

CAER's Response to the
ASX Corporate Governance Council's
Principles and Recommendations
Review 2018

Background

CAER is a leading provider of independent research on the environmental, social, governance (ESG) and ethical performance of companies. We work directly with our clients to ensure the ESG information they receive is tailored for purpose. We also help implement responsible investment considerations across all facets of a client's investment journey.

We provide global ESG research coverage on 4,000 issuers as well as thematic research covering up to 10,000 issuers. This includes coverage of the ASX300 and the NZ50 across the entire Vigeo Eiris product suite.

We have a deep understanding of the responsible investment market and the types of challenges organisations are facing in our region. Our expertise in combining and integrating ESG data and ethical considerations for clients enables us to add value in transforming ESG research into practical solutions for investors.

Given the role we play within the Australian responsible investment landscape, it is important to CAER that we offer feedback on the ASX Corporate Governance Council's Principles and Recommendations Review conducted this year.

Broad Response

CAER commends the work of the Council in the development of the latest version of the Principles & Recommendations.

In our response below we will provide specific feedback in areas where we believe we are able to add most value to the discussion.

We note that in the most recent round of recommendations, the Council has turned its mind particularly to the emerging importance of environmental & social disclosures by listed corporations, and the importance of these factors being incorporated into an organisation's DNA.

In CAER's opinion this emphasis is a reasonable reflection of the growing prominence of these considerations in the investment market, as illustrated by the ongoing growth of the responsible investment sector in Australia, set out the Responsible Investment Association Australasia's regular Benchmarking Reports.¹

In participating in this consultation, CAER aims to promote the importance of including sustainability in governance codes, in particular with regard to Board accountability, management of sustainability risks, reporting on sustainable performance and sustainable rewards for executives.

International context

CAER notes that in a global context, the convergence between **Corporate Governance and sustainability issues** has accelerated significantly, both in terms of legislative trends and stakeholder expectations:

- **Governance codes have integrated provisions related to sustainability.** This is the case for France (with the AFEP-MEDEF code amended in November 2016); Spain (with the Good Governance Code of Listed Companies from Comisión Nacional del Mercado de Valores as reviewed in February 2015); and the G20/OECD Principles of Corporate Governance (2015).
- In September 2015, the PRI, UNEP FI, UNEP Inquiry and UN Global Compact published the report "**Fiduciary Duty in the 21st Century**". The purpose of this report was to end the debate about whether fiduciary duty is a legitimate barrier to investors integrating environmental, social and governance (ESG) issues into their investment processes. The report concluded that "Failing to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty".
- The launch (in 2015) of the **ESG in Credit Ratings Initiative** by investors and credit rating agencies with the aim of enhancing the transparent and systematic integration of environmental, social and governance (ESG) factors in credit risk analysis.
- The **Declaration signed in December 2017 by French investors, asset managers and insurers** that "*invite issuers to a communication of their ESG rating (Environment, Social and Governance), as and in addition to their financial rating "building on the belief that social, environmental, ethical and governance factors constitute real areas of risk that have an influence on the quality of credit and the intrinsic value of companies, and that they are drivers for future value creation"*.

¹ 2017 RIAA Benchmarking Report: <https://responsibleinvestment.org/resources/benchmark-report>

Question 1: whether stakeholders agree with the nine proposed new recommendations and, if not, why not?

CAER will respond to each of the new recommendations in turn.

Recommendation 2.7: language fluency

CAER supports this recommendation. It is generally accepted that it is more difficult to assess Environmental, Social & Governance (ESG) risks for companies operating in emerging markets, so improving the ability of the Board to communicate about such issues will go some way to ameliorating these risks.

Recommendation 3.1: core values

CAER supports this recommendation.

It is our experience that good corporate practices tend to follow the following progression:

- Policy
- Management system
- Transparency (reporting)

Having a statement of core values will improve a company's ability to communicate its approach to maintaining its social license to operate, and will further empower investors to make judgments in this area.

Recommendation 3.3: whistleblowers

CAER supports this recommendation.

We note that some of the public damage being done to corporate reputations at the moment (notably the Hayne Royal Commission) might have been reduced to some extent had the organisations involved done a better job of managing the concerns raised by whistleblowers within their organisations.

CAER's global research partners Vigeo Eiris regularly look for the existence of whistleblower policies and systems when evaluating the effectiveness of a company's business ethics management.

Recommendation 3.4: anti-bribery & corruption

CAER supports this recommendation.

Our research has for many years sought to rate a company's exposure to bribery & corruption risks, and to assess how well they are managing such risks.

Under Australian legislation it is a criminal offence to bribe foreign government officials. Many Australian companies are operating in countries where it is generally accepted that bribes be routinely paid in order to do business. As a result, employees of those companies are being exposed to risks of criminal prosecution if they are carrying out business activities in such countries.

Furthermore, the damage done to the economies of countries where corruption is a problem has been well documented, particularly through the work of Transparency International: www.transparency.org

There has been an increase in the enforcement of anti-bribery legislation in Australia, with high-profile cases demonstrating the exposures faced by entities listed on the ASX. In these instances, one of the defences of company officials has been that they were not made aware of the allegations. Making it a requirement that material breaches be escalated through senior management to board level should go some way to removing this type of defence.

We would note that the Council might look to provide additional guidance around the precise definition of 'materiality' in this context, given that a relatively small illegal transaction might still result in criminal charges for an individual and significant reputational harm for a corporation.

Recommendation 4.4: report validation

CAER supports this recommendation.

While the primary source of information that CAER has always relied on is a company's Annual Report, we have sought for many years to promote Corporate Sustainability Reporting, given its obvious relevance to our work and to the responsible investment community at large.

We have been long-term stakeholders and supporters of the Global Reporting Initiative (GRI). We have also noted with enthusiasm the growth of services to provide independent 3rd-party verification of the claims made in corporate sustainability reports.

We are supporters of the notion that the same level of due diligence and commitment should be applied to environmental and social disclosure as is applied to financial disclosure.

Recommendation 5.2: copies of announcements

No strong opinion.

Recommendation 5.3: presentation release

No strong opinion.

Recommendation 6.4: poll vs show of hands

No strong opinion.

Recommendation 8.4: clarification around related-party transactions with directors

CAER supports this recommendation.

CAER's research services have long included a thorough assessment of the independence of directors, including whether or not the directors is involved in any related-party transactions with the company.

Additional clarity in the disclosure under this heading will be of assistance to responsible investors seeking to make consistent assessments of the independence of directors.

Question 2: whether stakeholders agree with the changes proposed to the existing recommendations in the third edition and, if not, why not?

CAER will respond to each of the proposed changes in turn.

Recommendation 1.1: board charter

CAER supports the changes to this recommendation.

We would note however that the Council might consider making a more explicit reference under this heading to the Board's responsibility for having oversight of the company's license to operate. For instance, in the following paragraph re the Executive's duties, specific reference is made to passing on material breaches of company codes, but under the Board duties the only reference to ESG-related material is made through the footnote's reference to Recommendation 3.1.

Recommendation 1.2: background checks

No strong opinion.

Recommendation 1.5: diversity

CAER supports the changes to this recommendation.

There are three primary comments we would like to make with reference to the proposed changes.

Firstly, while we support the introduction of clear guidance re a 30% target for female directors on a Board, we would note that this is a measure that has been considered to be good practice for a number of years by ESG research organisations such as ourselves, and so would not be regarded as particularly aspirational by many of our responsible investor clients. Nevertheless we applaud the intent.

Secondly, while we are a strong supporter of the work of the WGEA and utilise their data on a regular basis, we would note that there is still a stark disparity between male and female pay within the Australian workforce. In a recent report released by the Australian Centre for Corporate Responsibility (ACCR) and CAER (based in part on WGEA disclosures), we note that in Australia today, the gender pay gap is 15.3% – more than in the UK (9.4%) but less than in the US (20%).² The Council might wish to consider making specific reference in this Recommendation to the desirability of equality of remuneration across genders at all levels for a listed company.

Thirdly, we note that while the Recommendation refers to 'diversity', in the implementation guidelines the focus is on gender diversity. We would note that definitions of diversity utilised by responsible investors usually contemplate a much more broader definition of diversity, for example:

- 'gender' being more than just binary
- age
- race/ethnicity/nationality
- sexual orientation
- religion
- disability

² For more information on this report: <https://accr.org.au/gender-pay-equity-report/>

Consideration might be given to including scope for broader concepts of 'diversity' under this heading. In CAER's view diversity criteria other than gender have a positive impact on ensuring a sound understanding of the workings of the company, on the complexity of the market in which the company operates and on maintaining lively concern for the interests of all stakeholders.

Other diversity measures relevant to our assessments of governance quality include:

- Non-executives board members have significant operational experience in the sector
- When the company is significantly present abroad, one or more members of the Board have experience in the different countries of the company's major operations
- Non-executives board members have varied and complementary professional experience
- In the case of a multi-activity group, Boards where at least one member has experience on one of the activities (eg. a new activity for the group)
- Employee representatives sit on the Board
- There is an adequate representation of men and women on the Board

In addition, we consider it important for the board to include ESG expertise. Board members with knowledge in this field can help to oversee the overall Corporate Social Responsibility (CSR) policy and strategy of the company; to raise awareness at board level about these issues; to work in partnership with the management on these topics; and to stimulate the discussion on CSR issues at board meetings.

Recommendation 1.6 & 1.7: board and management reviews

No strong opinion.

Recommendation 2.3: disclose independence and length of service of directors

CAER supports the changes to this recommendation.

We note that we have for some time recorded a term on the Board in excess of 10 years as counting against the independence of a director.

Recommendation 2.6: induction and professional development

CAER supports the changes to this recommendation.

Recommendation 3.1: code of conduct – inform board re material breaches

CAER supports the changes to this recommendation.

As noted above re anti-bribery recommendations, the ability of a board to deny knowledge of a breach can be a fig-leaf that enables malpractice at lower levels within the organisation. By making it clear that breaches are board-level business, it is to be hoped that this type of situation will not arise in future.

Recommendation 6.2: investor relations program – two-way communications

CAER supports the changes to this recommendation.

We note that the growth of social media and improvements in communication and information handling technology are a double-edged sword for listed corporations. On the one hand they have better tools to communicate with their stakeholders, but on the other hand their stakeholders are more empowered to be critical of the company's actions.

We endorse the Council's encouraging of corporates to develop stakeholder engagement programs that go beyond just investors.

Recommendation 6.3: participation at meetings of security holders

CAER supports the changes to this recommendation.

We would highlight to the Council the increase in the last few years of direct shareholder action by groups seeking to improve corporate behaviour on a range of ESG issues. We would encourage the Council to consider additional guidance under this heading to encourage listed companies to facilitate rather than block action of this kind. We note that in other jurisdictions (primarily the USA) there is a considerable amount of often productive engagement that takes place around the placing of ESG-related shareholder resolutions on corporations' AGM agendas. To date such communications in Australia have been wanting, and often unnecessarily adversarial.

Recommendation 7.2: annual risk review

No strong opinion.

Recommendation 7.4: sustainability disclosures

CAER supports the changes to this recommendation.

We strongly endorse the Council's specific encouragement to all companies to address risks arising from climate change – we have observed that growth in disclosure in this area has slowed down as less exposed companies don't feel they have an obligation to take steps in this area. Hopefully this change will result in improved disclosure and improved information for responsible investors.

Question 3: whether stakeholders agree with the Council’s proposal to include as part of recommendation 1.5 a requirement that entities in the S&P/ASX 300 set a measurable objective to have a minimum of 30% of directors of each gender on their boards by a specified date?

CAER strongly supports this recommendation.

As noted above, we feel that 30% female representation should not be a stretch target for Australian boards, given the depth of talent in the local marketplace, and the existence of similar targets for many years.

We do acknowledge that from time to time such objectives can be difficult to achieve even under the best of circumstances, but note that under the ‘if not, why not?’ regime, there is plenty of scope for companies to explain why they have failed to meet their targets.

It is our experience that the recommendations of the ASX Corporate Governance Council tend to be taken very seriously by listed companies, and there is therefore the potential for this recommendation to be very powerful in terms of promoting gender diversity at Australian board level.

Question 4: whether stakeholders agree with the annual timeframes proposed for board reviews in recommendation 1.6 and management reviews in recommendation 1.7?

No strong opinion.

Question 5: whether stakeholders agree with Council’s proposed changes to box 2.3, setting out the factors relevant to assessing director independence?

CAER agrees with the proposed changes.

We would suggest that the Council consider providing additional links or guidance around the length of time a director may service on a board before independence is compromised. As is noted above, we have for some time utilised a threshold of 10 years in these circumstances, and we believe this to be a widely shared understanding among governance practitioners.

Once again, given the ‘if not, why not?’ regime within the Guidelines, there is nothing to stop a company explaining the special circumstances surrounding a director’s extended tenure.

Question 6: whether the proposed amendments to principle 3 and the accompanying commentary deal adequately with governance-related concerns related to an entity's values, culture and social licence to operate?

CAER supports the proposed amendments.

As we have noted in our response to specific changes under Question 1 above, CAER notes that the emphasis on elevating material breaches of corporate codes of conduct to Board level will act to remove a fig leaf that has sheltered some boards in the past. This guidance may have allowed us to avoid the fallout surrounding the Hayne Royal Commission, and the associated damage to shareholder value arising from that enquiry.

We would recommend that the Council consider providing some additional guidance around the definitions of 'materiality' used in this Principle. This is particularly relevant to the recommendations around bribery & corruption, where a relatively small corrupt payment might give rise to very material outcomes further down the track.

We would also suggest that the Council consider amending Recommendation 3.3 re Whistleblowers to include the application of the whistleblower policy to material breaches of the code of conduct, in addition to lawful, ethical or social responsibility matters. There is a risk that under the current structure we might see different thresholds applied to the elevation to board consideration of whistleblower complaints specifically vs code of conduct breaches, to the detriment of whistleblowers.

Question 7: whether compliance with any of the new or amended recommendations might have any unforeseen consequences or give rise to undue compliance burdens for listed entities?

CAER does not consider this to be a serious risk, although we do note that the new Recommendation 4.4 re extending due diligence to all reporting is likely to result in additional verification work for companies issuing sustainability reports. We would regard this as a positive outcome.

Question 8: whether the level of guidance in the draft fourth edition is appropriate and whether stakeholders would like more guidance on any particular principles or recommendations?

CAER notes above that additional guidance might be considered in the following areas:

- materiality under Recommendation 3, especially with regard to bribery & corruption
- board tenure beyond which independence is compromised, under Recommendation 2
- with regard to Recommendation 6, we support additional guidance around the two-way communication between companies and shareholders, in the light of increasing numbers of AGM resolutions around ESG-related matters. Ideally corporations could be encouraged to be more pro-active rather than blocking in their handling of such matters

Question 9: whether there are any other gaps or deficiencies in the Principles and Recommendations that have not been addressed by the proposed changes in the consultation draft of the fourth edition?

It would be helpful for the Principles to make suggestions as to appropriate international principles companies may wish to use as the basis for their reporting. The Global Reporting Initiative or the Sustainable Development Goal's would be prime examples of this, although we would acknowledge that references to specific principles run the risk of becoming dated, and therefore it would be wise to refer to "or other principles which the company may deem equivalent".

Linking remuneration with sustainability outcomes

CAER believes that in order to achieve long term sustainable performances, companies should ensure that:

- executive remuneration is used as a tool to align the interests of executives with those of the company and its shareholders
- executive remuneration is designed in a manner consistent with that of the other officers and employees of the company (horizontal and vertical remuneration), avoiding unbalanced remuneration structures
- executive remuneration is designed to properly incentivize the management to pursue the company's CSR strategy through the integration of sustainability objectives within executive remuneration policies

In particular, with respect to the integration of sustainability objectives, we support the UNPRI's stance on the integration of ESG into executive pay:

"Companies should link appropriate ESG metrics to reward systems in a way that they form a meaningful component of the overall remuneration framework. In order to do so:

- ESG targets should be integrated into an appropriate time horizon that is in line with business strategy.
- ESG targets should be stringent and challenging to ensure incentivising outperformance.
- Companies should select appropriate mechanisms and structures when creating incentive pay packages to ensure long-term shareholder value creation.
- Incentive compensation should be subject to downward discretionary adjustments by the compensation committee to account for unusual events or unintended consequences as well as claw-back provisions.
- In quantifying ESG metrics and measuring performance, the board may apply a clearly substantiated degree of discretion."³

We applaud efforts in the current version of the Guidelines to encourage boards to link executive remuneration with diversity outcomes, and we note under Principle 8 that reference is made to longer term success for the entity. We also acknowledge and support changes to the Principle relating to excessive executive pay. We do suggest, however, that clearer emphasis could be placed under this Principle on linking executive remuneration with outcomes arising from the company's Core Values statement and

³ United Nations Principles for Responsible Investment (UN PRI), "Integrating ESG issues into executive pay" (2012)

ABOUT CAER

CAER's mission is to broaden the reach of ethical and responsible investment. To achieve this we provide, structure and add value to ESG information on companies and investment portfolios.

CAER's business activities focus on the provision of expertly assessed ESG information. Our team of analysts have a deep knowledge of the responsible investment market, and are able to provide our clients with expert insights in addition to high quality, well-structured global ESG data.

For our global ESG data provision we have an exclusive distribution and research partnership with Vigeo Eiris, a leading independent provider of ESG research, ratings and services for investors, public and private organisations and NGOs.

If you are interested in learning more about CAER please go to www.caer.com.au, send us an email or give us a call on:

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