Submission to ASX Corporate Governance Council

Comments on Draft 3rd Edition

I congratulate the Council on its initiative to update the 2nd Edition of the Principles and Recommendations which have generally served the listed company sector well for the past decade. In my judgement, as an experienced public company director and chairman, the "if not, why not" approach has proven to be resilient, adaptable and effective.

Many of the changes proposed in the draft 3rd Edition are commendable. I will comment here only on the changes and wording which I believe should be reconsidered by the Council. I will also make a couple of stylistic comments in the interests of ensuring the readability and general appeal of the document.

Relocation of Sections

I believe all the proposed relocations make good sense.

Recommendation 1.2(a)

I query the necessity for this paragraph. It states the obvious. Moreover, it little recognises the extensive due diligence which the great majority of listed companies undertake before choosing a director candidate. This due diligence is hardly captured in the words "undertake appropriate checks". The basic "checks" mentioned in the Commentary should, of course, be undertaken if there is any reason for concern about a candidate, but the due diligence on the suitability of a director candidate goes well beyond these basics. I would delete the paragraph. If it is retained, I would suggest that it be reworded to say "undertake appropriate due diligence before appointing …"

Recommendation 1.3

I query the appropriateness of mandating a "written agreement with each director … setting out the terms of their appointment". This connotes a more formal legal contract than the previous Commentary which referred to "formal letters upon appointment … setting out the key terms …". The proposed new wording suggests the need to set out all relevant terms, and I don't this is practicable. Preferable wording would be "a letter of appointment … setting out the key terms of their appointment".

Moreover, director's terms of appointment are governed by the Corporate Constitution and the Company's Act which would override (where necessary) any contrary provision of a written "agreement". A director's relationship to the company is not in the nature of a contract with the company.

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A further problem with the new wording is how the term "senior executive" is to be interpreted. How far down the organisation should it go? In my view the Recommendation should not extend beyond the key management personnel (i.e. those whose remuneration is required to be disclosed in the Remuneration Report).

An alternative wording for the new Recommendation 1.3 might be as follows:

> "A listed entity should provide each director with a letter setting out the key terms of their appointment and should have in place formal employment contracts with its key executives."

The Commentary could then define "key executives" as being KPMs.

Recommendation 1.4

I think the phrase "a direct reporting line" is unclear and apt to create confusion. The previous Commentary (Recommendation 2.5) is reflected in the third paragraph of the new Commentary, and seems to me to set out the more important (and less ambiguous) governance principles (i.e. access to the board and the board's role in appointment/removal).

The problem with the phrase "a direct reporting line" is that it does not make clear who is the company secretary's "real boss". It is generally accepted that the company secretary does not report to the board chairman in the sense that the board chairman determines the company secretary's performance (though they may have input), remuneration, scope of responsibilities, etc. This is, therefore, more in the nature of a "dotted line" relationship. The important notion is that the company secretary has direct access to the chairman and, where appropriate, to all non-executive directors, and vice versa.

I suggest that Recommendation 1.4 be reframed as follows: "The company secretary of a listed entity should have direct access to the chairman and the non-executive directors who should also have direct access to the company secretary. The appointment or removal of the company secretary should be made only after consultation and with agreement by the board".

Recommendation 1.5

The drafting of this Recommendation is cumbersome. See suggestions below.

I query the use of the phrase "important governance ramifications" in the first paragraph of the new Commentary. The rest of the Commentary makes clear that gender diversity is a business performance issue, not a governance issue. The better phrase would, therefore, be … "can enhance business performance".

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Box 2.1

I have great difficulty with the legalistic wording of the first paragraph in the revised Box 2.1.

The important principle is that it is entirely a matter for the board to decide on the independence or otherwise of each director and it a matter for board judgement. It is, therefore, only the board's assessment of materiality of any interest or relationship. It is not a matter for an objective third-party assessment of whether an interest or relationship "might influence, or reasonably be perceived to influence" that independence.

Accordingly, I would suggest this paragraph be deleted. Alternatively it should be reworded to make it clear that it is a matter for the board to judge. Furthermore, the wording is too absolute. The phrase "is free of <u>any</u> interest, position …" must surely be qualified in terms of materiality or likelihood to impair independent judgment. By contrast, the current Box 2.1"s introductory words are perfectly appropriate.

My further objection to Box 2.1 is the inclusion of the 7th dot point relating to years of service. Nine years is a totally arbitrary number. Most companies nowadays have no reference to tenure in their corporate governance statements. This is appropriate because independence is, at the end of the day, a judgement about a director's approach, diligence and mindset, not a function of tenure. The last dot point is even more objectionable when prefaced by the phrase "positions … that might cause doubts about the independence of a director include …". This wording is awkward and suggests bias against longer serving directors. This is inappropriate as many boards discovered during the GFC that they lacked directors with long business memory across the business cycle. Also, the right mix of youth and experience on boards is a matter for each board to consider.

If a statement about tenure is to be made (which I prefer not be made), I suggest the approach and wording used in other jurisdictions is more appropriate; namely, that "boards should undertake a rigorous review of the independence of those directors who have served three or more terms".

Recommendation 2.6

The wording of paragraph (b) is sensible in relation to describing an induction program, but not really appropriate in relation to "providing appropriate professional development opportunities". The nature of ongoing development will vary widely from director to director, company to company and will often be hard to characterise as a "program" comparable to an induction program.

Principle 3

I agree with the consultation paper that it is inappropriate to have a Principle specifically designed around the employment of people with disabilities.

I also believe that the phrasing of the new Principle 3 is grammatically awkward. Even though there is comma after "decision-making", the Principle can be read to suggest that it is only necessary to be ethical where this is consistent with creating value for securityholders. I am sure this is not the intended reading.

Perhaps the Principle should be restated as follows:

> "To create long-term value for securityholders, a listed entity should actively promote ethical and responsible decision-making."

Further, some of the wording in the Commentary is less than ideal. For example, in the first dot point, invoking examples of forced labour or employment of underage workers is not particularly pertinent in the Australian context where such practices would be illegal as well as unethical. Similarly, ensuring a safe workplace may be considered a "human right" at some level, but it is not necessary to invoke "human rights" to say that this is an example of acting ethically and responsibly. Similarly, the phrase "socially harmful activities" and "conflict minerals" are ambiguous and obscure, as is the phrase "local community initiatives". I believe better examples could be chosen. The might include:

- Dealing honestly and fairly with customers
- Creating a safe and non-discriminatory workplace
- Dealing where possible only with business partners who demonstrate ethical and responsible business practices

Recommendation 7.1

This strikes me as a somewhat heavy-handed approach to encouraging boards to give increased attention to risk management, potentially by having a dedicated board sub-committee. (Also, the wording is cumbersome – see comments below.) My comment here is that, unlike the recommendations dealing with the Nominations and the Audit Committees, Recommendation 7.1 adopts the new and somewhat puzzling (also unnecessary) wording in (b) saying that the Risk Committee should have "the responsibilities normally undertaken by a Risk Committee". I submit that this has no meaning as it is not yet usual for public companies (other than banks) to have separate risk committees. Nor do the roles set out in the second paragraph of the Commentary constitute a comprehensive statement of what is "usual". I submit that paragraph (b) is superfluous. It is adequately covered by paragraph (c).

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Recommendation 7.2

I believe that we have lost something important in the new formulation of the proposed Recommendation 7.2. The new 7.2 requires the board to review the entity's "risk management framework with management …". This seems to me to be conceptually and materially different from the former 7.2 which required the concrete steps of a) the board requiring management to implement a risk management and internal control system to manage material business risks, b) requiring management to report whether those risks are being managed effectively and c) for the board to disclose that management has so reported. This is now replaced with less precise wording; namely, to review a "framework". The "framework" is not a precise term and is not as clear a concept as a "system for risk management and internal control". The definition provided in footnote 26 is not particularly helpful in the terms "framework", "components", "foundations" and "organisational arrangements" are less precise than the phrase "risk management and internal control system".

Furthermore, I submit that it is unreasonable to expect the board to "ensure" that new material business risks "remain within the risk appetite set by the board". Many new business risks are caused by external factors beyond the control of the board. These may require a change of strategy, the implementation of new risk mitigation initiatives or a revision of the board's risk appetite, but the board cannot "ensure" (a word courts routinely interpret as meaning "guarantee") that those risks remain within the board's risk appetite.

I submit that this recommendation should be rephrased and should pay more regard to the current 7.2.

Recommendation 7.4

As a general comment, the approach taken in this new Recommendation is sensible, but I wonder if it should come under Principle 3? I submit, however, that the phrase "social sustainability risks" is obscure and probably meaningless. While acknowledging that this recommendation is described in the Consultation document as being "non-prescriptive", the Commentary seems to require disclosure of benchmarks used to measure "social sustainability". At the very least, this term needs clearer definition if companies are to be expected to provide meaningful benchmarks and performance metrics.

I feel strongly that Recommendation 7.4, located where it is, misses the whole point of environmental, sustainability and governance reporting which is about positive business performance and long-term value creation, rather than merely management of risks. The current wording puts ESG disclosure in a negative, defensive context, rather than a positive, proactive context.

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Supplementary Guidance on Principle 7

Is it intended to now withdraw or amend this Supplemental Guidance? There are a few important aspects of that Supplementary Guidance that could well be reflected in the new Commentary, including guidance on what is a material business risk and what is not required to be disclosed.

Principle 8

I find the rephrasing of this Principle quite awkward in that it says that remuneration for directors should be "aligned to the creation of value for securityholders" when it is considered to be good governance that director remuneration is not variable or tied explicitly to the performance in the way that we expect for executive remuneration. Perhaps this Principle needs to be rephrased as follows:

> "A listed entity should pay remuneration sufficient to attract high-quality directors and should design executive remuneration to attract, retain and motivate high-quality senior executives and to align their remuneration with the creation of long-term value for securityholders."

Recommendation 8.2–Guidelines

A few phrases in these Guidelines are awkward. Under "fixed remuneration" what is meant by "taking into account the entity's legal and industrial obligations"? Do we mean "potential director liability"? Similarly, the comments regarding the acceptability of "initial allocation of fully paid ordinary securities" to non-executive directors is confusing. Is this talking about an IPO situation only? Or does it mean it is acceptable whenever a new director is appointed? Surely all such allocations are by definition "acceptable" if approved by securityholders? Why is this "initial allocation" confined to fully paid shares? Why not options? Options are frequently used by cash-strapped, start-up companies to attract and retain quality directors. Since this is the case, I submit that the statement that NEDs generally should not receive options is not appropriate for companies of all sizes.

Recommendation 8.3

I submit that paragraph (c)(2) is unrealistic and should be deleted. It is for the board alone to decide whether remuneration should be clawed back. It makes no sense to suggest that a board would determine that a clawback "should have been" made, but determine not to do so. This is internally contradictory.

Stylistic Comments – Legalistic Phrasing

One of the beauties of the current Principles and Recommendations is that they are, by and large, framed simply in plain English and easy to read. This has, I submit, added to their utility, not only for listed companies, but for corporate governance more generally.

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Some of this simplicity has been lost in the "legislation-like" framing of many of the new recommendations. Examples include 1.5, 4.1 and 7.1. All of these Recommendations have three or four levels of sub-paragraphs, e.g. 1.5(c)(2)(A). This will make citing the Recommendations overly complex for ordinary readers, and will add unnecessary complexity for companies reporting against them.

Most of this complexity is unnecessary. Let me illustrate by reframing Recommendation 1.5 as follows:

> "A listed entity should have a diversity policy and should disclose its policy (or a summary) and, at the end of each reporting period, the measurable objectives set by the board under that policy and the entity's progress towards achieving those objectives. It should also disclose the respective proportions of men and women on the board, in senior executive positions and across the organisation or, alternatively, should disclose the entity's "Gender Equality Indicators" under the Workplace Gender Equality Act 2012."

I submit that such simplification of language would be advantageous in many of the newly framed recommendations.

Company vs. Listed Entity

I further submit that one of the advantages of the current document is that it uses the simple language of "company" rather than the less generic phrase "listed entity". Of course, new draft seeks to extend application to listed trusts and funds. But this is simply a definitional point and could be handled by defining "company" to include all listed entities.

The word "company" is simpler and more familiar to ordinary readers. Again, using the phrase "listed entities" will, I believe, militate against adoption of the Principles and Recommendations by non-listed companies. I think this would be a shame because the boards of many companies that are not listed have over the past decade used the Principles and Recommendations as a guide for their governance policies. I would suggest that the Council give serious thought to reverting to the previous style in this regard.

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Dated: 21 August 2013

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