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Review of the Corporate Governance Principles and Recommendations- Public Consultation

16 August 2013

Submission to ASX Corporate Governance Council

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Scope of the Submission

The focus of this submission is the position of small resources companies, particularly in relation to Recommendation 2.2, Recommendation 4.1 and Recommendation 7.1 (noting especially paragraphs 56 and 78) of the Public Consultation document dated 16 August 2013 published by the ASX Corporate Governance Council and entitled “Review of the Corporate Governance Principles and Recommendations” (“**Review”**) including a draft third edition of the Principles and Recommendations (“**Third Edition”**). In this submission the Second Edition of the ASX Corporate Governance Principles and Recommendations (“**ASX Principles**”)[1] will also be referred to.

Reference will be made to the results of a survey conducted in the first half of 2013 by the Centre for Mining Energy and Natural Resources law and KPMG. This is the KPMG UWA Survey of Corporate Governance for Small and Mid Tier Resources Companies (“**survey**”). The survey covered the challenges and risks faced by the companies, board structure, reports and indicators used by boards of the companies and continuous disclosure amongst other things. A PDF version of the survey Report (“**Report**”) can be accessed at http:///www.uwa.edu.au/research/cmenrl/Corporate-Governance-Survey-2013. A copy is also attached.

About the authors

Professor John Chandler is the Co-Director of the Centre for Mining, Energy and Natural Resources Law at the University of Western Australia, where he teaches corporate governance, mining and petroleum law. He has over 30 years’ experience in the resources industry as a partner in large commercial law firms and as a director of resources companies. He is the editor of Lexisnexis’s Energy and Resources Law service and the co-author of Petroleum Law in Australia.

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[1] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 2nd Ed, 2007, amended in 2010.

Executive Summary

The picture that emerges from the survey responses is one of differences in board size and structure according to the market capitalisation and project cycle of the company. While this is hardly surprising, it does mean that small companies with fewer directors (typically 3 or 4) and few independent directors (typically 1) are generally going to operate in a different way from the board of a large company having more directors (typically 6) and more independent directors. It is going to be impossible for companies with, say, one independent director to comply with Recommendation 2.2 of the Third Edition ("a majority of the board of a listed entity should be independent directors)[2] or the independence requirement of Recommendations 4.1 (audit committee)[3] and 7.1 (risk committee)[4] of the Third Edition.

While the amendments in the form of the new paragraphs in these Recommendations 4.1 and 7.1 to allow other complying processes are helpful and are supported in general terms by the authors, this submission suggests that more guidance should be given in the Commentary on these Recommendations (at pages 21 and 27) as to possible best practice for companies (particularly small ones) who elect not to have an audit committee or a risk committee. The survey shows that companies scale their governance processes as they move into development and then production and their market capitalisation increases. The authors submit that the ASX Principles should recognise this progression explicitly in the Commentary and give some further guidance for small companies..

We also submit that Recommendation 2.2 should contain a new paragraph (b) aligned with the final paragraphs in Recommendations 4.1 and 7.1. This would say that:" If the board of a listed entity does not have a majority of independent directors, it should disclose that fact and the processes it employs to bring a sufficient degree of independence to the board's decisions". The basis of this submission is that it is not logical to have that paragraph in Recommendations 4.1 and 7.1 and not Recommendation 2.2.

This may on first glance appear a more difficult question, as having a strong independent element in a board is recognised in many jurisdictions (for example in the United States) as being a cornerstone principle of good corporate governance. Nevertheless the survey results show that many companies, particularly small ones, do not comply with Principle 2.2; presumably many cannot afford the cost. This may be a particular factor for a resources economy such as Australia. The survey results indicate that as resources companies move into development and production they

[2] Currently Recommendation 2.1 in the ASX Principles.
[3] The draft successor to Recommendations 4.1 and 4.2 of the ASX Principles.
[4] Recommendations 7.1 to 7.4 of the ASX Principles do not require a risk committee.

increase the number of independent directors. We submit this change would be consistent with Principle 2 (“a listed entity should have a board of an appropriate size, composition, skills and commitment to enable it to discharge its duties effectively”) cover this in broad principle.

The results of the survey also suggest that many companies are focusing their risk management on financial matters. If substantial change is desired in the improvement of risk management in Australian companies, then in the authors’ submission it would be better if the Commentary to Recommendation 7.1 could give guidance as to what might represent good practice in risk management.

The authors acknowledge that there may be other ways of doing this. For example we note that on the ASX website there is a guide prepared by Deloitte and Blakiston and Crabb on Principle 7 for small and medium-sized companies. That guide could be updated in the light of the Third Edition and comments made in this submission about small companies.

The Survey base

The survey was sent to directors of companies with securities listed on the Australian Stock Exchange Limited (ASX) in the GIS Sector (Materials and Energy) Sector which had their head offices domiciled in Western Australia[5].

As at 30 June 2013, energy and resources companies represented 998 (53 per cent) of the 1899 entities listed on the Australian Securities Exchange (ASX) and 25 per cent of the capitalisation of the market. Of these approximately 568 had their head office domiciled in Western Australia and represented a market capitalisation of $AU74.3b and 22.5 per cent of the market capitalisation of energy and materials companies in Australia.[6]

The survey was conducted using a survey form that was mailed out to directors of the applicable companies. They were also informed that the survey was available to be done on-line. The survey had previously been tested by four directors and been subjected to internal review. Amendments were made to the survey questions and format following that test and review. A reminder letter was sent to the directors who had not responded. The survey attracted 127 respondents from over 100 companies. Their market capitalisation ranged from under $AU50 million to over a billion dollars. Personal information was removed from the data by the principal investigator and it was then subject to further analysis in its consolidated form. Interviews were conducted with two directors and an officer of ASIC, which formed part of the report.

[5] The authors of this submission would like to acknowledge the support of KPMG in producing the survey and the Report. The views expressed in this submission are the views of the authors. KPMG has no responsibility for those views or any information quoted in this submission.

[6] ASX Listed companies GIS sector (Materials and Energy) June 30, 2013.

This was done in part because the response rate for the survey was not high,[7] which is common for a survey of this kind, and it was felt desirable to seek some verification of the representative nature of the results.

For the purposes of the survey report and this submission companies have been categorised as Small if they have a market capitalisation of A$50 million or less, Medium or Mid-sized if they have a market capitalisation between A$50 million and A$499 million and Large if they have a market capitalisation over $500 million.[8]

The initial section of the survey asked respondents which company the survey related to, the exchanges on which its securities were quoted on 31 December 2012, the nature of its operations, which countries it operated in, the number of directors at 31 December 2012, and how many directors were women. Of the companies represented 54 were Small, 41 were Medium and 27 were Large. 25 companies had projects at the pre-feasibility stage, 24 had projects in development and 32 were in production. Nearly all the companies were conducting exploration. Given that some companies seemingly had multiple projects it was not possible to accurately assess those only conducting exploration. However, it is suggested that it is likely to be quite close to the number of Small companies, being 54. The companies included 18 oil and gas companies which represented 14% of the total.

The aim of the Survey and features of small resources companies

A main aim of the survey was to assemble information about the systems, processes and practices that listed energy and resources companies are actually using. There is very little publicly available information about this.

What generally distinguishes energy and resources companies from most others is the lifecycle of an energy or resources project. If a company starts as an explorer it will normally be spending its money on exploration (as well as administration and other related costs and expenses). It is unlikely to have any revenue unless it is selling off its exploration interests. Once a potentially commercial resource has been found, work will have to be done to define a project and then evaluate its commercial feasibility. At this stage and at the development stage the company will incur further expenditure for geological, drilling, testing, engineering and other services. Once the final investment decision is made, that expenditure will increase significantly, as money is spent on construction and the purchase of plant and equipment. It is generally only when the project is in production that it will be selling product and deriving revenue.

[7] Responses were received from approximately 17.5% of companies surveyed.
[8] Market capitalisation is taken from the responses to question in the survey asking for market capitalisation as at 31 December 2012.

While not all energy and resources companies will follow this lifecycle, the authors suggest that many of them will. We have not sought to draw parallels with other industries, but we expect they will exist. Any company which is based on research (such as medical research) or is developing a product or service, or is otherwise in the early stages of development, is likely to share some of these lifecycle characteristics. Some of the survey findings are likely to resound with these companies as well.

Conclusion on board structure and number of independent directors

The survey results show that the most common number of directors for a Small company is 4, for a Medium company is 5 and for a Large company is 6. No Large company had less than 5 directors and no Small company had more than 5. See Figures 6 and 7 on page 14 of the Report.

The most likely number of independent directors for a Small company is 1 to 2 and 3 for Medium and Large companies. See Figure 8 on page 15 of the Report.

An example of one of our findings is in relation to the recommendation in the ASX Principles that a majority of the board should be independent directors. The survey responses show that many of the small and mid-sized companies whose directors responded to the survey do not have a majority of independent directors.

Implications for Recommendations 4.1 and 7.1.in the Review

It seems from the survey results that many companies which the Report and this submission categorise as Small or Medium have insufficient independent directors to comply with the independence requirements of Recommendation 4,1 (an audit committee should have at least 3 members all of who are non-executive directors and a majority of whom are independent directors). Nevertheless it appears that many companies in these categories have an audit committee, albeit that it may not comply. See Figure 9 on page 17 of the Report.

Although paragraph 56 of the Review does not recognise that many Small and Medium companies will not be able to satisfy Recommendation 4.1, it does say that they “may legitimately decide not to have an audit committee and institute alternative processes to independently verify and safeguard the integrity of financial reporting. Provided they disclose these alternative practices, Recommendation 4.1(b) allows them to report that they comply with these recommendations on this matter”.

Rule 4.10 of the ASX Listing Rules requires an entity to disclose the extent to which the entity has followed the recommendations set by the ASX Corporate Governance Council. The rule also requires disclosure of the reasons why a rule was not followed.

What this amendment appears to do is to allow a company to dispense with an audit committee entirely, provided it discloses its alternative practices. The authors expect that many companies will simply take the opportunity to have the functions of the audit committee performed by the whole board.

This may not be particularly desirable. Indeed Guidance Note 9 makes the point on page 7[9] that "Security holders are unlikely to find brief statements such as "the board as a whole performs the role that such a committee would ordinarily undertake" - to be particularly insightful in understanding why an entity has chosen not to follow a particular CGC recommendation or what alternative corporate governance arrangements the entity may have instituted to address the underlying principle to which that recommendation is directed."

In the authors' submission it would be better if the Commentary to the recommendation could give some guidance as to what might represent good practice in this situation. The focus of this should be ensuring that audit issues are considered both thoroughly and with a degree of independence. Although the operations of small companies are likely to be less complicated than those of large companies, difficult issues can still arise particularly because the company will be very dependent on its executive directors. Remuneration issues and conflicts of interest are ones that spring to mind. As companies grow, so they need to scale their corporate governance practices.

In giving more detailed guidance it is necessary to balance some competing ideas. The first of these is that each company is different. The second is that as a matter of the current policy of the ASX "It is not the role of ASX under Listing Rule 4.10.3 to pass judgement on the quality or effectiveness of the corporate governance policies and practices that a listed entity may have adopted….Those judgements are initially for the entity's board and then ultimately for its security holders and the broader investment community to make "(ASX Guidance Note 9 at page 5). The third is that some ideas in corporate governance achieve such recognition that they become enshrined in global practice; an obvious example is having an audit committee. But at the same time this is an evolving story as the global or local environment changes. So for example the Review introduces the idea of the recommendation of the introduction of a risk committee into Recommendation 7.1 by the statement that "building on the lessons of the GFC, the issue of risk management has received much closer attention in the third edition." This is accompanied by amendments to Recommendations 7.2 and 7.3 to do with the review of the risk management framework and the internal audit function.

At the same time the authors suggest that there is good reason for the ASX Principles to be both realistic and aspirational; realistic in the sense that they recognise that many small companies in particular are on a corporate governance journey and that in the early stages they do not have the same financial resources

[9] Taken from draft Guidance Note 9 amended 1/7/14

and number of independent directors as large ones; and aspirational in suggesting ways in which those companies can improve their corporate governance performance. It would be helpful to those small companies considering not having an audit committee to have some alternatives listed in the ASX Principles.

The danger of not providing alternatives and a pathway to progression is simply that companies will choose the approach that has the least negative public perception. Small companies may choose to continue to have an audit committee for several reasons: first, because that is the solution adopted by large companies, secondly, because it is the only one set out in Recommendation 4, and thirdly because they need only disclose that limited degree of non-compliance with Recommendation 4 caused by lack of independence of the committee.

Similar questions arise in relation to Recommendation 7.1, although problems associated with risk are likely to be different from those associated with audit. Further comment is made on risk below.

Given the specific nature of the amendments to Recommendation 7, some further guidance would be helpful for those companies with insufficient directors to have a risk committee or the financial wherewithal to afford an internal audit function. Note Fiona Harris's comments in the Report at page 12.

Risk Management

Figures 14, 15 and 16 on Pages 24 and 25 of the Report show a strong focus on reporting financial performance throughout the lifecycle stages. Companies in exploration and with a narrower focus of activities tend to focus more on financial performance reporting relative to other reporting. A large part of financial reporting is linked to performance against budget. This is a lag reporting tool used by 76 per cent of companies surveyed as a means of testing the strategy of the business

The survey results reflect that reporting on risk management is relatively low, reaching a high of only 50 per cent in the development stage across companies responding to the survey.

Reporting against Key Performance Indicators is overall at 35 per cent across respondents surveyed. The survey results indicate a limited tracking of risks or other targeted performance indicators, and a limited testing of how well systems are operating. This was also seen in relation to ethical and cultural issues. While respondents placed significant importance on ethical behaviour, a much lesser number actually tested it in a formal sense. This is an area where small companies could scale their reports to suit their operations.

For example, rather than having an internal audit function to monitor bribery and corruption they could do spot checks. The concern here for all directors is that if they are not tracking risks or checking critical performance areas a major problem may not be picked up until it is too late.

Implications for Recommendation 7.1

The results of the survey suggest that many companies are focusing their risk management on financial matters. If substantial improvement in risk management is desired, then in the authors' submission it would be better if the recommendation could give some guidance as to what might represent good practice in this situation. Having an audit committee is not on its own going to make a substantial improvement to risk management. For example, the recommendation could include a list of possible key performance indicators.

The reasons for taking this proactive approach are set out in the discussion concerning the implications for Recommendations 4.1 and 7.1.

Concluding Discussion

The picture that emerges from the survey responses is one of differences in board size and structure according to the market capitalisation and project cycle of the company. While this is hardly surprising, it does mean that small companies with fewer directors (typically 3 or 4) and few independent directors (typically 1) are generally going to operate in a different way from the board of a large company having more directors (typically 6) and more independent directors. The differences in operation are likely to be seen not only in lesser degree of independent perspective in the board and its committees, but also in the way in which the board operates. This is a reason why we submit that Recommendation 2.2 should have an additional paragraph similar to that in Recommendations 4.1 and 7.1. This will facilitate boards without a majority of independent directors engaging with stakeholders on how they deal with not having that degree of independence.

The differences in operation are also likely to be seen in things like the focus of reporting being more likely to be a financial performance report or a report of expenditure against budget and the means of informing the board is more likely to be a presentation by the CEO or an executive. This relates to the previous paragraph and how the objectivity and appropriateness of those reports can be tested.

What is also apparent is that boards evolve in line with the lifecycle of a company's projects. As a company moves to development the size of its board will increase as will the number of independent directors and the number of board committees. With the increasing maturity of its projects board gender diversity will increase, with more female directors joining. So in that sense boards are scaling themselves as their operations grow in complexity and, presumably, their finances allow. Yet at the same time in many instances small companies are endeavouring to follow the recommendations in the ASX Principles by having the recommended committees and policies. What they are generally not doing is having sufficient independent directors to comply with Recommendation 2.1 of the ASX Principles.

The authors support the recognition of the position of small companies in the Third Edition and also the efforts of the ASX to produce that revision. We hope that you will find our suggestions constructive.

Date 14 November 2013

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