes

Proposed ASX amendment	Recommended provision	Reason for recommendation
		are only effective under Australian tax laws if offered to employees or directors (and will not be tax effective if offered to family members).
LR 10.16 — No underwriting by directors or their associates/related parties		
10.16 An entity must not permit any of the following persons to underwrite a dividend or distribution plan. 10.16.2 A~~n associate~~ related party of a director of the entity (in the case of a trust, of the responsible entity).	10.16 An entity must not permit any of the following persons to underwrite a dividend or distribution plan. 10.16.2 An associate ~~related party~~ of a director of the entity (in the case of a trust, of the responsible entity).	This Listing Rule currently applies to associates of directors only (not related parties). This proposed amendment is of less concern, but it would be god to know what the new policy reason is for extending this prohibition to related parties (eg family members that are ***not*** acting in concert with the director)? The current explanation simply states that 'ASX considers that this expression better reflects and serves the purpose of Listing Rule 10.16'. Note: ASX already has a separate discretion under Listing Rule 10.16.3 to exercise its discretion and extend the prohibition to such persons if the particular circumstances warrant it.
LR 3.19B — On-market purchases by or on behalf of employees or directors		
3.19B If an entity, a child entity, or anyone else to whom the entity or a child entity has directly or indirectly provided funds for that purpose, purchases securities on-market under the terms of a scheme that provides for the purchase of securities by or on behalf of employees or directors, the entity must give ASX the following information no more than 5 business days after the purchase: • 3.19B.3 If all or any of the securities were purchased on	3.19B If an entity, a child entity, or anyone else to whom the entity or a child entity has directly or indirectly provided funds for that purpose, purchases securities on-market under the terms of a scheme that provides for the purchase of securities by or on behalf of employees or directors, the entity must give ASX the following information no more than 5 business days after the purchase:	If Listing Rule 3.19B is introduced, which we do not support (see our comments earlier in this submission), references to 'related parties' of directors should be removed and replaced with references to 'associates' (for the reasons explained in relation to Listing Rule 10.14 above).

Proposed ASX amendment	Recommended provision	Reason for recommendation
behalf of a director or a related party of a director: • the name of the director; • if they were purchased on behalf of a related party of a director, the name of the related party; • the number of securities purchased on behalf of the director or related party; and • the average price per security at which the securities were purchased on behalf of the director or related party.	3.19B.3 If all or any of the securities were purchased on behalf of a director ~~or a related party of a director~~ or an associate of a director: • the name of the director; • if they were purchased on behalf of an associate ~~a related party~~ of a director, the name of the ~~associate; related party;~~ • the number of securities purchased on behalf of the director or associate ~~related party~~; and • the average price per security at which the securities were purchased on behalf of the director or associate ~~related party~~.	

Attachment A

Review of the Principles of Good Corporate Governance and Best Practice Recommendations

ASX Corporate Governance Council
Explanatory Paper

And

Consultation Paper
2 November 2006

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The proposed changes to the Principles of Good Corporate Governance and Best Practice Recommendations outlined in the Explanatory Paper, Consultation Paper and Exposure Draft represent ASX Corporate Governance Council's collective view of what should be released for public comment and consultation. The material should not be interpreted as representing the final view of any Council member on any issue.

About the ASX Corporate Governance Council

ASX Corporate Governance Council (Council) was formed in August 2002.

The overriding objective of Council is to develop and deliver an industry wide flexible framework for corporate governance that can provide a practical guide for listed companies, to enable them to enhance the transparency of their existing practices and to encourage boards and investors to consider the appropriateness of governance practices for their companies. Following an extensive review of corporate governance issues, Council released its *Principles of Good Corporate Governance Practice and Best Practice Recommendations* (Principles and Recommendations) on 31 March 2003.

The Principles and Recommendations are not prescriptive. If a listed company considers that particular Recommendations are not appropriate to its circumstances, it has the flexibility – under the "if not, why not?" approach - not to adopt them, as long as it explains why. In line with ASX's disclosure focus, listed companies are required to publish a statement in their annual reports on the extent to which they have adopted each Recommendation.

Council brings together representatives of 21 different business, shareholder and industry groups. Each group offers valuable guidance and information specific to their constituencies and industry. These groups are:

- Association of Superannuation Funds of Australia Ltd
- Australian Council of Superannuation Investors
- Australian Institute of Company Directors
- Australian Shareholders' Association
- Australian Stock Exchange Limited
- Business Council of Australia
- CPA Australia
- Group of 100
- The Institute of Chartered Accountants in Australia
- Investment and Financial Services Association
- National Institute of Accountants
- Securities & Derivatives Industry Association
- Australasian Investor Relations Association
- Australian Financial Markets Association, (formerly International Banks and Securities Association of Australia)
- Australian Institute of Superannuation Trustees
- Chartered Secretaries Australia
- Financial Services Institute of Australasia, (formerly the Securities Institute of Australia)
- Institute of Actuaries of Australia
- Institute of Internal Auditors Australia
- Law Council of Australia
- Property Council of Australia

Introduction: What this Explanatory Paper and Consultation Paper is about.

Review of the Principles

1. When Council released the Principles and Recommendations in March 2003 it acknowledged the evolving nature of the corporate governance debate – in particular, the requirements of investors for corporate governance information, and the capacity of issuers to provide this information.[1] Council accordingly committed itself to ongoing review of the Principles from time to time to ensure they remain relevant and appropriate to the Australian business community.

2. After two years of practical experience of the Principles and two years of ASX's review of company disclosures under the Principles in Annual Reports, Council concluded that it was an appropriate time to conduct a review.[2] In addition, a number of discrete developments during the last two years suggest it is time to update and review the Principles. These developments include:

    - Recent legislative and regulatory changes to the Corporations Act and the Accounting Standards which have resulted in overlap and duplication with the Principles
    - Recommendations from two internal reviews undertaken by Council to further improve the Principles and Recommendations.[3]
    - Feedback to Council from users of corporate governance information in its User Survey[4]
    - Understanding of and practices in, and reporting on risk management, both in relation to financial reporting risk and other risks.

3. Over the last twelve months the Council has reviewed the Principles and Recommendations and recommended changes to them.

Proposed changes to the Principles

4. The proposed changes to the Principles are designed to achieve the following:

    - Remove areas of regulatory overlap between the existing Principles and equivalent provisions in the Corporations Act or the Accounting Standards
    - Provide further assistance for companies and investors to better understand the application of certain Principles by merging principles which cover common areas of governance (for example, the merger of Principles 3 and 10)[5]
    - Refine the Principles to take into account internal feedback from Council review groups and feedback from users of corporate governance information
    - Ensure consistent terminology throughout the Principles

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[1] ASX Corporate Governance Council *Principles of Good Corporate Governance and Best Practice Recommendations*, March 2003.
[2] The term "company" is used throughout this document. The term "company" includes all ASX listed entities.
[3] The Implementation Review Group established by the Council undertook two reviews of the operation of the Principles and published two reports *Principles of Good Corporate Governance and Best Practice Recommendations Report to the ASX Corporate Governance Council 31 March 2004* and *Second Report to the ASX Corporate Governance Council February 2005*.
[4] See the *Key findings of the Survey of users of corporate governance information* released on 6 March 2006 at www.asx.com.au/marketsupevision/corporategovernance.
[5] In the Explanatory Paper and Consultation Paper all references to the numbering of the Principles and Recommendations is to the numbering of the current version of the Principles and Recommendations. The numbering will be amended when the Principles are re-issued. Appendix 1 to this paper contains a Comparative table of changes to the Principles and Recommendations.

- Provide greater clarity and remove possible ambiguities in certain Principles.

What has not changed?

5. A number of fundamental things have not changed.

6. The membership of Council remains unchanged and it continues as a group of 21 different business, shareholder and industry groups, each offering valuable guidance and information specific to their constituencies and industry.

7. The Council remains committed to the Principles as "non-prescriptive" Principles designed to improve the efficiency, quality and integrity of Australian corporate governance practices. The "if not, why not?" approach remains central to the philosophy of the Council, and the Principles are supported by the ASX Listing Rules.

The contents of the Explanatory Paper and Consultation Paper

8. The paper is divided into two parts.

9. Part A outlines and explains the proposed changes to the Principles and Recommendations. A Comparative table of changes to the Principles and Recommendations is at Appendix 1. The details of the changes are attached in an Exposure Draft, in both unmarked and marked amended versions to enable the reader to consider these changes.

10. Part B deals with the concept of material business (non-financial) risks and also discusses whether Council has a role in relation to "sustainability" / "corporate responsibility" (CR)) and if so whether Principle 7 should include additional reporting requirements in relation to these risks.

11. Council will use responses to this Paper to finalise the Principles and Recommendations. These responses will also assist Council in determining:

    - The content of any updated guidance in relation to reporting on other "material business risks" under Principle 7
    - Whether Principle 7 should contain a specific recommendation requiring the disclosure of material business risks and, if so, how the recommendation should be drafted.

Why you should consider this Explanatory Paper and Consultation Paper

12. Input from listed companies, investors and other stakeholders on the changes to the Principles and Recommendations will assist Council in ensuring that they remain relevant and useful.

13. Two recent public inquiries have asked companies, investors and other stakeholders to respond on the subject of CR.[6] The subject matter of Part B differs from the scope of these two inquiries in that Part B addresses the specific issue of sign-offs relating to systems for managing "material business risks" which are not the subject of financial reporting obligations, currently set out in the proposed Recommendation 7.3 and the issue of whether there should be reporting against these risks. If stakeholders believe that Council has a role in

[6] The Corporations and Markets Advisory Committee received a reference in March 2005 and issued its Discussion Paper *Corporate Social Responsibility* in November 2005 at http://www.camac.gov.au/CAMAC/camac.nsf. The Parliamentary Joint Committee announced its Inquiry into Corporate Responsibility in June 2005 and released its Report *Corporate Social Responsibility: Managing risk and creating value*, June 2006 at http://www.aph.gov.au/senate/committee/corporations_ctte.

relation to "sustainability" / CR risk reporting, Council wants feedback on what it can do to assist companies to report usefully on their risks in this area. Council also wants to know what the impact of its involvement in this area could be on listed companies and investors. Feedback on the matters addressed in Part B will help Council determine what role, if any, it undertakes. No other inquiry has considered these practical issues.

14. Feedback on the issues raised in Part A and Part B will provide valuable assistance to Council in resolving the issues raised in this document.

15. The deadline for comments is Friday, 9 February 2007.

16. All submissions will be regarded as public documents and may be made available on the ASX website unless there is a specific request that all or part of a submission be regarded as confidential. If feedback is to be treated confidentially, it will be aggregated with other responses.

Closing date for submissions: Friday 9 February 2007

Submissions can be sent via email to regulatorypolicy@asx.com.au

Submissions can be posted to:

ASX Regulatory and Public Policy Unit
Level 7, 20 Bridge St
Sydney NSW 2000

Telephone queries: 02 9227 0874.

PART A: CHANGES TO THE PRINCIPLES AND RECOMMENDATIONS

Background to the review

17. After two years of practical experience of the Principles and two years of ASX's review of company disclosures under the Principles, Council concluded that it was an appropriate time to conduct a review. In addition, a number of developments during this period suggest that it is time to update and review the Principles. These developments include:

- There has been a number of recent legislative and regulatory changes: the amendments to the Corporations Act in CLERP 9 in 2004, the implementation of the Financial Services Reform Act 2001 and the recent review of over-regulation.[7] The CLERP 9 legislation and the Accounting Standards on remuneration disclosure were not final at the time the Principles were released and areas of the Principles now overlap with the Corporations Act and the Accounting Standards. Recommendations 4.1 and 6.2 are now largely captured in Sections 295A and 250RA of the Corporations Act. Material in Recommendation 9.1 is now captured in the Corporations Act and the Accounting Standards.[8] Recommendations 4.1, 6.2 and 9.1 have been removed to reduce overlap[9]
- There has been a wide range of practical experience in applying the Principles to the circumstances of listed entities since their release. Two internal reviews conducted by the Council also have resulted in a range of recommendations to Council to improve the Principles[10]
- Council commissioned a survey of users of corporate governance information which indicated a number of ways in which companies could improve their reporting of corporate governance information[11]
- Three reports on corporate governance disclosures by listed companies released by ASX have provided Council with information on areas of difficulty for companies.[12] Council also has considered other factors in its review, including feedback from ASX's Markets Supervision which deals with listed companies and market commentary such as analyses of listed companies' disclosures and practices by professional firms and others
- There have been a number of recent developments in the understanding of and practices in risk such as the revised Basel II framework[13]

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[7] See *Corporate and Financial Services Regulation Review* Consultation Paper, April 2006. See also the ASX Submission on the Consultation Paper at http://www.asx.com.au/about/regulatory_policy_unit.

[8] The position of listed companies not subject to the Corporations Act will be specifically addressed in the Principles. See below.

[9] CLERP 9 introduced a new section 295A [Declaration in relation to listed entity's financial statements by chief executive officer and chief financial officer] into *Part 2M – Financial Reporting* of the *Corporations Act*. The directors' declaration under s295(4) can now only be made once the directors have received a declaration from the CEO and CFO, or equivalents that: (a) the financial records have been properly maintained, (b) the financial statements comply with Accounting Standards and (c) the financial statements and notes give a true and fair view. Section 250RA [Auditor required to attend listed company' AGM] of the *Corporations Act* makes it an offence for the lead auditor not to attend a listed company's AGM, or arrange to be represented by a suitably qualified member of the audit team who is in a position to answer questions about the audit. Section 300A [Annual directors' report – Specific information to be provided by listed companies] of the Corporations Act and AASB 124 (*Related Party Disclosures*). See also Chapter 2 of the Department of Treasury's 'Corporations and Financial Services Regulation Review', April 2006. See also AASB 124 *Related Party Disclosure*.

[10] See Note 3 above.

[11] Op cit.

[12] See *Analysis of Corporate Governance Practices reported in 2004 Annual Reports* and *2005 Analysis of corporate governance practice disclosure* and *2005 Analysis of corporate governance practice disclosures Listed trusts* at www.asx.com.au/marketsupervision/corporategovernance./

[13] See the revised *International Capital Framework* at www.bis.org. The framework, aims to strengthen the soundness and stability of the international banking and finance system through consistent capital adequacy and

- There also has been an evolving debate on reporting on other material business risks, corporate responsibility and sustainability reporting. Sustainability/CR reporting was considered by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) Inquiry into Corporate Responsibility and the Companies and Markets Advisory Committee (CAMAC) Discussion Paper on Corporate Social Responsibility. Council also has considered an approach on the issue of sustainability reporting by the Minister for Environment and Heritage, Senator Campbell as well as the recommendations in the PJC report on CR.[14]

Overview of key issues

Use of the phrase "best practice"

18. The revised draft of the Principles deletes the phrase "best practice". Council considers that use of the phrase "best practice" to describe the Council's Recommendations has been the source of misunderstanding in the wider community since the phrase implies that all other practices, no matter how sensible, are second class. The Recommendations were developed by the Council as a distillation of rapidly evolving global 'best practice'. It was the Council's expectation that the Recommendations would apply to the majority of larger listed companies. However, Council considers the phrase causes unnecessary confusion and concern and recommends that the Recommendations be amended to make it clear that, except where they may duplicate Listing rules or the Corporations Act, the Recommendations are not intended to be prescriptive and that the words "best practice" to describe the Council's Recommendations be removed. Council considers that by making this change listed companies will focus more clearly on how they report on their practices against the Principles and on the quality of their disclosure.[15]

19. The phrase "How to achieve best practice" has been removed from each Principle and the phrase "departures from best practice recommendations" from each "Guide to reporting" at the end of each Principle.[16]

Form of the Principles and Recommendations

20. Council's overall aim in recommending changes to the Principles and Recommendations is to assist companies in making disclosures about their corporate governance practices for the benefit of investors and other stakeholders. Council has therefore recommended changes or clarification in areas where it has feedback or evidence that companies are experiencing difficulties with their reporting or that change to the Principles and Recommendations would be of assistance.

21. Feedback to Council indicates that there is a wide variety of listed entities to which the Principles and Recommendations apply and they need to assist all listed entities. Companies have differing levels of resources available, are at different stages of development and need different levels of assistance. The inherent flexibility of the "if not, why not?" approach allows companies which consider the Principles and Recommendations too detailed, not to follow them, provided they explain why. A detailed approach, as in the current and proposed Principles and Recommendations allows smaller companies to understand the reasons for the Recommendations so that they can better illustrate any alternative method of achieving good corporate governance. On this view, Council's proposed changes to the Principles and

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risk management approaches. It requires financial institutions to assess operating and other non-financial risks as well as financial risk and is based on "Three Pillars".

[14] See Note 6 above.

[15] The deletion of the phrase "best" practice will require a consequential amendment to Listing Rule 4.10. Council will make this recommendation to ASX.

[16] These changes have been made to all the Principles and will not be referred to again in this Explanatory Paper unless the context requires.

Recommendations encourage these companies to adopt alternative approaches to those detailed in the Principles and Recommendations and to disclose the level of detail appropriate to their circumstances.

22. Feedback to Council from ASX indicates that there is a view that the Principles and Recommendations contain too much detail. On this view, a preferable approach would be to restructure the existing material into a document containing a set of high level Principles and an accompanying document describing issues to consider when applying the high level Principles. On this view, the level of detail currently in the Principles and in the changes proposed potentially impairs rather than enhances companies' disclosure. This approach may also assist ASX in its role in monitoring and promoting corporate governance disclosures. Council welcomes feedback and comment on this issue.

23. ASX is seeking comments on this issue at the same time as Council is seeking comments on revisions to the Principles and Recommendations.

Re distribution of material in Principles 8 and 10

24. During the review the structure and content of each of the Principles was reviewed with the aim of ensuring that the recommendations and accompanying guidance were easy to understand and accessible to users. Council considers that some Recommendations are better placed under a different Principle.

25. Council has decided to re-distribute the recommendations and accompanying guidance to Principle 8 - Encourage enhanced performance – between Principles 1 and 2. Council believes the recommendation in relation to performance evaluation processes for management fits better as a separate recommendation in Principle 1. The recommendation about conducting and disclosing the performance evaluation processes for directors is now included in Principle 2 alongside other material about board structures and processes.

26. Council also has decided to re-distribute the content of Principle 10 – Recognise the legitimate interest of stakeholders – between Principles 3 and 7. The material relating to codes of conduct has been moved to Principle 3 in line with the findings of the ASX *2005 Analysis of corporate governance disclosure*.[17] Council considers that the material relating to the need to take a broad range of stakeholders into account, particularly in the context of risk management, fits better into Principle 7 than in Principle 10.

27. The number of Principles is reduced from ten to eight as a result of this re-distribution. The number of Recommendations remains the same following the review.

Listed trusts and collective investment vehicles, especially externally managed entities

28. In the first version of the Principles each Principle, with the exception of Principle 5, included wording designed to provide guidance to trusts about how the Principles apply to their circumstances.

29. As part of the review, Council considered whether the existing wording achieves the desired result of meaningful corporate governance disclosures by this sector. The revised Principles remind companies that the Principles apply to "Listed trusts and other externally managed entities".[18] Council's consultation during the review indicates that this will encourage improved disclosure and will help listed companies with an external manager with their reporting. Council also intends to make it clear in the Introduction to the revised Principles that while there are historical and legal reasons for the current governance practices of these entities, they are a popular investment choice for retail investors. For this reason it is

[17] The report noted that companies were reporting against these recommendations in a way that suggests that Council could provide greater clarity as to the scope of these Recommendations. Op cit at page 11.
[18] This change has been made to all the Principles and will not be referred to again in this Explanatory Paper unless the context requires.

important that collective investment vehicles adopt the spirit of the Principles and provide explanations in relation to governance structures, even where the law does not require this level of disclosure. This policy ensures that investors are provided with sufficient information to understand the governance processes of these vehicles and to form their own opinion as to their suitability.

Listed companies not subject to the Corporations Act

30. There are a number of listed companies that are not subject to certain provisions of the Corporations Act. The proposed removal of Recommendations 4.1, 6.2 and 9.1 from the Principles would result in there being a potential 'gap' in that these listed companies would have no obligations regarding the matters set out in those Recommendations. The potential gap results from the fact that the sections of the Corporations Act and one of the Accounting Standards which have captured the matters set out in those Recommendations do not apply to these companies. [19] These listed companies are: foreign companies listed on ASX (Sections 295A, 250RA and 300A and AASB 124), trusts (Sections 250RA and 300A) and foreign exempt companies (Listing Rule 4.10.3, Sections 295A, 250RA, 300A and AASB 124).[20]

31. Council considers that the vast majority of listed companies will benefit from removing duplications and overlap between the Principles and the Corporations Act and the Accounting Standards. Council proposes to expand the commentary on listed trusts in the Guide to reporting on Principle 6 to make it clear that, where, foreign companies and trusts are not required to hold AGMs, they should consider the range of means by which they may achieve the same ends and should disclose the extent to which they have complied with the section and give reasons for any non-compliance. Council intends to make it clear in Principle 7 that where a listed company is not subject to section 295A of the Corporations Act it should consider the range of means by which it can achieve the same ends and include in its annual report a statement disclosing the extent to which it has complied with the section and provide reasons for any non-compliance. Council also recommends adding additional wording to the end of the section on listed trusts and externally managed entities at the end of Principle 9 to the effect that where a listed company is not required to comply with section 300A of the Corporations Act and AASB 124 it should consider how it can achieve the same ends.

Material on further guidance to the Principles

32. The first version of the Principles contains a range of references to information that gives further guidance to the various Principles. The references to this information will be updated at the end of this review. Where Council considers there is new or additional material that would assist users of the Principles, references to this material will be included. The references will be re-located to the end of the document so as to provide a complete reference guide to the available material. The "Guidelines for notices of meeting" now located at Attachment A in the existing version of the Principles have been revised and updated and will be re-located on the Corporate Governance section of the ASX website at www.asx.com.au.

Small and medium-sized entities

33. Since Council released the Principles there has been discussion about whether the Principles should be modified to assist smaller companies by providing "carve-outs" from the Principles. During its review, Council considered the possibility of modifying the Principles and

[19] See below for the discussion of the various Principles. The relevant sections of the Corporations Act are Section 295A, 250RA and 300A and AASB 124 *Related Party Disclosures*.

[20] There are approximately seven foreign exempt companies which are all subject to the provisions of the United States Sarbanes-Oxley legislation. On this basis Council considers that there is no need to make specific provision for these companies. There is also one listed company incorporated under state based co-operative legislation.

Recommendations for smaller companies and has decided that the Principles and Recommendations should be the same for all listed entities. ASX conducted a market research program among Small to Medium Enterprises (SMEs) and their advisers which found that there was overall support for the Principles, while acknowledging that the independence and audit committee requirements were more difficult for this sector.[21]

34. Council considers that all companies, regardless of size or industry, that have made the decision to raise capital from the public, should provide investors with sufficient disclosure to enable them to assess the quality of the corporate governance policies and processes in place in those companies in which they invest.

35. The revised Principles provide assistance for smaller listed companies which adopt alternative practices from those outlined in the Principles, such as removal of the phrase "best practice". Other changes include recognising that companies may use alternatives to board committees in Principles 2, 4 and 9. Council reminds smaller companies that it is entirely acceptable for them to adopt effective governance practices that differ from the Principles, provided they make appropriate disclosure.

Consistency

36. Council has sought to introduce consistent terminology to lessen potential confusion. For example, terms such as "managers", "key executives" or "senior management" have been replaced by one term "senior executives", unless the text discusses the 'board' as opposed to 'management'. The first edition of the Principles uses "should", "must' and "needs to" interchangeably. The revised Principles use "should". The term 'chairperson' has been replaced by "chair" to align with the Corporations Act.

Overview of key changes by Principle

Principle 1 – Lay solid foundations for management and oversight

37. Principle 1 includes a new Recommendation 1.2; that companies should disclose the process for evaluating the performance of senior executives. This new Recommendation largely reproduces the material relevant to senior executives previously in Principle 8. Council considers that setting out this material in a separate recommendation gives it more prominence than combining it with the material on performance evaluation for directors. The new Recommendation 1.2 also follows better from the discussion of how a company distinguishes between the roles of the board and management. Council considers that this is a clearer distinction from the board than the term "management" which was used previously.

38. Several style changes have been made to Principle 1. The wording of the opening section of Principle 1 has been revised to use the third person as opposed to the second person, for example, "Companies should". The active voice is now used rather than the passive voice. The term "senior executives" is used when talking about individuals in the senior management team to distinguish them from the "board".[22]

Principle 2 – Structure the board to add value

39. Principle 2 is about how to achieve an appropriate balance between achieving a desirable level of board independence and maintaining sufficient relevant experience and competence to enable the board to achieve its objectives. Council recognises the importance to shareholders of director independence and objectivity.

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[21] Companies below the Top 500 are not required to form an audit committee although the Principles require that they disclose how they carry out the functions of an audit committee.

[22] These changes have been made to all the Principles and will not be referred to again in this Explanatory Paper unless the context requires.

40. The opening of Principle 2 has been revised to bring the various components of board structure, particularly the exercise of "independent judgement" into sharper focus. This is at the heart of the changes to the "Commentary and guidance" under Recommendation 2.1. The discussion of "independent decision making" has been given greater prominence at the beginning of the Recommendation.

41. The title for Box 2.1 has been changed from "Assessing the independence of directors" to "Relationships affecting independent status" The reason for this change is that the existence of the relationships in Box 2.1 may, but does not necessarily, affect the capacity to exercise judgement independent of management. The relationships are initial indicators of matters that could affect independent decision making. Boards should use them to trigger questioning when assessing a director's independence and as a framework for disclosure of their reasoning about a determination of independence. Council considers the new title for Box 2.1 "Relationships affecting independent status" makes this clearer. The obligations to disclose relationships of a kind referred to in Box 2.1 remains.

42. The wording of Box 2.1 has been changed to recast the language positively rather than negatively achieving a less 'legalistic' effect. The wording of the second sub-point in Box 2.1 has been clarified. The sixth sub-point in Box 2.1 has been removed as Council considers that directors have an obligation under the law to act in the "best interests of the company", whether or not they are independent. In Council's view length of service on a board is an issue relating to succession which is discussed under Recommendation 2.5 about nomination committees. The seventh sub-point has been elevated in status so that it now appears immediately below the sub-heading "Independent directors" in this Recommendation. Finally, the reference at the end of Recommendation 2.1 to the Higgs Report has been removed. Feedback to Council indicated this reference was confusing due to a tendency to interpret it as meaning that the Principles recommended tenure of ten years for directors.

43. The wording of the recommended composition of the nomination committee in Recommendation 2.4 has been revised to harmonise with the recommended composition of the other board committees, the audit and remuneration committees.[23] The section on the charter for the nomination committee in Recommendation 2.4 has been revised to recommend that the charter include procedures for inviting non-committee members to attend committee meetings. Council believes that it is important for committees to consider having these procedures in place so that committees are not in a position where they could be dominated by uninvited attendees.[24] The Commentary and guidance to this Recommendation has been restructured by reworking the italicised headings to fall into the section of the commentary on "Selection process and re-election of directors".

44. Principle 2 contains a new Recommendation 2.5 dealing with performance evaluation of directors. This largely reproduces material previously situated in Principle 8 with necessary amendments. This new material follows more suitably from the material on "Selection process and re-election of directors". The material appears under new headings "Induction and education", "Access to information" and "The board and the company secretary". Council considers this provides a better indication of the nature of the contents of the Commentary and guidance.

45. The "Guide to reporting on Principle 2" now recommends that where companies do not have a nomination committee, they should describe how they carry out the functions of a nomination committee. By making this change Council provides companies with the opportunity to disclose alternative practices.[25]

[23] Except to the extent that the audit committee should be chaired by an independent director – See Principle 4.
[24] A similar amendment has been made for audit and remuneration committees.
[25] A similar amendment has been made to Principles 4 and 9.

Principle 3 – Promote ethical and responsible decision making

46. The revised Principle 3 includes material previously in Recommendation 10.1. There are several reasons for this change. ASX's 2005 review of corporate governance disclosures by listed companies indicates that a number of companies were unclear about the distinction between Recommendations 3 and 10.[26] The opening section of Principle 3 has been revised to include material previously in Principle 10 that highlights the need for companies to consider their legal obligations and a broad range of stakeholders when making decisions. The new language also reminds companies of the importance of demonstrating a commitment to appropriate corporate practices.

47. Recommendation 3.1 has been revised to make it clear that any code of conduct should be disclosed. This was not clear in the first edition of the Principles. The Recommendation also includes a new sub-point that incorporates the fundamental concept, previously in Principle 10, of companies' complying with their legal obligations and having regard to the expectations of their stakeholders. The revised "Commentary and guidance" under Recommendation 3.1 elevates the principle of the board's responsibility to "set the tone and ethical standards". The commentary also makes the point that senior executives have a responsibility to implement practices consistent with these standards. These concepts were previously in Principle 10 but have been given greater prominence by the revisions.

48. The revised draft also recommends that the code of conduct should apply to directors, senior executives and all employees. However, the Commentary and guidance leaves it open to companies to adopt separate codes of conduct for directors.

49. The revised draft of Box 3.1 –"Suggestions for the content of a code of conduct" represents an amalgamation of the contents of Boxes 3.1 and 10.1. Duplicated material was removed and the various related items were grouped together by subject. The revised point seven deals clearly with "Business courtesies, bribes, facilitation payments, inducements and commissions" as a separate item rather than including it with other material. The revised draft also makes it clear that the Principles recommend that a code of conduct regulates business courtesies and facilitation payments and prohibits bribes, inducements and commissions. These types of situations were previously dealt with implicitly in Box 3.1 under the points relating to "Conflicts of interest", "Corporate opportunities" and "Protection of and proper use of the company's assets" and explicitly in Box 10.1 under "Employment practices" .[27] The revised drafting makes the point explicitly in one location in the document. The revised text of Box 3.1 also refers to "whistleblowers" and the most recent version of the Australian standard.

50. Box 3.2 recommends that the content of a trading policy require "designated officers" to notify an appropriate senior member of the company of intended trading. Trading includes entering into transactions in associated products which operate to limit the economic risk of security holdings in the company. This new wording is directed at "hedging" arrangements.

51. The rationale for awarding equity-based remuneration is that an appropriately designed equity-based remuneration scheme including suitable performance benchmarks aligns the interests of the recipient with the interests of the other shareholders. That is, the recipient's remuneration is 'at risk' - their entitlement to receive the award depends on achieving a performance benchmark. In recent times there have been a number of concerns raised about the practice of "hedging" entitlements under equity-based incentive schemes which has the effect of limiting the economic risk of the recipient's entitlement.

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[26] Op cit at pages 11 and 12.

[27] See "Just how business is done? A review of Australian business' approach to Bribery and Corruption", report by Center for Australian Ethical Research at pages 9 and 12. This report noted the references to these matters in Principle 3 but not in Principle 10.

52. Accordingly, sub-point 8 in Box 3.2 has been amended to clarify that the recommended content of a trading policy should prohibit "entering into economic transactions in associated products which operate to limit the economic risk of security holdings in the company over unvested entitlements". Council's rationale for the amendment is that companies should prohibit these arrangements in relation to unvested entitlements on the basis that such arrangements mean that the entitlements are no longer "at risk".

53. Council also recommends that where vested entitlements are hedged this should be disclosed to the company; so that the company is not in a position where it might inaccurately hold out that any entitlements are "at risk" or that the interests of shareholders and executives are aligned by reason of such holdings.[28]

54. The Guide to reporting on Principle 3 has been revised to require disclosure of the code of conduct or trading policy as opposed to a summary. Council's reasoning is that the use of websites by companies as a means of communication is now the rule rather than the exception. Council considers that companies should display the full text of this document, not a summary.

Principle 4 – Safeguard integrity in financial reporting

55. The previous Recommendation 4.1 which required the chief executive officer/chief financial officer to sign off the financial statements has been removed as this requirement is now captured in section 295A of the Corporations Act.[29]

56. The revised Recommendation 4.1 relating to audit committees has been re-structured to elevate the importance of the concept that where a company does not have an audit committee, it should still have procedures in place that consider the issues that would otherwise be considered by an audit committee. The revised drafting also reminds companies of the importance of disclosing how their alternative approach assures the integrity of the financial statements and the external auditor's independence.

57. The revised Recommendation 4.2 about audit committee composition no longer contains references to transitional arrangements for companies in the All Ordinaries Index as they are no longer relevant.

58. The section of the revised Recommendation 4.2 also clarifies the expertise of audit committee members. After consideration, Council recommends that in the absence of 'safe harbour' legislation, the reference to "financial expertise" …should refer instead to "relevant qualifications and experience".

59. The Guide to reporting on Principle 4 also now includes wording asking companies which do not have audit committees to disclose how the functions of an audit committee are carried out.

Principle 5 – Make timely and balanced disclosure

60. The proposed changes to this Principle are minor. One change involves revising the style of the writing to make it consistent with the style of the other revised Principles. A second change is inserting the words "and disclose" in Recommendation 5.1. The requirement to disclose this policy was implicit in the original Recommendation 5.1 and explicit in the "Guide to reporting on Principle 5".

61. The "Guide to reporting on Principle 5" also now requires that companies disclose their full policy on compliance with ASX Listing Rule disclosure requirements. The reason for this change is the same as that set out for the change in Principle 3 above.

[28] Similar amendments have been made to Principle 9 – see below.
[29] See above. A corresponding amendment has also been made to Recommendation 7.2 – see below.

62. The wording relating to listed trusts was not included in the original version of this Principle and is not been included in the revised draft. The reason for this is that listed trusts' or externally managed entities' obligations under the ASX Listing Rules' disclosure requirements will not differ from listed companies' obligations and the additional reference is unnecessary.

Principle 6 – Respect the rights of shareholders

63. The style of this Principle has been revised to make it consistent with the style of the other revised Principles. The reference to the "Guidelines for notices of meeting" has been changed to make it clear that this document will be available in future on the ASX website. Given the now widespread use of websites as a means of communicating with shareholders and other investors, Council considers listed companies should have websites. For this reason the wording of Recommendation 6.1 has been revised.

64. Recommendation 6.2 has been removed as its provisions are now effectively captured by Section 250RA of the Corporations Act which was one of the CLERP 9 amendments to the Corporations Act in 2004. The commentary in the Box relating to listed trusts and externally managed entities at the end of the Principle has been expanded to make it clear that where a listed company is not required to hold an AGM and therefore there is no formal opportunity for questions to be asked of the auditor, it should consider the range of means by which it may achieve the same ends and should disclose the extent to which it has complied with the section and give reasons for any non-compliance.

65. Principle 6 now includes a new Recommendation 6.2 that companies provide the information indicated in Guide to reporting on Principle 6. This aligns it with the other Principles.

Principle 7 – Recognise and manage risk

66. Principle 7 deals with the framework for identifying, managing and disclosing risks and risk management. Council has identified several major areas of difficulty for companies in relation to the first version of Principle 7. They are:

- The way companies are reporting against Recommendations 7.1 and 7.2
- Confusion about the nature of the risks covered by Principle 7- Is Principle 7 confined to "financial reporting risks" or does it have broader coverage?
- What does the sign-off under Recommendation 7.2 cover and who should provide the various assurances that support this sign-off?

Current reporting difficulties

67. The two internal reviews undertaken by Council during the past two years have concluded that companies were experiencing difficulties with Principle 7.

68. A 2004 KPMG survey of the ASX top 130 companies reported that there were low compliance levels with Recommendation 7.2 relating to management sign-off of risk management and controls. [30] This survey found low compliance levels with Recommendation 7.2. A core group of companies made reasonably comprehensive disclosure under Recommendation 7.2 but most companies provided limited, generic information. A second survey by KPMG a year later showed that companies are "taking a more considered approach to sign-offs and disclosure under Recommendation 7.2", but that there remains room for improvement.[31]

[30] Only 18 per cent of companies disclosed their risk profile and only 32 per cent disclosed a detailed description of the system of risk management and internal control. See *Compliance with the ASX Corporate Governance Council's Recommendation 7.2 in 2004*, KPMG, 2005.

[31] See *Another year on Compliance with Chief Executive/Chief Financial Officer sign-offs under the ASX Corporate Governance Council's Recommendation 7.2*, KPMG 2006 at www.kpmg.com.au at page 5.

69. The ASX review of 2004 Annual Reports found that over 20% of companies did not make an explicit statement of their risk management practices in their annual report. The ASX review of 2005 annual reports showed that while there had been an improvement in reporting against Recommendation 7.2 there is still room for improvement.[32]

70. Council considers that one reason for the low standard of reporting against Principle 7 generally may be that risk management reporting is still a relatively new phenomenon for many companies. To be in a position to report effectively about its risk management and internal control systems – and in particular to identify any material deficiencies in their systems – companies must have undertaken a number of processes. For example, companies must first identify risks, monitor those risks, measure their risk exposure, manage their risks, develop and implement procedures to ensure that their risk management systems are working and finally make decisions about how they will report and whether they will have these reports audited or reviewed.

The scope of Principle 7

71. There has been a number of recent developments in the understanding of risk particularly post-Basel II.[33] They include: publication of the new Committee of Sponsoring Organisations of the Treadway Commission (COSO) enterprise risk management framework and adoption of the revised Australian Standard in relation to risk management.[34] "Risk" is not just financial risk. It includes operational, compliance and strategic external risks. It is also clearly recognised that these other risks can have a significant impact on the financial position and reputation of a company and investor sentiment in relation to the company.

72. More recent guidance such as COSO and the updated AS/NZS4360, referred to in the commentary on Recommendation 7.1, make it clear that all risks can ultimately have a direct or indirect financial impact and must be included even in a financially-focused approach to risk management.

73. Council concluded in May 2005, following an examination of the overlap between Principle 7 and the requirements under the Sarbanes-Oxley legislation, that further guidance was needed to encourage companies to recognise that a sign-off which is limited to financial reporting risks potentially creates a false degree of security as it ignores the potential financial impact on non-financial reporting risks.

74. The company board has ultimate responsibility for risk oversight and for determining the company's risk profile. As part of its oversight, each board will need to determine what risks are "material" for a company of its type and size and how they should be taken into account in the process of sign-off.

75. Council's view is that the term "material business risks" in Principle 7 covers a broad range of risks. This was always implicit in Principle 7. However, the revised draft of Principle 7 makes it clear that "material business risks" can include the following:

    - Financial risks – the risk of a material error in the financial statements

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[32] See *Analysis of Corporate Governance Practices in 2004 Annual Reports*, ASX, May 2005 and also *2005 Analysis of corporate governance practice disclosure*, ASX, May 2006 both at www.asx.com.au/marketsupevision/corporategovernance.

[33] Op cit.

[34] See *COSO Enterprise Risk Management – Integrated Framework*, published by the Committee of Sponsoring Organisations of the Treadway Commission at www.coso.org. See also AS/NZS *Risk Management* and its associated handbook HB436 *Risk Management Guidelines Companies*.

- Other risks, such as operational, environmental, sustainability, compliance, strategic or external, ethical conduct, reputation or brand, technological, product or service quality and human capital which if not properly managed will impact on the company.[35]

76. Council has deliberately avoided using the term "non-financial risks" in the revised Principle 7 as it believes this term is not well understood and there is no commonly accepted meaning. In Council's view using the term "non-financial risks" is likely to increase rather than decrease any confusion as to the scope of Principle 7.

Recommendation 7.1

77. The revised draft of Principle 7 opens with a statement that clarifies the nature of risk management. There is also a discussion of what a company's risk profile should cover. Council considers the discussion of risk profile should be the opening concept in Principle 7 because all of a company's activity relating to risk flows from its risk profile. The revised drafting of Recommendation 7.1 moves through each stage of the risk management and internal control process – risk management policy, risk management and internal control system, internal audit and the risk management committee.

78. The revised Recommendation 7.1 also makes it clear that companies should describe their policies on risk management and internal control. This was implicit but not explicit in the previous version of Recommendation 7.1. As previously, companies are not expected to disclose their risk profile.

79. The Commentary and guidance to the revised draft of Recommendation 7.1 now begins with a discussion of the board's responsibility for establishing the company policy on risk and developing the system of risk management and internal control.

80. The revised draft of Principle 7 incorporates and elaborates on material previously in Principle 10 relating to the link between risk and factors such as compliance with legal obligations and corporate reputation. There is a new section in the Commentary and guidance on "Risk management policy" under Recommendation 7.1 which makes it clear that a company's risk management system should take into account its "legal obligations and the expectations of its stakeholders". Legal obligations include a range of matters such as trade practices and fair dealing laws, environmental protection laws, privacy laws and other relevant legislation. The guidance encourages companies to consider carefully who their stakeholders are. The revised Commentary also reminds companies that effective risk management involves considering "factors which bear upon the company's continued good standing with its stakeholders and the community".

81. The section on internal audit in the Commentary and guidance in Recommendation 7.1 also has been revised to clarify the terminology used. Feedback to Council indicates that the term "chief internal audit executive" was confusing for companies. The revised draft uses the term "head of internal audit". Similarly, the revised draft clarifies that the appropriate reporting line for internal audit is to the audit committee.

Sign-off under Recommendation 7.2

82. Following the release of the Principles in 2003, Council received many requests for clarification of Recommendation 7.2. The G100 prepared detailed guidance which was linked to the Council's own guidance. [36] The original intention of Principle 7 was to capture both financial and "non-financial" or "other material business risks". Council considers that

[35] Some of these other risks which a board includes in a company's risk profile may include sustainability/CR risks or issues. However, Principle 7 only requires these other risks to be addressed insofar as the board determines there is a "material" business risk arising from the issue. See also Part B of this paper.
[36] Available on www.group100.com.au. See also the *Guidance in relation to the interpretation of Principle 7* at www.asx.com.au/marketsupevision/corporategovernance.

companies have not necessarily understood this point. The guidance does however, make it clear that boards have the flexibility to request Recommendation 7.2 declarations on areas relating to "non-financial reporting integrity" controls if they desire. The aim of this flexibility is to encourage management accountability in other risk areas appropriate to the company – and to link the accountability for these areas with the senior executive who has ownership or responsibility for the company's practices. This enables investors to make their own assessment of the company's overall risk management and internal control procedures, based on the company's annual disclosure.

83. The initial guidance on the scope of Recommendation 7.2 was given during a time of uncertainty. The Sarbanes-Oxley legislation was not final and Council was concerned that its guidance should avoid unnecessary complications for companies caught by both Australian and United States governance regimes. There was also recognition at the time that the move towards Chief Executive Officer/Chief Financial Officer sign-off was a significant step for some companies.

84. Council considers that the business community is more attuned to the concept of CEO and/or CFO sign-offs which are now mandated for listed companies for their financial statements under Section 295A of the Corporations Act.[37] The business community also has now had time to consider its risk management approach. In addition, investors have become accustomed to the discussion of other risks included in prospectuses and product disclosure statements.

85. Companies have adopted Principle 7 in a variety of ways. Some have adopted a Sarbanes-Oxley approach to Recommendation 7.2, documenting all the key processes and controls and having in place detailed procedures to test their design and operating effectiveness. Other companies have limited their procedures to obtaining representations or self assessment sign-offs from line management.

86. Council's intention was always that the board received some form of assurance as to the effectiveness of the risk management and internal control system. The section 295A sign-off in the Corporations Act does not require disclosure or sign-off in relation to underlying risk management and internal control. It is not a substitute for the current form of Recommendation 7.2. For this reason Council has considered how to ensure that the reporting in relation to underlying risk management and internal controls is not lost or diminished.

87. Feedback to the Council indicates that, in line with the Council and G100 guidance, board discretion is driving the scope of the CEO and/or CFO sign-off under the current Recommendation 7.2. Advisers suggest that boards which require sign-off against other material business risks may need to consider establishing parallel sign-offs with legal personnel, the company secretariat, human resources, operational executives or others. This sign-off is to ensure that accountability is properly aligned to responsibility and authority.

88. Council has therefore decided to split the existing Recommendations 7.2.1 and 7.2.2 into two separate Recommendations, Recommendations 7.2 and 7.3. The revised Recommendation 7.2 recommends a written statement from the CEO/CFO to the board that the sign-off under section 295A of the Corporations Act is founded on a sound system of risk management and in relation to "financial reporting risks" is "operating effectively in all material respects". Feedback to Council and from advisers indicates that the previous formulation "operating efficiently and effectively" was a source of difficulty for companies. The revised draft Recommendation 7.2 does not contain the word "efficiently". The revised "Guide to reporting on Principle 7" contains an explicit confirmation that the board has received the written statement under Recommendation 7.2.

[37] See the discussion above on Principle 4.

89. A note has been added to make it clear that where a listed company is not subject to Section 295A of the Corporations Act it should consider the range of means by which it can achieve the same ends. The company should include in its annual report a statement disclosing the extent to which it has complied with the provisions of the section during the reporting period and provide reasons for any non-compliance.

90. The new Recommendation 7.3 recommends a written statement to the board from the CEO or equivalent and other responsible senior executives confirming the effectiveness in all material respects of the risk management and internal control system in relation to "material business risks" not covered by Recommendation 7.2. The Commentary and guidance to the new Recommendation makes it clear that the board retains responsibility for oversight of all risks and that each company retains the flexibility to determine management accountability for sign-off of its "other material business risks". The revised "Guide to reporting on Principle 7" contains an explicit confirmation that the board has received the written statement under Recommendation 7.3. The Guide to reporting also explicitly refers to disclosure of any qualified sign-off.

91. The reference to a possible Recommendation 7.4 is the subject of Part B of this document.

Other matters in relation to Principle 7

92. Council intends to revise its existing supplementary Guidance on Principle 7. The form of the updated Guidance will depend on the results of Council's consultation on Part B of this document. However, there are several matters which Council believes should be included in any revised Guidance. They include:

- More detailed discussion of the types of risk management and internal control frameworks that companies may wish to consider – this will be of particular assistance to smaller companies which may have less developed systems of risk management and internal control
- More detailed discussion of the internal audit function – Council acknowledges that there have been a number of developments in this area since the Principles were released and that more information on these issues may be of particular assistance to smaller companies.

Principle 9 – Remunerate fairly and responsibly

93. The opening of Principle 9 has been revised to read more clearly and to remind companies of the need to ensure that there is a clear link between remuneration and performance. The text reminds companies that investors focus on remuneration issues and of the need to balance paying sufficient remuneration to attract talented employees against not paying 'excessively' for their services.

94. The Accounting Standards on remuneration disclosure and the CLERP 9 legislation were not finalised at the time the Principles were released which meant that much of the material in Recommendation 9.1 was not produced elsewhere at the time. During the review of the Principles Council consulted on the content of the existing Recommendation 9.1 and has concluded that it reproduces material now captured by the Corporations Act and the Accounting Standards. [38] Recommendation 9.1 has therefore been removed to reduce overlap.

95. The revised Recommendation 9.1 is now about remuneration committees and the drafting has been revised so that it aligns with Recommendations 2.4, 4.1 and 4.2 relating to other board committees. The material on the design and content of senior executive remuneration packages in Box 9.1 has been moved to Recommendation 9.2.

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[38] See Section 300A [Annual directors' report – Specific information to be provided by listed companies] of the Corporations Act and AASB 124 *Related Party Disclosures*.

96. Recommendation 9.2 is now about distinguishing between the structure of senior executive and non-executive director remuneration. The boxes outlining the recommendations on appropriate guidelines for senior executive and non-executive director remuneration are now included in the same Recommendation. The headings for these boxes are now consistent. Box 9.1 has been revised to refer to "senior executives". Point 3 of Box 9.1 has been revised to make it clear that the Principles recommend that the terms of equity-based remuneration schemes should prohibit "hedging" of unvested entitlements. The Guide to reporting on Principle 9 also includes a reference to this prohibition.[39] The reference to retirement benefits for directors has been removed because, as a result of the Recommendation, the practice rarely occurs.

Recommendation 9.4

97. Recommendation 9.4 currently reads:

"Recommendation 9.4: Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders."[40]

98. Council has considered Recommendation 9.4 for two reasons. The first relates to the actual scope of the Recommendation, as feedback to Council indicates that companies have had difficulties in understanding the disclosures required by this Recommendation. The second relates to issues surrounding Listing Rule 10.14.

Background

99. Recommendation 9.4 implies a need for shareholder approval of equity-based executive remuneration plans. However, neither the Corporations Act nor the Listing Rules currently require shareholder approval for the plans themselves, the issue of securities to employees, who are not directors, or the acquisition of shares by those employees, whether on-market or off-market.

100. The fact that this approval is not required is consistent with the view that it is the board's responsibility, rather than that of shareholders, to satisfy itself that acquisitions are consistent with proper corporate governance arrangements relating to alignment with shareholder interests, management of conflicts of interest and avoidance of insider trading. This is subject to the directors' obligations to report adequately to shareholders, through the remuneration report, on how they have carried out their oversight responsibilities.[41]

101. The position in relation to executives contrasts with the position in relation to directors, whether or not they are also executives.[42] The Listing Rules distinguish between the issue of securities to directors, which requires shareholder approval and the acquisition of securities, which does not require approval in all circumstances. There is currently debate on the width of the exception from shareholder approval for directors. This debate turns on whether

[39] For further discussion of Council's reasoning see above in relation to Recommendation 3.2.
[40] There is no Commentary and Guidance to this Recommendation.
[41] The requirement relating to the remuneration report is in Section 250R of the Corporations Act. The requirement was introduced as part of the CLERP 9 legislation after the Principles were released in March 2003.
[42] Some companies do obtain shareholder approval for issues under these plans to obtain the benefit of the exception for employee incentive schemes under Exception 9 to Listing Rule 7.2, the general requirement for shareholder approval for the issue of more than 15% of shares in any twelve month period. Listing Rule 10.11 contains a general prohibition against the issue of shares to related parties, including directors. Note however that Exception 4 to Listing Rule 10.11 excepts persons receiving shares under an employee incentive plan approved under Listing Rule 10.14.

approval is required only in circumstances where there is a potential dilution or in a wider range of circumstances. The focus of this debate is Listing Rule 10.14.[43]

102. This issue differs from the majority of the issues discussed in this Explanatory Paper in that it is about the content of particular Listing Rules, a matter normally determined by ASX after appropriate consultation, rather than by the Principles. However, ASX is seeking comments in this process on the Listing Rule issue relating to directors at the same time as Council is seeking comments on the issue relating to approval for equity-based executive remuneration plans, which will include executives who are also directors.

Recommendation 9.4 - The position in relation to executives

103. Feedback to Council indicates that companies have had difficulties in understanding the disclosures required by this Recommendation. These difficulties by and large stem from the fact that while Recommendation 9.4 appears to contemplate shareholder approval, approval is not required in the case of executives who are not directors.[44] Council has received feedback both in favour of and against requiring shareholder approval in the case of executives.

104. One approach to clarifying the ambiguity felt to reside in Recommendation 9.4 is to delete the Recommendation on the basis that neither the Corporations Act nor the Listing Rules require shareholder approval in relation to executives. On this approach, shareholders have an opportunity to express their views on remuneration by means of the non-binding vote on the remuneration report. The legislature has made its view clear and, on this view, it is suggested that Council should not be 'second guessing' the legislature.

105. Another approach would be to amend Recommendation 9.4 to clarify that where shareholder approval has been obtained for an equity-based executive remuneration plan, companies should confirm that payments to the executives are in accordance with the thresholds set in those plans. This approach would leave it open to companies to decide whether or not they should obtain shareholder approval. However, companies would be required to disclose on an "if not, why not?" basis whether payments are in accordance with plans approved by shareholders. This approach would not involve moving beyond what the law currently requires but would encourage companies to turn their minds to whether they should obtain shareholder approval.

106. A third approach would be to amend Recommendation 9.4 to clearly recommend that companies obtain shareholder approval for equity-based executive remuneration plans and require "if not, why not?' disclosure as to whether approval was obtained. This approach would involve moving beyond what is currently required by the Corporations Act or the Listing Rules in a situation where, it is suggested, the legislature has arguably made its intention clear.

The position in relation to directors – Listing Rule 10.14

107. The question of whether there should be any exclusion from the shareholder approval requirement in relation to directors under the Listing Rules, whether or not they are also executives, turns on which of the following approaches is preferred:

- There should be no exclusion, because where directors are involved and there is a potential for conflict between the interests of shareholders and the interests of individual directors, this

[43] Shareholder approval is required under Listing Rule 10.14 for directors to acquire shares under employee incentive schemes. However, following amendments to Listing Rule 10.14 at the end of 2005 approval is not required for on-market purchases under the terms of a scheme that provides for purchases of securities by or on behalf of employees or directors.

[44] See above.

conflict should be managed by requiring shareholder approval for any acquisition of securities in the company

- There should be an exclusion based around the fact that shareholder approval should only be required where the acquisition of securities involves dilution of shareholders' existing interests. On-market share purchases do not require shareholder approval because there is no dilution of existing shareholders' interests. This is the current position in relation to Listing Rule 10.14
- There should be a narrower exclusion based on the proposition that shareholders should have the opportunity to approve all share acquisitions by directors, even if they do not result in dilution of existing shareholders' interests, except where the acquisition is pursuant to a salary sacrifice arrangement. This would involve an amendment to Listing Rule 10.14 so that directors are excluded from the exception for on-market share purchases except where they 0are made pursuant to a salary sacrifice arrangement.

Invitation to comment

108. Council welcomes comments and feedback on all or any of the issues raised in this Explanatory Paper and Consultation Paper.

Appendix 1 to Part A

Comparative Table of Changes to the Principles and Recommendations

Existing Principle/Recommendation	Revised Principle/Recommendation
Principle 1 – Lay solid foundations for management and oversight	No change
1.1 Formalise and disclose the functions reserved to the board and those delegated to management	1.1 Companies should recognise and disclose the functions reserved to the board and those delegated to management
Box 1.1 Content of a director's letter of appointment	Box 1.1 Content of a director's letter upon appointment
	1.2 Companies should disclose the process for evaluating the performance of senior executives
	1.3 Companies should provide the information indicated in the Guide to reporting on Principle 1
Principle 2 – Structure the board to add value	No change
2.1 A majority of the board should be independent directors	2.1 A majority of the board should be independent directors
Box 2.1 Assessing the independence of directors	Box 2.1 Relationships affecting independent status
2.2 The chairperson should be an independent director	2.2 The chair should be an independent director
2.3 The roles of chairperson and chief executive officer should not be exercised by the same individual	2.3 The roles of chair and chief executive officer should not exercised by the same individual
2.4 The board should establish a nomination committee	2.4 The board should establish a nomination committee
2.5 Provide the information indicated in Guide to reporting on Principle 2	2.5 Companies should disclose the process for evaluating the performance of the board, its committees and individual directors
	2.6 Companies should provide the information indicated in the Guide to reporting on Principle 2
Principle 3 – Promote ethical and responsible decision making	No change
3.1 Establish a code of conduct to guide the directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any other key executives as to:	3.1 Companies should establish and disclose a code of conduct as to:
3.1.1 the practices necessary to maintain confidence in the company's integrity	3.1.1 the practices necessary to maintain confidence in the company's integrity
3.1.2 the responsibility and accountability of individuals for reporting and investigating reports of unethical practices	3.1.2 the practices necessary to take into account their legal obligations and the expectations of their stakeholders

Existing Principle/Recommendation	Revised Principle/Recommendation
	3.1.3 the responsibility and accountability of individuals for reporting and investigating reports of unethical practices
Box 3.1 Suggestions for the content of a code of conduct	Box 3.1 Suggestions for the content of a code of conduct
3.2 Disclose the policy concerning trading in company securities by directors, officers and employees.	3.2 Companies should establish and disclose the policy concerning trading in company securities by directors, senior executives and employees
Box 3.2 Suggestions for the content of a trading policy	Box 3.2 Suggestions for the content of a trading policy
3.3 Provide the information indicated in Guide to reporting on Principle 3	3.3 Provide the information indicated in the Guide to reporting on Principle 3
Principle 4 – Safeguard integrity in financial reporting	No change
4.1 Require the chief executive officer (or equivalent) and the chief financial officer (or equivalent) to state in writing to the board that the company's financial reports present a true and fair view, in all material respects, of the company's financial condition and operational results and are in accordance with relevant accounting standards	4.1 The board should establish an audit committee Previous Recommendation 4.1 superseded by Section 295A of the Corporations Act.
4.2 The board should establish an audit committee	4.2 The audit committee should be structured so that it: • consists only non-executive directors • consists of a majority of independent directors • is chaired by an independent chair, who is not chair of the board • has at least three members
4.3 Structure the audit committee so that it consists of: • only non-executive directors • a majority of independent directors • an independent chairperson, who is not chairperson of the board • at least three members	4.3 The audit committee should have a formal charter
4.4 The audit committee should have a formal charter	4.4 Companies should provide the information indicated in the Guide to reporting on Principle 4
4.5 Provide the information indicated in Guide to reporting on Principle 4	See 4.4 above
Principle 5 – Make timely and balanced disclosure	No change
5.1 Establish written policies and procedures designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior management level for that compliance	5.1 Companies should establish and disclose written policies and procedures designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at senior executive level for that compliance

Existing Principle/Recommendation	Revised Principle/Recommendation
Box 5.1 Continuous disclosure policies and procedures	Box 5.1 Continuous disclosure policies and procedures
5.2 Provide the information indicated in Guide to reporting on Principle 5	5.2 Companies should provide the information indicated in the Guide to reporting on Principle 5
Principle 6 – Respect the rights of shareholders	No change
6.1 Design and disclose a communications strategy to promote effective communication with shareholders and encourage effective participation at general meetings	6.1 Companies should design and disclose a communications strategy to promote effective communication with shareholders and encourage their participation in general meetings
Box 6.1 Using electronic communications effectively	Box 6.1 Using electronic communications effectively
6.2 Request the external auditor to attend the annual general meeting and be available to answer shareholder questions about the conduct of the audit and the preparation and content of the auditor's report	6.2 Companies should provide the information indicated in the Guide to reporting on Principle 6 Previous Recommendation 6.2 superseded by Section 250RA of the Corporations Act.
Principle 7 – Recognise and manage risk	No change
7.1 The board or appropriate board committee should establish policies on risk oversight and management	7.1 The board should establish policies on risk oversight and management
7.2 The chief executive officer (or equivalent) and the chief financial officer (or equivalent) should state to the board in writing that: 7.2.1 the statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the board 7.2.2 the company's risk management and internal compliance and control system is operating efficiently and effectively in all material respects	7.2 The chief executive officer (or equivalent) and the chief financial officer (or equivalent) should state to the board in writing that the statement given in accordance with section 295A of the Corporations Act is founded on a sound system of risk management and internal control which implements the policies adopted by the board in relation to financial reporting risks, and that the system is operating effectively in all material respects
7.3 Provide the information indicated in Guide to reporting on Principle 7	7.3 The chief executive officer (or equivalent) and other responsible senior executives should state to the board in writing that there is a sound system of risk management and internal control which implements the policies adopted by the board in relation to material business risks other than those covered by Recommendation 7.2, and that the system is operating effectively in all material respects
	7.4 Subject of Part B Consultation paper
	[7.5] Companies should provide the information indicated in the Guide to reporting on Principle 7

Existing Principle/Recommendation	Revised Principle/Recommendation
Principle 8 – Encourage enhanced performance	See Principle 1 Lay solid foundations for management and oversight See Principle 2 Structure the board to add value
8.1 Disclose the process for performance evaluation of the board, its committees and individual directors, and key executives	For senior executives see 1.2 above For directors see 2.5 above
Principle 9 – Remunerate fairly and responsibly	No change
9.1 Provide disclosure in relation to the company's remuneration policies to enable investors to understand (i) the costs and benefits of those policies and (ii) the link between remuneration paid to directors and key executives and corporate performance	9.1 The board should establish a remuneration committee Previous Recommendation 9.1 superseded by Section 300A of the Corporations Act and AASB 124 *Related Party Disclosures*
Box 9.1 Disclosure of remuneration policies and procedures	See Box 9.1 below
9.2 The board should establish a remuneration committee.	9.2 Companies should clearly distinguish the structure of non-executive directors' remuneration from that of senior executives
Box 9.2 Content of executive remuneration packages	Box 9.1 Guidelines for executive remuneration packages
	Box 9.2 Guidelines for non-executive director remuneration
9.3 Clearly distinguish the structure of non-executive directors' remuneration from that of executives	9.3 Companies should ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders
Box 9.3 Guidelines for non-executive director remuneration	See Box 9.2 above
9.4 Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders.	9.4 Companies should provide the information indicated in the Guide to reporting on Principle 9
9.5 Provide the information indicated in Guide to reporting on Principle 9	See Recommendation 9.4 above
Principle 10 – Recognise the legitimate interests of stakeholders	See Principle 3 – Promote ethical and responsible decision making See Principle 7 – Recognise and manage risk
10.1 Establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate stakeholders	3.1 Companies should establish and disclose a code of conduct as to: 3.1.1 the practices necessary to maintain confidence in the company's integrity 3.1.2 the practices necessary to take into account

Existing Principle/Recommendation	Revised Principle/Recommendation
	their legal obligations and the expectations of their stakeholders

PART B: REPORTING OF MATERIAL BUSINESS RISKS AND CORPORATE RESPONSIBILITY/SUSTAINABILITY RISKS

Introduction

1. In 2005 Council undertook a review of Principle 7. The review focussed on reporting of material business risks that are not financial reporting risks - also referred to as "non-financial risks". Material business risks are not normally dealt with under companies' statutory financial reporting obligations. As a result of its review, Council has recommended changes to Principle 7 - see part A above.

2. Council has also considered what role, if any, it should have in relation to reporting of material business risks that are sustainability risks or corporate responsibility (CR) risks. Part B considers this issue.

3. Council's review also takes into account the Inquiry into Corporate Social Responsibility being carried out by the Corporations and Markets Advisory Committee (CAMAC) and the two recommendations made in relation to Council by the Parliamentary Joint Committee on Corporations and Financial Service's (PJC) review of Corporate Social Responsibility.[45] Council's review of material business risks that are sustainability/CR risks also encompasses the September 2005 request by Senator Ian Campbell, Minister for Environment and Heritage (DEH), that Council develop a set of agreed non-financial reporting guidelines, for voluntary compliance on an "if not, why not?" basis.

4. There is currently a range of international and domestic activity around sustainability/CR issues and about the way in which companies report on these issues.[46] To avoid the uncertainties associated with the difficulties relating to definitions of CR and sustainability, and to emphasise its focus on corporate governance, in this paper Council includes CR or sustainability risks in the term "material business risks".

5. Council has decided to undertake public consultation to explore:
   - Whether there is a role for Council in relation to sustainability/CR reporting, given that the Principles relate to governance issues and some sustainability/CR issues may fall outside the scope of the Principles?
   - Whether Council should provide updated guidance in relation to reporting on material business risks that are not financial reporting risks under Principle 7?
   - Whether Principle 7 should contain a specific recommendation requiring the disclosure of "material business risks"? If so, how should the recommendation be drafted?
   - Whether it should recommend to ASX that it consult on establishing a web-based tool for the dissemination of sustainability information, similar to the London Stock Exchange's Corporate Responsibility Exchange?[47]

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[45] CAMAC was asked to report on, amongst other things, whether the Corporations Act should require companies to report on the social and environmental aspects of their activities. CAMAC issued its Discussion Paper *Corporate Social Responsibility* in November 2005 (CAMAC Paper). CAMAC is expected to publish its report in late 2006. The Parliamentary Joint Committee announced its Inquiry into Corporate Responsibility in June 2005 and released its Report *Corporate Social Responsibility: Managing risk and creating value*, June 2006.

[46] Both CAMAC and the PJC acknowledge that while there is an increasing recognition of CR as an issue, the term does not have a precise meaning. The terms "sustainability", "corporate responsibility" and "corporate social responsibility" are used almost interchangeably by a variety of commentators. This Part B uses the term "sustainability/corporate responsibility".

[47] See the PJC Report Recommendation 16 at page 148 ff.

Whether Council has a role in sustainability/CR reporting – a threshold issue

6. While there is no generally accepted definition of the term "sustainability reporting", it is usually described as reporting on "social, environmental and economic performance". It is also sometimes referred to as "non-financial reporting".[48] In Council's view this type of reporting involves reporting on matters that are not necessarily reflected in a company's financial statements, but which relate to information described as "other material business risks" in the revised Principle 7, such as operational matters, human capital, environmental matters, compliance, reputation or brand.[49]

7. Council was formed to develop a framework for disclosure of corporate governance practices. A threshold issue for Council to consider before undertaking any role in relation to sustainability/CR reporting is whether Council has a mandate to extend its activities into this area.

8. In this paper, Council explores whether the Principles framework is an appropriate tool to encourage companies to improve their reporting on sustainability/CR risks under the auspices of material business risk reporting.

9. This paper also considers whether sustainability/CR reporting should be included in the Principles on an "if not, why not basis?"

10. This paper discusses two possible reporting options for Council to consider in relation to sustainability reporting and provides a mechanism for seeking feedback from key stakeholders. Responses to this paper will be taken into account by Council when it determines what role, if any, it should undertake in this area.

Issues Council has considered

11. In Part A of this paper Council has set out its views on the scope of Principle 7. Council considers that the term "material business risks" in Principle 7 currently captures risks that are not "financial reporting risks". Council intends clarifying Principle 7 to describe some of the other types of risks that are captured by Principle 7. While the existing language of Principle 7 states that "material risks include financial and non-financial matters", Council considers that the term "material business risks" provides greater clarity.[50] Council considers that the term "non-financial" is widely used but not well understood and that the term "material business risks" is clearer and easier to understand.

12. If the results of public consultation indicate that reporting on risks relating to sustainability/CR should be incorporated into the Principles and associated guidance, Council believes it is critical that this reporting should be tailored to the specific circumstance of Australian companies. In formulating the criteria for this reporting, Council will take into account companies' existing legal obligations and the need to maintain an affordable cost of capital. Council also is conscious of the need to arrive at an appropriate balance between investor demand for this type of reporting and the increase in the regulatory burden and costs of compliance for companies who would be required to provide sustainability/CR reporting.

13. In considering its role in relation to this type of reporting, Council will bear in mind the introduction of Section 299A to the Corporations Act. This section requires companies to include in the directors' report information members would reasonably require to make an informed assessment of companies' operations, financial position, business strategies and

[48] See the PJC Report at para 2.23 ff.
[49] See Part A above in relation to the proposed new Recommendation 7.3.
[50] Principles at page 44. See also Part A above on Principle 7.

prospects for future financial years. This requirement has the potential to increase sustainability/CR reporting and other disclosures by companies.

Current Reporting Practices

14. The ASX review of 1162 annual reports of companies with a 30 June 2005 reporting deadline showed that some companies already report on sustainability/CR issues in their annual reports.[51] Council notes that the ASX review is limited to a review of reporting in annual reports and that many companies report on sustainability/CR issues in other ways such as a separate report or on their website.

15. Companies currently choose whether to report sustainability/CR information in the context of the Principles, or separately. A number of the top 300 companies report on sustainability/CR issues but not necessarily in the context of a specific Principle. Where companies did refer to a Principle they referred to Principles 1, 3, 4, 7 and 10 or a combination of these Principles.

16. Of the 1162 entities reviewed, 108 annual reports included reporting which falls in the categories: corporate responsibility, corporate social responsibility, sustainability/environmental, community or people reporting. While some entities referred to this type of reporting in the context of a specific Principle, most did not. Of the 1162 entities, 151 were in the Top 300 companies. These companies reported in the categories: corporate social responsibility, sustainability or environmental, community or people.

17. The DEH has undertaken research to monitor the level of sustainability reporting by Australia's largest companies over the last three years. The companies surveyed include ASX listed companies, private companies and unlisted public companies. The third report was released in March 2006 (DEH Report).[52] That report found that of the total 486 companies researched, 119 (24 per cent) produced a "sustainability report" and 295 (61 per cent) were ASX listed companies. Of the 295 ASX listed companies 52 (18 per cent) produced a "sustainability report". This was an increase from 42 ASX listed companies in the 2004 report which was a greater proportional increase than for non-listed companies. "Sustainability reports" are now the most common type of report increasing from 26 per cent in the 2005 report to 37 per cent in the 2006 report and the majority of these reports are "stand alone" reports as opposed to reports produced as part of the annual report or on company websites. Mining and manufacturing companies are most likely to produce sustainability reports.

18. The DEH Report notes that according to the KPMG International Survey of Corporate Responsibility 2005, reporting rates in Australia are lower than many other countries surveyed by percentage of the Top 100 publicly listed companies in each country. The average rate of reporting across the sixteen countries surveyed was 41 per cent compared with 23 per cent in Australia for the S&P/ASX 100. The highest rate of sustainability reporting according to that report occurs in Japan, at 80 per cent followed by the UK with 71 per cent.[53]

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[51] Op cit at page 13. The total number of annual reports reviewed was 1162 which represents approximately 66% of all listed companies at 30 June 2004, the total number being 1638.

[52] *The State of Sustainability Reporting in Australia 2005*, Department of Environment and Heritage, KPMG, Deni Green Consulting Services, March 2006. See also *The State of Sustainability Reporting in Australia 2003* and *The State of Sustainability Reporting in Australia 2004,* Department of Environment and Heritage, KPMG, Centre for Australian Ethical Research and Deni Greene Consulting Services.

[53] Op cit at page 4.The KPMG International Survey is produced triennially.

Additional Compliance Costs for Companies

19. Council considered a range of drivers for improving sustainability/CR reporting. However, Council did not have access to detailed material concerning the possible increase in compliance and reporting costs which companies may experience if they choose to report on sustainability/CR issues.

20. Council invites feedback from companies on this point and encourages companies to consider the two options put forward by Council below, and to provide feedback to Council on the likely regulatory burden and compliance costs resulting from each of these options.

Perspectives on the drivers for better disclosure in this area

21. Council considers both CAMAC's and the PJC's discussion of the various approaches to and drivers for CR/sustainability to be very helpful. The PJC Report also includes a good discussion of the background to "sustainable development".[54] Both reports also provide a great deal of background information on current developments in this area. A range of views on the drivers for better disclosure in this area have been put forward. The World Economic Forum and Business in the Community (UK) have identified economic drivers which underpin the business case for sustainability/CR. Some of the key drivers are:

    - Employee recruitment, motivation and retention
    - Learning and innovation
    - Reputation management
    - Risk profile and risk management
    - Competitiveness and market positioning
    - Operational efficiency
    - Investor relations and access to capital
    - Licence to operate.[55]

22. Using the World Economic Forum and Business in the Community approach, it can be seen that Council's revised Principles 3 and 7 incorporate elements of sustainability/CR. The table below sets out the possible relationship between the eight drivers, and the revised Principles 3 and 7.

Principle	Drivers
Ethical and Responsible Decision making - Principle 3	• Reputation management • Licence to operate • Investor relations and access to capital • Competitiveness and market positioning • Learning and innovation • Employee recruitment, motivation and retention

[54] Op cit at page 7.

[55] Sarah Roberts, Justin Keeble and David Brown, *The Business Case for Corporate Citizenship*, World Business Council for Sustainable Development Economic Forum, http://www.weforum.org/site/homepublic.nsf/Content/Global+Corporate+Citizenship+Initiative\The+Business+Case+for+Corporate+Citizenship and Arthur D Little, *The Business Case for Corporate Responsibility*, Business in the Community (UK), www.bitc.org.uk , quoted in the Business Council of Australia Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Responsibility, October 2005 at page 14.

Risk management – Principle 7 – see also Part A of this Paper	• Risk profile and risk management • Operational efficiency • Competitiveness and market positioning • Employee recruitment, motivation and retention • Reputation management • Learning and innovation • Investor relations and access to capital • Licence to operate

23. Investors in particular point to social, political and economic changes as prompting the need for companies with long-term interests to consider sustainability/CR risks and to inform the market of those risks. These changes relate primarily to meeting stakeholders' concerns and interests. Sustainability/CR reporting is still a developing area and there are fewer widely accepted benchmarks than in respect of other non-financial risks. Equally, the benefits of sustainability/CR reporting are also only just becoming understood.

24. A number of investors, particularly institutional investors are increasingly demanding sustainability/CR information from companies. They point to the trend towards "permanent share ownership" by superannuation funds as highlighting the need for greater reporting of longer term risks, such as sustainability/CR risks. There are also recent superannuation fund and investment bank initiatives that demonstrate heightened interest in sustainability/CR issues:
    - Some superannuation funds are embedding sustainability considerations into their investment process, either generally or by allocating a percentage of their investments on the basis of sustainability strategies
    - Large investment banks are looking at the potential impact of sustainability issues on long-term shareholder value in some sectors
    - Some fund managers are considering factors such as human capital performance as an indicator of longer term company performance.

25. Studies have examined the link between sustainability/CR issues and investment outcomes and a consensus is emerging that taking sustainability/CR issues into account does not detract from investment performance. In Australia research by AMP found that companies that act in a socially responsible way outperform those that fail to do so by more than three per cent a year.[56]

26. In addition to historical studies a number of surveys of analysts and other market participants show that the manner in which companies approach sustainability/CR issues is beginning to be considered a "leading indicator" as to their performance. Current work in this area suggests a growing appetite for information on sustainability/CR issues:
    - A 2006 survey of 282 market participants concluded that analysts in the Asia Pacific, including Australia, were more likely to rate corporate governance and transparency as very important or extremely important when making a recommendation about a company compared with their North American counterparts [57]

[56] Dr Ian Woods, AMP Capital Investors, *New Frontiers in Extended Performance Reporting*, John V Ratcliffe Memorial Lecture 2005

[57] *Return on Reputation Corporate Reputation Watch 2006*, Hill & Knowlton, March 2006 at www.hillandknowlton.com

- A survey of 157 investment management firms from around the world, found almost three-quarters (73 per cent) of the managers predicted that social and/or environmental corporate performance indicators would become mainstream investment considerations within ten years. The proportion of managers expecting increased client demand for the integration of environmental, social and corporate governance ESG) analysis into mainstream investment processes is 13 per cent in the coming year, rising to 38 per cent over the next three years [58]
- The Enhanced Analytics Initiative is a group of asset managers and pension funds, representing assets under management of US$920 billion which aims to encourage investment research that considers the impact of extra-financial issues on long term company performance. Under the Initiative, participants allocate a minimum of five per cent of their annual broker commissions to research firms that best analyse the extra-financial material and intangible issues that can affect a company's or sector's performance. This extra-financial material largely focuses on "sustainability".[59]

27. One other recent development which may also increase the demand for sustainability/CR information is the UN *Principles for Responsible Investment*.[60] These Principles talk about ESG issues and encourage investors to incorporate these types of issues into their investment analysis and decision making processes. While a small number of Australian superannuation funds are currently signatories to these Principles, Council anticipates this number is likely to grow.[61]

The PJC report

28. Council has considered the PJC's Report and its recommendations concerning Council activity. The PJC referred to four possible options Council was considering pursuing.[62] Council has decided not to pursue two of the options referred to by the PJC: incorporate a standardised reporting framework or await the results of the PJC and CAMAC inquiries. Council considers that it is premature to adopt a standardised reporting framework in Australia and notes that the PJC concurs with this view. Given that the PJC has now reported and that CAMAC's discussion paper contains a very full discussion of the issues, Council considers there is little benefit to be obtained by further delaying its own consultation on these issues.

29. Council has particularly considered PJC Recommendation 10. This proposes that Council provide additional guidance to Principle 7 that companies should "inform investors of the material non-financial aspects" of their risk profile "by disclosing their top five sustainability risks (unless they demonstrate having fewer)".[63] In the discussion preceding this recommendation, the PJC refers to "long term risks, such as those posed by environmental and social risks".[64] Council considers that these are some of the sorts of risks that are within the current scope of Principle 7 and as clarified in the way Council recommends in Part A.[65]

30. For the reasons stated above, Council considers that it is preferable to use the term "other material business risks" to embrace sustainability/CR risks. Council also notes that the current version of the Principles already capture some aspects of sustainability/CR

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[58] See *2006 Fearless Forecast What do investment managers think about responsible investment?,* March 2006 at www.merceric/knowledgecenter/reportsummary
[59] See www.enhanced-analytics.com
[60] *Principles for Responsible Investment*, April 2006 at http://www@unipri.org.
[61] See also the discussion in Chapter 8 of the PJC Report and Recommendation 22 – op cit at page 141ff.
[62] Op cit at page 127 discussing the evidence of the Chair of the ASX Corporate Governance Council.
[63] Op cit at page 132.
[64] Loc cit.
[65] See Part A above on Principle 7.

reporting under Principles 3, 7 and 10. This remains the case following Council's recommended changes to Principles 3 and 7.[66] Companies have the flexibility to regard "environmental and social risks" as "other material business risks" under Principle 7.

31. The PJC discussion leading to its Recommendation 10 contemplates that companies "self identify" the sustainability risks of greatest importance to them and their strategies to manage those risks, on the basis that this allows a large degree of flexibility.[67] Council considers that flexibility is important given the diverse nature of listed companies in terms of their governance practices, the nature of their businesses and their size. It is the recognition of the need for flexibility, tempered by the requirement to explain why, that underpins the Principles. However, Council considers that asking companies to self identify a specific number of risks is potentially unworkable and may lessen rather than increase disclosure.

32. Council's reasons for not supporting the PJC recommendation that listed companies self identify their top five sustainability risks and their strategies to manage those risks are as follows:

    - Companies may be reluctant to identify their top five risks because this potentially exposes directors or others to liability if their priorities prove to be wrong, for example, what if the sixth ranked risk ultimately proves to be more damaging than any of the top five identified?
    - Any top five risks will relate to a point in time, because the risks faced by any business will be constantly changing and evolving. As such, any top five risks could be considered an arbitrary list
    - Companies may have legitimate reasons for not disclosing certain risks; for example, reasons relating to commercially-sensitive information. In these sorts of situations, subject to the requirement for companies to make disclosure under Listing Rule 3.1, Council considers that it is unrealistic to expect companies and their boards to make these sorts of disclosures.[68]

What options are open to Council?

33. If Council considers, on the basis of this consultation, that it has a role in sustainability/CR reporting, there are two possible options Council could pursue. The first could involve the release of voluntary guidance only. The second could involve a new Recommendation requiring additional disclosure about other material business risks. More detail on these options is set out below. Council invites comment on the threshold question of whether there is a role for Council in relation to sustainability/CR reporting and any other issues raised in this Part B including the two options described below.

Options considered by Council

Option	Key Points
A	Council releases voluntary additional guidance in the context of Principle 7 with no additional reporting obligations for companies.
B	Council introduces an additional "if not, why not?" reporting requirement in Principle 7 with guidance, involving additional reporting obligations for companies.

[66] Council considers that the re-distribution of material from Principle 10 between Principles 3 and 7 means that the most likely areas where companies will consider these issues is under the revised Principles 3 or 7.
[67] Op cit at page 131.
[68] This notion is recognised in the "carve outs" that exist under the Listing Rule 3.1 relating to continuous disclosure.

Option A

Council releases voluntary additional guidance to Principle 7 with no additional reporting obligations for companies

34. Council could release guidance to Principle 7 on sustainability/CR issues including accountability for those issues and promote voluntary reporting on other material business risks included in the risk profile against Principle 7 and information on the strategies to manage those risks.

35. If this option is implemented it could be reviewed, for example in two years time, to assess its impact and to reconsider whether there is a need to move to an "if not, why not?" reporting requirement. The guidance would emphasise the importance of recognising and managing other material business risks, including sustainability/CR risks, and the desirability of reporting on a company's performance and activities in these areas.[69] For the reasons outlined above Council would not propose including a reference to a particular number of risks in this Guidance.

36. There would not be a specific reporting recommendation beyond the existing Principles. The guidance would be provided to encourage, but not mandate, that companies provide greater reporting in relation to their other material business risks, including sustainability/CR risks, and the way in which they are addressing them. This approach would clearly explain to companies that reporting is entirely voluntary and be clear about what companies are expected to report.

37. The guidance could include:

- some suggested topics or issues the company may wish to take into account
- practical guidance in relation to the development of practices in relation to reporting on other material business risks including sustainability/CR and suggested methods of reporting or presentation
- references to guidance currently available in this area.

Arguments identified in favour of Option A:

38. Encouraging companies to be more rigorous, even on a voluntary basis, in their reporting on their risk management practices will alleviate some of the reported difficulties with companies' reporting on risk.[70]

39. There would be no additional reporting obligations for companies under this option. The guidance would be voluntary and outside the "if not, why not?" framework. This approach would therefore limit the regulatory and financial costs imposed on companies and allows companies to distinguish themselves in the market by the manner in which they approach these issues.

40. There is evidence that companies benefit from being transparent about the practices which they have adopted. It is desirable that the benefits of this sort of reporting are recognised more widely by companies so that they demonstrate to the broader community the true extent to which they are aware of, and act on, these matters. Transparency on these issues provides investors and others with reassurance that companies are accountable for their practices.

[69] The revised Guidance to Principle 7 would also include the additional matters outlined in Part A above such as more detailed discussion on risk management and internal control frameworks and the internal audit function.
[70] See Part A above on current reporting on Principle 7.

41. The emphasis would be on cultural change and on companies developing practices that best suit their operations.

Arguments identified against Option A:

42. Council's role should be restricted to providing guidance on corporate governance only. Regardless of the merits of sustainability/CR reporting, this may not be Council's role.

43. Guidance, in the absence of an "if not, why not?" framework, may not go far enough to encourage companies to turn their minds to the issue of reporting on other material business risks, and sustainability/CR reporting. This option may not improve companies' risk management reporting.

44. Conversely, even without a reporting requirement, there may be some concern that an obligation is created to report in this area or that this is what the market expects.

45. Even "guidance" is likely to result in increased compliance costs and regulatory burden to companies.

Option B

Council introduces an additional "if not, why not?" reporting requirement under Principle 7, with guidance, involving additional reporting obligations for companies

46. Council could introduce a new Recommendation in Principle 7, including a reporting requirement on material business risks that covers sustainability/CR risks. At a minimum, this would require companies to address their minds to all "material business risks" facing the company. If this option is adopted Council would envisage that companies currently reporting this information in stand-alone reports or on their websites would be able to provide a cross reference to the location of this information in the corporate governance section of their annual report.

47. If this option is adopted the new Recommendation 7.4 could include the following:
    - A recommendation that companies disclose their other material business risks and the steps they are taking to manage those risks
    - Commentary and guidance to the effect that:
        a. Material business risks are determined by the company's board. They will include the risks set out in the company's risk profile
        b. Some companies will have a number of material business risks and may choose to disclose these risks with reference to one or more developed frameworks.

48. Under Option B, Council could also release updated guidance to Principle 7 which would be in similar terms to the updated guidance proposed under Option A.

Arguments identified in favour of Option B:

49. An "if not, why not?" model means that the recommendation is not mandatory, but would ensure that companies which are not currently considering these issues do consider them at board level and disclose the practices they have adopted to take their circumstances into account.

50. The benefits to investors and to companies in providing additional information about risks relating to sustainability/CR reporting and the benefits or increased transparency are considered above.

51. Improving the level of information available will enable investors to compare reporting on risk between companies.

52. Requiring companies to separate and identify their risks including those relating to sustainability/CR issues ensures that these issues are not "buried" as relevant risks. This would be in line with the continued growth in local and global recognition of the potential for risks relating to sustainability/CR issues to pose material risks to company performance.

Arguments identified against Option B:

53. As is the case with Option A above, Council's role should be restricted to providing guidance on corporate governance only. Regardless of the merits of sustainability/CR reporting, this may not be Council's role.

54. A recommendation, even though it is an "if not, why not?" one, may promote form over substance reporting or "greenwashing" where companies are not active in this area.

55. Many companies refer to the concept of a "journey" when referring to their experiences with sustainability/CR. They note progress towards sustainable corporate behaviour is an evolutionary process, which requires flexibility to respond to changing stakeholder expectations and benchmarks for disclosure.[71] In addition, a number of these frameworks are still evolving so that this option may be premature.

56. The recommendation would result in an additional regulatory burden for companies, with associated compliance costs and is likely to be perceived as subjecting them to further "red tape".

57. Including a new reporting requirement potentially broadens the information currently disclosed under the Principles. The scope of the framework contained in the Principles relates to reporting in relation to corporate governance principles and recommendations – that is, the practices whereby corporate entities govern themselves, particularly the relationship between shareholders, management and directors. While reporting on some sustainability/CR issues is covered by the Principles, reporting on a number of other sustainability/CR issues may fall outside the scope of the existing Principles.

Establishing a web-based tool for the dissemination of sustainability information

58. The PJC recommended that ASX, in consultation with companies, investors and rating agencies, establish and operate a central web-based tool for the dissemination of sustainability information, based on the London Stock Exchange's Corporate Responsibility Exchange.

59. The LSE's Corporate Responsibility Exchange (CRE) was set up in October 2004 with a systems update completed in June 2006.[72] It forms part of the LSE's commercial business and is not seen as a supervisory or disclosure activity. The pricing regime involves charging users, mostly listed companies, a basic annual fee and additional fees for extra functions. The intention was that the CRE assist listed companies deal with the "questionnaire fatigue" of responding to the many different surveys and information requests by buy-side investors, analysts and agencies. Take-up however, remains lower than planned.

60. The reporting mechanism on the CRE website required development of a data taxonomy; negotiating, building and implementing this framework appears to have taken considerable effort. In addition, it appears that different agencies have sought different

[71] See the PJC Report at page 40 ff.
[72] See www.londonstockexchange.com/en-gb/products/irs/cre/

data in various formats on a wide range of CRE topics, which required the negotiation of agreed solutions and the building of an additional web-based tool.

61. A similar, though less extensive, web-based service operated in Melbourne until mid-2004 at www.sustainabilityreporter.com. The service allowed listed companies to lodge sustainability reports online without a fee and without the complexity of a common taxonomy or reporting framework. About a dozen listed companies participated. The service received modest support from State and Federal Governments and some superannuation groups.

62. Council welcomes feedback on whether it should recommend to ASX that it consult with listed companies and others regarding the establishment of a web-based tool as a means of disseminating sustainability information.

Request for Comments

63. To enable Council to refine its views, Council invites comments on any of the issues raised in this part of the paper.

64. In particular, Council invites comments on the following:

General

1. Is there a role for Council in assisting companies to report on risks relating to sustainability/CR? Why do you say that?

2. Of the two options presented for better reporting on sustainability/CR risks captured by Principle 7 which is your preferred option? Why is that your preferred option?

3. Do you consider that there are other areas of the Principles where Council should provide further guidance in relation to sustainability/CR issues, for example Principle 3? What areas are these and why?

For listed companies

4. If you are a listed company what sort of information would you anticipate disclosing under:
   - Option A - Council releases voluntary additional guidance to Principle 7 with no additional reporting obligations for companies?
   - Option B – Council introduces an additional if not, why not?" reporting requirement under Principle 7, with guidance, involving additional reporting obligations for companies?
5. If you are a listed company what is the likely impact on your company resulting from the options outlined above? Please describe this impact.

6. If you are listed company is there likely to be an increased regulatory burden on your company resulting from the options outlined above? Please describe any increased burden.

7. If you are a listed company what are the estimated costs including compliance costs to your company resulting from the options outlined above? Please describe these costs.

8. If you are listed company are you in favour of posting sustainability information on a web-based exchange? Would you be willing to pay an annual fee for using such an exchange?

For investors

9. If you are an investor what sort of information would you anticipate receiving under:
   - Option A?
   - Option B?
10. How would you use the information disclosed under Option A or B?
11. If you are an analyst or investor would you access information on a web-based exchange? In what format would you require this information?

Invitation to comment

Council welcomes comments and feedback on all or any of the issues raised in this Explanatory Paper and Consultation Paper.

Attachment B

Section 6

MATTERS RELATING TO ISSUE OF SECURITIES TO RELATED PARTIES

Rules considered in this section: rule 7.2 exception 7A, 10.12 exception 3A, 10.13, 10.1 & 10.18

COMMENTARY

6.1 Listing rule 7.3.1 states that a notice of meeting to obtain security holder approval for the purposes of listing rule 7.1 must state the maximum number of securities the entity is to issue (if known) or the formula for calculating the number of securities the entity is to issue. Listing rule 10.13.2 does not make equivalent provision for a maximum number of securities to be stated in a notice of meeting to obtain security holder approval for the purposes of listing rule 10.11. It is proposed to amend rule 10.13.2 to be consistent with rule 7.3.1.

6.2 The policy rationale of listing rule 10.14 is to ensure that shareholders of an entity are given the opportunity to approve any dilution of their holdings by the issue of securities to related parties. The terms of many share plans provide for the securities to be acquired on market as opposed to being issued by the entity, and where the purchase is funded by salary sacrifice.

6.3 Waivers have been commonly granted from listing rule 10.14 where existing shares are being acquired on-market for related parties, on the basis that this approach does not result in dilution of existing holdings and nor does it result in securities being acquired on advantageous terms. It is therefore proposed to amend the rule to provide a carve-out for those types of circumstances.

6.4 It is also proposed to delete listing rule 10.18, which deals with termination payments payable to an officer in the event of change of control. ASX considers this is not a matter for the Listing Rules as takeover matters are dealt with in Chapter 6 of the Corporations Act.

LISTING RULE AMENDMENTS

LISTING RULE 10.13.2

Proposal

6.5 Listing rule 10.13.2 be amended as follows

Requirements for the notice of meeting under rule 10.11

10.13 The notice of meeting to approve the issue of +securities must include each of the following.

...

10.13.2 The **maximum** number of +securities to be issued (if known) or the formula for calculating the number of securities to be +issued to the +person.

...

Introduced 1/7/96. Origin: Listing Rule 3E(8)(a)c. Amended 1/7/98, 1/7/2000, 30/9/2001, #/#/####.

Cross reference: Rule 7.2 exception 14, which requires an additional statement in the notice of meeting in order to rely on that exception.

Purpose of Amendment

6.6 The amendment is proposed to be consistent with listing rule 7.3.1.

LISTING RULE 10.14

Proposal

6.7 That listing rule 10.14 be amended as follows.

Approval required to acquire securities under an employee incentive scheme

10.14 An entity must not permit any of the following +persons to +acquire +securities under an +employee incentive scheme without the approval of holders of +ordinary securities of the +acquisition. The notice of meeting to obtain approval must comply with either rule 10.15 or 10.15A. **This rule does not apply to securities purchased in the ordinary course of trading on ASX under the +terms of a scheme that provides for the purchase of securities for employees by way of salary sacrifice.**

Note: Salary sacrifice includes incentive payments.

See revised amendment

10.14.1 A director of the entity.

10.14.2 An associate of the director.

Note: The relevant interpretation of "associate" for the purposes of this rule is the interpretation in section 11 and sections 13 to 17 of the *Corporations Act*. *Section 13 is to be applied as if it was not confined to associate references occurring in Chapter 7.*

10.14.3 A +person whose relationship with the entity or a +person referred to in rules 10.14.1 or 10.14.2 is, in ASX's opinion, such that approval should be obtained.

Introduced 1/7/96. Origin: Listing Rules 3E(8)(a)d., 3W(10). Amended 1/7/2000, 30/9/2001, ##/##/####

Example: An acquisition of securities by a director's private company is caught by this rule.

Note: Where a single person who fits into a category of persons covered by the rule is to participate in a scheme which is an employee incentive scheme for the purposes of the rule, the entity must seek approval under this rule.

The issue of shares following the exercise of options which have been issued under an employee incentive scheme is not regarded as the acquisition of securities under the scheme.

Purpose of Amendment

6.8 The amendment is proposed to provide a carve-out for circumstances where securities acquired for related parties under an employee incentive scheme are acquired on market, and so do not compromise the policy rationale for the rule.

LISTING RULE 10.18

Proposal

6.9 That listing rule 10.18 be deleted.

Attachment C

CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

27 March 2007

Malcolm Starr
General Manager, Regulatory and Public Policy
Australian Securities Exchange
Level 7
20 Bridge Street
SYDNEY NSW 2000

Dear Mr Starr

Listing Rule 10.14

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. We are an independent, widely respected influencer of governance thinking and behaviour in Australia. Members of CSA regularly deal on a day-to-day basis with Australian Securities Exchange (ASX) and have a thorough working knowledge of the operations of the markets, the needs of investors, the law and the Listing Rules.

Reasons for CSA submission on Listing Rule 10.14

CSA recently lodged a submission with the ASX Corporate Governance Council on its Exposure Draft of the revisions to the *Principles of good corporate governance and best practice recommendations* (the Principles). In the Exposure Draft, questions were raised in relation to Listing Rule 10.14 in conjunction with questions raised in relation to Recommendation 9.4 of the Principles.

In its response to the Exposure Draft of the revised Principles, CSA noted that it would make a separate submission to the ASX on Listing Rule 10.14,.

CSA recommendations in relation to redrafting of Listing Rule 10.14

CSA believes that the role of shareholders in approving certain equity issues is widely supported by all sections of the market. CSA also believes that the market widely supports the principle that executive remuneration is primarily the responsibility of boards, with shareholders given the right to comment on executive remuneration through the non-binding vote on the remuneration report and ultimately through their decision whether to elect or re-elect particular directors. Much of the confusion with respect to Listing Rule 10.14 has arisen as a result of proxy advisory groups and others seeking to use Listing Rule 10.14 as a means for shareholders to set directly some aspects of executive remuneration.

CSA also notes that shareholders currently approve the total amount of non-executive directors' fees under Listing Rule 10.17 and that no further shareholder approval should be required where directors choose or a company requires directors to take some part of their fees in shares purchased on-market.

On this basis, Listing Rule 10.14 should be redrafted to state more clearly that the only acquisitions of securities by directors under employee incentive schemes that require

shareholder approval are those involving an issue of new shares (or, in the case of executive directors, an issue of options and/or performance rights that will ultimately result in the issue of new shares if performance hurdles are met), and not those involving the on-market purchase of existing shares.

Companies should continue to be required to address in their remuneration reports the particulars of their share plans, including the policy behind the adoption of the share plan and the relationship between the policy and the company's performance.

CSA recommendations in relation to a Guidance Note for Listing Rule 10.14

CSA recommends that ASX issue a comprehensive Guidance Note on Listing Rule 10.14 to clarify the Listing Rule's intended application. (CSA notes that, in December 2006, ASX issued Guidance Note 25 on the exercise of its discretions in relation to the Listing Rules, including Listing Rule 10.14, but that Guidance Note 25 does not address the issues raised here.)

CSA recommends that the Guidance Note:

- confirm that the only circumstances under which the ASX *requires* listed companies to obtain shareholder approval for share issues to directors is where the proposed allotment is of new shares as distinct from the on-market purchase of existing shares

- confirm that the underlying ASX philosophy for the approval requirement is a combination of :
    - protection of other shareholders whose shareholdings (as a percentage of issued capital) may be diluted by such 'new' issues and
    - protection of shareholders where directors may have a conflict of interest in approving such plans and share issues

- confirm that there may be special circumstances in which companies seek shareholder approval for their share plans, for example, Listing Rule 7.1, so that shareholders are not confused when they are asked to approve a particular share plan but not others.

CSA would welcome the opportunity to review a draft of such a Guidance Note and provide ASX with feedback from CSA members.

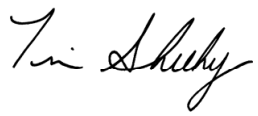
Conclusion

CSA recommends that:

- Listing Rule 10.14 be redrafted to clarify the precise nature of its intended application, and
- a Guidance Note be issued on Listing Rule 10.14 to clarify the underlying philosophies and particular interpretations that will be applied under certain circumstances.

In preparing this submission, CSA has drawn in particular on the expertise of its national Legislation Review Committee, comprising members working in listed companies with the responsibility to interpret this Listing Rule.

Yours sincerely



Tim Sheehy
CHIEF EXECUTIVE
cc Eric Mayne