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Introduction

Regnan is pleased to provide comment on the draft third addition of the ASX Corporate Governance Council's *Principles and Recommendations*.

Regnan provides governance advisory services to institutional investors whose collective holdings represent approximately 4.5% of the S&P/ASX200 as at 30 June 2013. Our mandate has been, and remains, to research, engage and advocate on ESG issues for the benefit of long term and widely diversified investors.

We view the ASX Corporate Governance Council's Principles and Recommendations as a useful tool for listed companies to understand and address investor expectations, and we welcome the ongoing review of this document to ensure it remains sufficiently current for this purpose.

Within this context, we see it as necessary to review and reaffirm the purpose of the *Principles*, and in particular, to clarify that the overarching intent is twofold: to codify governance norms prevailing within established companies for the benefit of less well-established listed entities; and to protect and enhance confidence in listed markets by supporting the continued advancement of governance practice among listed entities.

To this end, we believe it appropriate that the Principles and Recommendations encompass best practice actions *and* strong disclosures. This theme is reflected in our more detailed comments below.

General Comments

Regnan broadly agrees with the proposed changes to the structure and format of the revised Principles, including use of corporate websites for corporate governance disclosures, and incorporating key elements of the commentary into the recommendations themselves, enabling them to stand alone if required. We note, however, that enabling the recommendations to stand alone may diminish the utility of the commentary. Apart from those outlined in the following, we do not believe additional commentary is necessary.

With regard to the question on the new *Principles* imposing undue compliance on listed entities, Regnan considers the revised version has generally got the balance right. Australia's listed entities face competition for capital from other asset classes /investment options. More transparency as delineated by these *Principles* promote confidence in listed markets by enabling investors, such as those who have a purely long-term focus, to make aligned investment decisions.

Principle 1 – Lay solid foundations for management and oversight

Regnan generally supports the proposed changes, but notes that self-reporting on internally generated targets may result in a softening of intent/action in relation to diversity. In relation to Recommendation 1.5 (diversity policy, targets and disclosure), we suggest:

- Diversity targets and their implications for business performance should be disclosed;
- Having identified a gap between current and desired states (targets versus performance) companies should be required to evidence attention to the reasons for these gaps and include more detail on *how* improved performance against targets are being pursued;
- Where the diversity guidelines (from WGEA, sector specific benchmarks expected in October 2014) are utilised, these should be supplemented with broader commentary on the company's diversity performance relative to the wider world, such as statistics on female workforce participation generally, or female graduate levels in relevant disciplines.

Principle 2 - Structure the board to add value

Recommendation 2.5: A listed entity should have and disclose a statement as to the mix of skills and diversity that the board is looking to achieve in its membership.

Regnan supports the changes to Principle 2, however we propose that Recommendation 2.5 stipulate that companies should disclose a skills matrix to investors. We see this as analogous to reporting against numerical targets for other matters (such as diversity) and view it as an important means by which investors can review and assess board composition. Requiring a matrix will help to ensure the avoidance of overarching (and often meaningless) statements about diversity and skills.

Principle 3 – Promote ethical and responsible decision-making

Regnan is concerned that the wording of this Principle suggests that ethical and responsible decision-making remains secondary to the creation of value. It is Regnan's view that in order to maintain adequate levels of confidence in public companies, ethical and responsible decision-making should not be treated as subordinate to value creation.

Recommendation 3.1: A listed entity should:

a) *have a code of conduct for its directors, senior executives and employees;*
b) *disclose that code or a summary of it;*
c) *disclose the consequences for breaching the code of conduct.*

Principle 4 – Safeguard integrity in financial reporting

Regnan is in agreement with the Principle and recommendations for Principle 4.

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Principle 5 – Make timely and balanced disclosure

Regnan notes that sentiment and other unpredictable factors often drive the price of securities in the short term and note that a reasonable person's expectation of what might impact price / value is an inappropriate test for timely and balanced disclosure.

We therefore do not support confining disclosure obligations to matters that a reasonable person would expect to have a material effect on the *price or value* of securities. We suggest either retaining the wording of the existing Principle; specifically mentioning long term value; or otherwise referencing the value of the entity instead of the price or value of its securities.

Principle 6 – Respect the rights of security holders

We are broadly in agreement with Principle 6.

Recommendation 6.2: A listed entity should design and implement an investor relations program to facilitate effective two-way communication with investors.

Regnan holds that it is critical that the board have ongoing dialogue with shareholders throughout the year, with the emphasis on two way communication. Shareholders should have reasonable access to the board to discuss matters of concern (including via mediated channels, such as web-submitted questions), and boards should be proactive in seeking shareholder views on material matters.

Principle 7 – Recognise and manage risk

Regnan is broadly supportive of the revised Principle 7.

Recommendation 7.4: A listed entity should disclose whether, and if so, how, it has regard to economic, environmental and social sustainability risks.

Investors understand that risk-taking is necessary for enterprise, and that varying tolerance for risk is a feature of a pluralistic market. However, frank disclosure is required if investors are to align their own risk profile with that of entities in which they invest. Regnan would prefer to see the Principles clarify that it companies are expected to disclose risks themselves as well as the approach to these (rather than merely overarching statements about risk management) as we see this detail as offering a better means by which investors can gauge the riskiness of the investment.

We note that draft says it is considered "premature to expect listed entities in Australia to adopt integrated reporting until the international framework for such reporting is much better developed than it currently is".

We note a study conducted by Net Balance and the ACCA in December 2011 noted progress toward adoption of integrated reporting principles in the ASX50 despite the absence of an IR standard.[1] We

[1] "Adoption of integrated reporting by the ASX50", NetBalance and Association of Chartered Certified Accountants, December 2011

note further progress since this study was conducted, with a number of ASX companies undertaking IR pilots over 2012/13. Regnan contends that these early adopters will be advantaged given the long lead times required to prepare companies for full integrated reporting.

Regnan holds that as the first edition of the IR framework will be introduced and utilised in December 2013, it would be unfortunate if an opportunity to promote / embed the framework was lost. We consider that the concerns with current disclosure practices underlying the push for integrated reporting are well understood and that there is no reason that companies should not be attempting to address these concerns and adopt the principles of integrated reporting now.

As the Principles and Recommendations may not be redrafted for a considerable time, we suggest that companies be encouraged to refer to integrated reporting guiding principles to identify opportunities to evolve current reporting practices toward IR.

Principle 8 – Remunerate fairly and responsibly

Regnan broadly agrees with the heading of Principle 8, however notes the wording “a listed entity should endeavour to pay remuneration that is sufficient to attract, retain and *motivate* high quality directors and senior executives and that is aligned to creation of value for security holders”.

There is an abundance of evidence and research literature that holds that pay in itself is not a “motivator”, however the word “motivate” has become inextricably linked to incentive pay and thus it may be inferred from the way Principle 8 is worded that investors prefer listed entities to offer incentive pay. While we see a role for incentives and other forms of variable pay, it is Regnan’s view, backed by a considerable volume of research, that the culture of providing incentives to “motivate”, regardless of business, sector, or the specific conditions of a company, has led to increasingly complex remuneration plans, which in themselves have delivered questionable outcomes, including windfall gains and subsequent regulatory reactions.

We therefore suggest Principle 8 be reworded to “*a listed entity should structure remuneration for executives and directors that supports the long term creation of value. Remuneration should be sufficient and reasonable, paying due regard to generally accepted human capital management principles.”*

Listed Trusts

Please see our paper on listed trusts (appended).

We thank the ASX for the opportunity to contribute our views.

Amanda Wilson
Managing Director

Position Paper – Corporate Governance Practices in Externally Managed Trusts

April 2012

Institutional investors recognise the value of strong governance structures in protecting their interests as providers of capital. In this context, governance structures that evidence alignment with the interests of unit-holders is a competitive advantage for issuers and managers of listed trusts.

Central to strong governance is the distinction between the interests of management and those of the owners of the capital provided. In the case of externally managed trusts, this requires particular attention to the mechanisms by which investors can be assured that their interests as unit-holders are prioritised ahead of the interests of the manager/responsible entity (RE).

We regard corporate governance principles (for instance those articulated within the *ASX Corporate Governance Principles and Recommendations*) as applicable to all listed Australian entities including externally managed trusts.

Our objective here is to offer guidance on how to address the specific corporate governance challenges faced by externally managed trusts. For the purposes of illustration, we include examples from the market of structures that apply (or approximate) the relevant principles within the externally managed trust structure.

Board independence

Unit-holders of the externally managed trust need adequate representation by genuinely independent directors and should be able to determine the independent directors on the board of the responsible entity.

Examples include:

- appointing a genuinely non-affiliated chairman with no relationship to the RE or its parent/s;
- limiting the number of manager-appointed directors proportionate to the manager's holdings in the trust;
    - capping manager appointments at 50% of directors - to protect the interests of minority unit-holders, even when the manager's holding exceeds 50%.
- requiring directors to stand for election and re-election (e.g. after a three year period on a rotating basis) at which time each unit-holder is able to vote their holdings; or

- at a minimum, providing for unit-holders to ratify the appointment of independent directors (external candidates appointed by the manager) at the annual meeting of unit-holders. Regardless of whether it is binding, this would offer unit-holders a means by which to voice assent or dissent, thereby promoting unit-holder-friendly appointments.

Remuneration

Executives employed by an external manager should have any variable pay structures aligned to the interests of unit-holders on whose behalf they are working.

Examples of good practice could include:

- the trust being responsible for executive remuneration and director fees, using a model where management is employed by the trust itself and non-executive director fees are also paid by the trust (not the manager);
- making any equity payments in units of the trust;
- ensuring any incentives are linked to the performance of the trust and not the financial performance of the managing entity; and
- preparing a remuneration report for an advisory vote by unit-holders vote in accordance with requirements for most ASX-listed companies.

Appropriate fee structure

To enable unit-holders to assess if the fee structure is in their interests, the manager should clearly and transparently explain how the external manager as a whole is rewarded and held accountable for performance. Relevant considerations for both structure and quantum include the cost and complexity of management activities, but also the relative risks borne by the manager versus the providers of capital. Different emphases may be appropriate for trusts with differing objectives (e.g. a highly leveraged trust or one with high deal volume versus a portfolio largely requiring property management) and a discussion of these considerations is worthwhile for unit-holders.

Disclosures of fees should be sufficiently comprehensive to enable institutional investors to compare fee loads among funds and to perform fee analysis across their portfolio.

Examples of good practice could include:

- clear disclosure in the annual report regarding base fee and performance fee calculations and the reasons for the chosen methodologies;

- performance fees based on measures of value-add rather than value; the manager should be rewarded for good management and not necessarily for measures of growth per se as these do not always represent value for unit-holders. Potential for upside should be clearly attributable to either management effort or the risk they bear; and
- Using a high watermark structure, so that past negative performance needs to be reversed before positive performance results are recognised in fees.

Entrenchment of management

The freedom of unit-holders to change the manager of the trust is an important principle. There have been cases where an underperforming manager has used undisclosed or poorly disclosed termination provisions to deter investors seeking to replace them and/or to extract high break fees.

Examples of good practice could include:

- avoidance of high termination/break fees or poison pills. Where any such fees are embedded in the management agreements, they need to be clearly disclosed to investors. This information becomes particularly important if there is speculation around a change of the manager; and
- avoidance of other mechanisms that penalise unit-holders under change-of-manager circumstances. Where unavoidable, they should be fully disclosed (including continuous disclosure where such arrangements change). The existence of debt covenants triggered by a change in external manager and joint-ownership arrangements or other clauses which may give another party the right to purchase assets upon a change in external manager are examples of this.

Transactions

Transactions between an investment vehicle and its external manager or entities related to the external manager carry the risk that terms may unfairly favour the external manager.

Examples of good practice could include:

- guaranteeing that any related party transactions (or any above a minimal threshold amount or percentage of the portfolio) will be offered for a shareholder vote;
- ensuring clear disclosure of:
    - the terms of the transaction (including management agreements); and

  - all related party transactions during the year (including dollar value).
- providing assurance that related party transactions have been subject to review by a committee consisting solely of independent directors, confirming that the directors were satisfied regarding the fairness of the transaction/s and detailing the methods the committee used to determine this; and
- an independent committee similarly reviewing other (non-related party) transactions that could involve conflicts (for instance where there are deal-related fees paid to the manager).

Asset valuation

The value of long-life assets typically both drives investor value in externally managed trusts and contributes to the determination of management fees. Independence in the asset valuation processes is therefore essential.

Examples of good practice could include:

- use of an independent third-party asset valuation service and clear disclosure of their identity;
- rotation of valuation firm to ensure no asset was valued by the same valuation firm for an extended period, e.g. three years; and
- regardless of whether relying on internal or external valuations, clear disclosure of:
  - valuation assumptions used; and
  - the dates of the latest valuation.

Audit firm

Employ a different external audit firm to that which is used by the external manager or its related entities for audit or other services, since using the same auditor can risk affecting the independence of the external audit function.

About Regnan

Regnan – Governance Engagement & Research Pty Ltd was established to investigate and address environmental, social, and corporate governance related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors with $54 billion invested in S&P/ASX200 companies (at June 2011).

Regnan was launched in 2007 having operated previously as the BT Governance Advisory Service. It is owned by eight institutional investors: Commonwealth Superannuation Corporation (formerly ARIA); BT Investment Management; Hermes (UK); HESTA Super Fund; Local Government Super; Vanguard Australia; VicSuper; and the Victorian Funds Management Corporation.