

30 July 2018

Mavis Tan
ASX Corporate Governance Council
c/o ASX Limited
PO BOX H224
Australia Square NSW1

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

Dear Ms Tan

Draft Fourth Edition of the Corporate Governance Principles and Recommendations

INTRODUCTION

1. The Law Council of Australia (**LCA**) welcomes the opportunity to comment on the *ASX Corporate Governance Council's draft fourth edition of the Corporate Governance Principles and Recommendations (CGPR)*. These comments have been prepared by the Corporations Committee (**Committee**) of the Business Law Section (**BLS**) of the LCA, which is a specialist committee of corporations and securities law practitioners and academics.
2. The comments below respond to the *ASX Corporate Governance Council's Review of the ASX Corporate Governance Council's Principles and Recommendations Public Consultation*, released 2 May 2018 (**Consultation Document**).
3. The Committee notes the significant place that the CGPR have come to occupy in Australian corporate governance theory and practice since the first edition was released in 2004. Their impact is not limited to the ASX listed entities to which the CGPR directly apply; many of the Principles and Recommendations have been adopted formally and informally elsewhere, including in other self-regulatory codes. This is noted in the Consultation Document. However, these comments focus specifically on the application of the CGPR to listed entities.
4. In preparing these comments, the Committee recognises that the CGPR comprise both Principles and Recommendations and that the two serve distinct functions in the architecture of the CGPR. The Principles are (or ought to be) seen as “non-negotiable” – that is, they are foundational principles of corporate governance with which all listed entities should comply. This is important because the Principles ought to be framed in such a way that they are universally applicable to all listed entities. The Recommendations are different – they reflect a “first best” approach to operationalising the Principles that is intended to work for most, but which may not work for all, listed entities. This is why ASX Listing Rule 4.10.3 requires that listed entities report only against the Recommendations (but not the Principles and commentary) on an “*if not, why not*” basis. In this way the Listing Rule recognises

that not all listed entities may want or need to follow all the Recommendations to give effect to the Principles and may quite legitimately choose not to do so. The comments that follow take account of this important distinction.

5. The Committee notes that the Council “*recognises the need to regularly assess and evolve the Principles and Recommendations to address emerging domestic and global issues in corporate governance*”. Given the place the CGPR occupy in the corporate governance framework, it is important that any evolution responds to real and verifiable shifts in community standards, not fluctuations in community sentiment as expressed in ephemeral media or commentary.
6. Further, we observe that although the CGPR can be described as “soft law”, they are intended to and do serve a regulatory function. That should be borne in mind in considering the commentary as well as the Principles and Recommendations. It is important that the commentary is authoritative, balanced and durable and does not rely on imprecise language or unsettled concepts. To do so risks undermining the normative force of the Principles in particular.

PRELIMINARY OBSERVATIONS

7. In providing these comments, the Committee has focused specifically on the interaction between the CGPR and existing Australian corporate law and regulation, the principal mechanisms for the regulation and enforcement of corporate governance norms and rules developed by statute and judge-made law over many decades.
8. The CGPR, like other self-regulatory arrangements for corporate governance, operate within a very substantial body of existing law. Therefore, the Committee considers it fundamental that the CGPR (including the commentary) do not:
 - (a) conflict with, qualify or undermine a listed entity’s existing legal or regulatory obligations; or
 - (b) conflict with, or directly or indirectly alter the content of, the existing legal duties of a listed entity’s officers.
9. We also think it is important that the CGPR do not seek to, or have the effect of, extending or changing the law. That is a matter for Parliament.
10. The Committee’s main recommendation therefore is **against** making the proposed changes to Principle 3. For the reasons explained below, we consider the current wording (requiring a listed entity to act ethically and responsibly) remains appropriate. Our specific concerns with the drafting of the proposed Principle 3 and the accompanying Recommendations and commentary are set out in paragraphs [34] – [78]. We note that it may be appropriate and desirable to modify the current Recommendations in support of Principle 3 to address some of the concerns identified in the Consultation Document and think this can sensibly be done. However, we consider that any loss of trust in business mentioned on page 6 of the Consultation Document is not caused by the current Principle 3 not meeting community expectations; it results from entities not complying the current Principle 3 or not complying with the law.
11. In making these comments, the Committee starts from the existing Australian law, which is that a corporation or other entity may be formed and operated for any lawful purpose, and that its affairs must be managed by the board and its delegates in

accordance with their statutory and general law duties, including to exercise their powers and discharge their duties for a proper purpose, in good faith in the interests of the company as whole. As the Corporations and Markets Advisory Committee concluded in 2006, “*directors have considerable discretion concerning the interests they may take into account in corporate decision-making, provided their purpose is to act in the interests of the company as a whole, interpreted as the financial well-being of the shareholders as a general body*”.¹

12. This necessarily involves the entity acting in accordance with the law and requires the board to balance various interests, including those of stakeholders other than security holders. The entity’s interests are not limited to its financial interests and should not be narrowly construed; the “*interests of the corporation, including its reputation, include its interests which relate to compliance with the law*”.² Nevertheless, the position in Australia is that the efforts of the board and its delegates must ultimately be directed towards the financial well-being of the shareholders as a general body, that being the fundamental *raison d’être* of all listed entities.
13. The Consultation Document argues on page 5 that the proposed changes are necessary because, “*Otherwise, pressures will inevitably mount for a more prescriptive legislative or rules-based response to these issues*”. This approach is, in our view, misplaced. If the intention is to change the existing legal framework for listed entities or their officers, it should be done by changes to the law properly made by Parliament.
14. If the CGPR are in fact seeking to vary the established legal norms of governance (which in our opinion they should not), that should be stated clearly and directly. We do not suggest that the overriding duty of directors to act in the best interests of the company does not accommodate consideration of wider interests if the decision is justifiable as being in the company’s best interests, but the phrasing of the CPGR is far less nuanced than that proposition.³ We accept the anecdotal evidence that the community has a higher expectation of our directors than a simple responsibility for wealth accretion. As with matters of governance more generally, the community expects directors to focus on what is “right” alongside their common law and statutory duties.⁴
15. That governments have the ability to impose legal obligations on managers is beyond question, but that is the role of government, and of the Parliament in particular, to shape those laws. A central issue here is whether it is appropriate to use the CPGR as a device to achieve a (perceived) community objective that listed entities ought to be subject to different governance norms, including those reflecting their underlying purpose. If that is the intention, then it ought to occur through proper legislative

¹ Commonwealth of Australia, Corporations and Markets Advisory Committee, *The Social Responsibility of Corporations* (2006) [3.7].

² *Australian Securities and Investments Commission v Cassimatis (No 8)* (2016) 336 ALR 209; [2016] FCA 1023 at [483].

³ McConvill J, “Directors’ Duties to Stakeholders: A Reform Proposal Based on Three False Assumptions” (2005) 18 *Australian Journal of Corporate Law* 88.

⁴ Indeed, the decision in *Australian Securities and Investment Commission v Cassimatis (No 8)* [2016] FCA 1023 suggests that directors who engage in unreasonable or intentional acts that are extremely likely to involve a serious breach of the law and perhaps threaten the existence of the company may breach their duties even when there is no actual breach of the law by the company.

processes: compare the extensive consultation process that gave rise to s 172 of the UK *Companies Act 2006*.⁵

16. Of course, if ASX takes the view that changing social norms require something different of listed entities than the lawful conduct of their operations in the best interests of their shareholders as a whole, it is open to it to mandate constitutional provisions as a requirement of listing that modify the entity's purpose, allowing a solution tailored to each entity's circumstances and the demands of the relevant community in which it operates.
17. We make two other important preliminary observations. The first is that listed entities and their officers must comply with the law. This is not a question of culture, nor one of competing goals or priorities or a matter for negotiation or risk management. The second is that, in our view, the CGPR ought not attempt to repeat or paraphrase existing legal obligations. To the (doubtful) extent that important principles of Australian law do not apply to foreign or non-corporate entities listed on the ASX, we think that lacuna is better addressed through a listing requirement that those entities agree to submit to those requirements as a condition of listing.
18. Our specific comments on the redrafted CGPR follow.

PRINCIPLE 1

Recommendation 1.5

19. The Committee supports the revised Recommendation 1.5(b) with respect to gender diversity and would support the application of the 30% gender diversity target to the boards of all ASX-listed entities.
20. However, the Committee is concerned about the breadth, practicality and vague expression of certain parts of the commentary concerning diversity under Recommendation 1.5.
21. The Committee supports diversity policies that promote tolerance, inclusion and anti-discrimination. However, the following commentary could be interpreted as requiring something more:

“A listed entity should have a diversity policy that expresses its commitment to “embrace” diversity at all levels and in all its facets, including gender, marital status,

⁵ That provision says: (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to: (a) the likely consequences of any decision in the long term; (b) the interests of the company's employees; (c) the need to foster the company's business relationships with suppliers, customers and others; (d) the impact of the company's operations on the community and the environment; (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company. (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes. (3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. See generally Tsagas, Georgina, Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures (July 1, 2017). Draft Paper for contribution: Tsagas, G, 2017, 'Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures' in Nina Boerger and Charlotte Villiers (eds.) *Shaping the Corporate Landscape* Hart Publications, Forthcoming. Available at SSRN: <https://ssrn.com/abstract=2996090> or <http://dx.doi.org/10.2139/ssrn.2996090>

sexual orientation, gender identity, age, physical abilities, ethnicity, religious beliefs, cultural background, socio-economic background, perspective and experience.”

22. The term “*embrace*” is vague, if not meaningless. It could well imply that an entity’s workforce at all levels should include diverse representation across all of these categories. If that is what is proposed, the commentary should say so. But that would be impractical and unjustified if the entity promoted tolerance, inclusion and anti-discrimination.
23. We suggest that this paragraph of the commentary could be revised to state:

“*A listed entity should have a diversity policy that promotes tolerance and inclusion at all levels of the organisation, regardless of gender, marital status, sexual orientation, gender identity, age, physical abilities, ethnicity, religious beliefs, cultural background, socio-economic background, perspective and experience, and prohibits discrimination on any of those grounds.*”
24. Item 2 in Box 1.5 should also be revised accordingly.
25. For the same reasons, we are concerned that the paragraph concerning diversity in board composition immediately before Box 1.5 could imply a requirement for a broad diversity that is impractical, even if it is advisable, when the optimum size of a board is 7 people and other critical objectives need to be satisfied in the composition of the board. This paragraph should be deleted.

PRINCIPLE 2

26. The revisions to Principle 2, adding the words “*and knowledge of the entity and the industry in which it operates*”, imply that all directors should bring that knowledge to the board. Such a requirement is unnecessary and precludes the appointment of people with desirable skills, expertise and other attributes.
27. We suggest that the amendment could be revised to read:

“*with members who have or are committed to developing a knowledge of the entity and the industry in which it operates ...*”

Recommendation 2.2

28. Recommendation 2.2 now includes commentary that suggests that boards should consider including members with expertise in “*culture, conduct risk, digital disruption, cyber-security, sustainability and climate change*”.
29. We submit that it is not practical to include people with all of these skills on boards, when boards principally require expertise in the industries in which their entity operates, business strategy, financial management and risk management, and when they are also endeavouring to achieve diversity.
30. We also note that the commentary contains no prioritisation of skills for boards, just a shopping list. It may well be preferable for a board to engage executives or outside consultants to manage or advise on these emerging issues. We do not believe that it is sensible for the commentary to suggest that, for example, a person with specialist skills in cyber-security (and who may not have any other skills or experience required of a director) is an appropriate person to appoint to the board.

Recommendation 2.3

31. The classification of a person associated with a substantial shareholder as not independent continues to be contentious.
32. The new commentary on this issue is based on false assumptions. The new commentary suggests that any director who has a substantial proportion of their wealth tied up in the company should not be classified as independent. Further, there is no basis for the assertion that a director associated with a substantial shareholder is likely to have a bias towards the interests of that holder rather than the interests of shareholders generally. That can only be an issue if those interests differ, in which case we have laws that deal with conflicts, disclosure of interests and related party transactions.
33. That said, we agree that a director associated with a controlling shareholder is not independent.⁶

PRINCIPLE 3

34. We have three general submissions about the proposed changes to Principle 3, followed by some specific comments.

Are the changes necessary or desirable?

35. First, there is no clear evidence that a change to the language of Principle 3 is warranted; or that the proposed changes will have a positive effect on the governance of ASX listed entities.
36. The Consultation Paper states that the changes respond to emerging governance challenges. However, with the possible exception of references to whistle-blowers and anti-corruption, the matters in question are not novel;⁷ the concepts of “*social licence to operate*”⁸ and corporate culture⁹ are hardly new.
37. There is, in our submission, no evidence that Principle 3’s imperative to act ethically and responsibly is in any way defective in the way that it is now expressed or is in need of expansion to be effective - if properly implemented. Principle 3 might not have been implemented effectively in practice by some particularly salient ASX listed entities. But that does not mean Principle 3 should be, or needs to be, amended and expanded.

⁶ P Hanrahan and T Bednall ‘Independence of Directors Affiliated with Substantial Shareholders: Issues of Law and Corporate Governance’ (2015) 33 *Company & Securities Law Journal* 239-265.

⁷ Even then, these are not new governance issues. Australia has had FCP laws since 1999 and whistle-blower provisions under the Corporations Act have been in place since 1 July 2004. That said, the Corporations Committee supports new recommendations 3.2 and 3.3, with some qualifications – see paras 74 to 75 and 76 to 77.

⁸ References to “social licence to operate” in relation to mining projects can be found as early as 1997 in the literature. See for example <https://onlinelibrary.wiley.com/doi/full/10.1111/capa.12218>: ‘More generally, mining was ranked the worst of 24 U.S. industries in a 1996 Roper opinion poll, behind even the tobacco industry (Thomson and Boutilier 2011). It was in this context in 1997 that Cooney reportedly characterized the industry’s problems to World Bank officials as a matter of obtaining a “social license to operate.” World Bank personnel are said to have circulated the term at a May 1997 conference on mining and the community (Thomson and Boutilier 2011).’

⁹ In Australia, references to corporate culture as a foundation for corporate criminal responsibility has been included in Part 2.5 of the Commonwealth Criminal Code since 2001.

38. Indeed, the purpose of a statement of “*soft law*” like Principle 3 is that entities and people are held to account in the court of public opinion and by stakeholders who use the Principles and Recommendations as a reference point for a failure to comply.¹⁰ That is exactly what has happened and is happening in relation to the conduct of certain ASX listed entities. Principle 3 in this sense does not need to be amended – the benchmark imposed is adequate, if it is properly complied with.
39. There is no apparent empirical basis for concluding that an effectively mandatory requirement to state “*core values*” will improve Australian corporate governance or corporate performance. Such a significant change should be supported by clear evidence, no matter how well-intentioned the measure might be.
40. Indeed, there is good reason to conclude that an enterprise having a mere statement of laudable core values, without actually living those values, would have an adverse effect on the governance and performance of the enterprise and the behaviour of those within it. Framing Principle 3 in the way proposed may well have the effect of turning a statement of values into a mere compliance exercise; in other words, to tick a box.
41. In our submission, there is a vast difference to having a statement of “*core values*” and actually believing in and living those values.¹¹ The latter cannot be mandated and is not the proper subject for regulation.
42. More importantly, decisions about values and how to go about choosing and implementing values – in the sense of translating values into acceptable and unacceptable behaviours – is a matter for choice and indeed competition among companies. How well an enterprise does or does not do this, will be reflected in its relative success in the markets in which it operates – customers, employees, suppliers and investors – and that is the way it should be; rather than seeking to legislate for “*values compliance*”, albeit with “*soft law*”.
43. If the main motivation for the change is a fear that additional “*hard law*” will imposed by the Federal Parliament,¹² in our submission that would be the appropriate forum for such a measure to be debated – and likely rejected. However, it would be a mistake, in our submission, for the ASX Corporate Governance Council to adopt counterproductive and far reaching “*soft law*” out of fear of further “*hard law*”, when such “*hard law*” should be resisted on the merits in any event.

¹⁰ We note that the Principles and Recommendations “comply or explain” framework is more effective in theory than in practice, with analysts and proxy advisers taking a checklist approach and departures are effectively unable to be comprehended – hence in many cases there is little choice but to comply, because it is pointless to explain to someone who is not listening.

¹¹ It is perhaps implicit, and deliberate, that a requirement to state corporate values will require them to be implemented. With respect, the much more likely result is that more damage will be caused by the diversion of corporate resources to the need to implement and police corporate values, rather than focus directly on behaviour.

¹² The CP refers to “pressures [that] will inevitably mount for a more prescriptive or rules-based response” (page 5). In our submission those pressures should be resisted, and at least a debate about corporate regulation can take place in the proper forum, with the Government taking responsibility for any measures imposed, rather than the Council amending the Principles and Recommendations to avoid a threat of regulation. The CP refers to the BEAR measure in this context. With the benefit of hindsight and the revelations of the Hayne Royal Commission, it is difficult to resist the conclusion that some form of additional rules-based regulation was required or at least desirable, and there is no basis to think that the proposed changes to Principle 3 would have had any effect on the relevant conduct. Principle 3 already said “act ethically and responsibly”.

44. More importantly, the proposed changes are “*gun jumping*”. To the extent that the changes are said to be a response to issues emerging from the Hayne Royal Commission, the Commission is both limited in its purview and obviously still in progress. Changes to Principle 3 (if any) should await the outcome of the Royal Commission – when the parties before the Commission have had an opportunity to make submissions, the Commissioner has made findings and recommendations, and the Government and the community at large has had a chance to consider the findings. At this point, any changes are premature.
45. Finally, the proposed changes use the idea of a “*social licence to operate*” as a conceptual touchstone. However, this concept is too vague and uncertain to serve as the touchstone for an important piece of regulatory policy. Exactly what does it mean? Is it nothing more than reputation in these times of a 24-hour news cycle and nowhere to hide thanks to social media?
46. Also, the concept tends to confuse two ideas. The first idea is that corporations are formed, and permitted by the community to exist, to serve only lawful purposes. That should be taken as a given, and enterprises that act unlawfully (especially when intentionally or recklessly) should not be surprised by the adverse community reaction – this is not truly about “*social licence to operate*” but rather about a reaction to unlawful conduct – legal licence to operate.
47. The second idea is that there can be customer, employee and investment market reactions to corporate behaviour that, while falling short of illegality, is thought to be unacceptable. This has an adverse effect on corporate reputation and the willingness of customers, suppliers, employees or investors to support the company. But does “*social licence to operate*” in this sense mean anything more than corporate reputation? If so, exactly what does it mean?
48. If the “*social licence to operate*” conceptual framework is really saying “treat your reputation as a valuable asset” that is hardly new, or necessary for the improvement of corporate governance in Australia.
49. In our submission, the regulatory policy implemented by the Principles and Recommendations should be placed on a firmer and clearer conceptual foundation than “social licence to operate”.

Corporate culture

50. **Second**, amended Principle 3 is proposed to be focussed on corporate culture. This focus, in our submission, is an error. Despite the relatively recent debates (including statements by regulators) about the importance of corporate culture, it is a mistake to focus primarily on culture from a regulatory policy point of view. It would be like focussing on character in the regulation of conduct of individuals – the character for an individual is the analogue of culture for a corporation.
51. The focus of regulation should be on behaviour, on conduct, rather than culture. In the end, both regulatory policy and management theory and practice are about getting the desired behaviours within the enterprise. Culture can be an intermediate step in getting the right behaviours, but it is not the main game. In a sense, the right culture is actually an output of getting the internal conduct and behavioural settings right.
52. Or to put this another way – if your behaviour is good, your culture is irrelevant. Likewise, if your behaviour was bad, it would be irrelevant if your culture was good.

Indeed, if you thought your corporate culture was good, but in fact your company's behaviour was bad, that would suggest you had failed from a governance perspective.

53. If enterprises want to focus on culture as a way of achieving all the things they have to do to be a successful organisation, then they should be free to do that. But if they think they can act lawfully, ethically and responsibly without an explicit organisational focus on culture, let them do so. In other words, a focus on culture should not be mandatory, even in the “*soft law*” comply or explain sense.
54. But more importantly, corporate culture is the *outcome* of the behaviours that are promoted and rewarded (both socially and financially), what behaviours are penalised, and what behaviours are tolerated. In the military it is sometimes said that it is the thing that you walk past that sets the culture of the unit – that is, what you are prepared to ignore or tolerate. It is not quite so simple as that, but that saying carries the key idea – culture is actually the result of permitted, encouraged and ignored behaviours. Better then that enterprises (and regulators) focus on those behaviours, rather than being distracted by culture as a construct.
55. Finally, the amendment to the commentary following Recommendation 3.2 appears to assume an overstated role for the board of directors in relation to corporate culture. The corporate culture in practice is set by the senior executive team, most importantly the CEO, not the board of directors, and non-executive directors ordinarily have limited visibility of, or ability to affect, corporate culture.
56. Indeed, corporate culture is intangible and except to those actually operating within the organisation, corporate culture is largely invisible – except where it is manifested in specific behaviours that can come to the attention of the board or external parties. This serves as another reason not to have something as important as Principle 3 based on the nebulous concept of corporate culture.

The conflation problem

57. Third, the proposed changes conflate similar ideas, but those ideas have important differences.
58. As noted, listed entities and their officers must comply with the law. This is not a question of culture or risk management.
59. The proposed changes seek to treat as one subject legal compliance, ethics and social responsibility. This is, in our submission, inappropriate (and dangerous) for a number of reasons.
60. The first reason is that legal compliance must be treated separately from other “*compliance*” obligations.
61. In orthodox risk management methodology, a decision must be taken about the acceptable level of risk. But there is no “*acceptable*” level of non-compliance with the law.¹³ If an enterprise decides, based on purely financial factors, that it will not comply with the law, or is reckless as to whether it complies, by ignoring risks because the enterprise is willing to accept the financial penalty, the community should be deeply

¹³ It is possible that *de minimis* non-compliance would be acceptable, or a technical rather than substantive non-compliance, and there may be situations where the law is so uncertain that a risk of non-compliance would be acceptable. The point here is that a conscious disregard for the law is unacceptable.

concerned, and the behaviour would be unacceptable to a court. It is a mistake to treat non-financial risks in the same way as financial risks, or indeed treat legal compliance in the same way as other business risks – legal compliance must be taken as a given rather than a choice made on the basis of business or financial factors.

62. It is not an exaggeration to say that this type of behaviour (i.e. treating legal compliance as merely another risk to be managed with an acceptable level of non-compliance) may be the cause of some of the current community dissatisfaction that is said by the Council to make the “*social licence to operate*” an emerging issue.
63. Directors and officers should act honestly, reasonably and diligently to ensure that the enterprise complies at all times with all its legal obligations. It is not appropriate to gamble on legal compliance. Legal compliance is not just a financial risk to be managed in the usual way. It is in a different category, but Principle 3 as amended seeks to conflate it with other matters. It should be treated separately to avoid encouraging dangerous confusion.
64. In contrast, ethical decision making in the context of a profit-making enterprise (or indeed making other decisions in the context of conducting an enterprise) involves the balancing of risks, costs and rewards. Ethical decision making may involve the balancing of the present and future effects of a decision on various stakeholders.
65. In conditions of inherently limited knowledge about current circumstances confronting the enterprise and likewise the inherent uncertainty about the future consequences of current actions, outcomes of decisions are uncertain – and risks of unwanted outcomes must be factored in.
66. Hence, in this context, the enterprise and those that govern it must make decisions about what adverse financial and reputational outcomes are acceptable – and these are factored into the so called “*risk appetite*” in risk management methodology.
67. But this involves a different conceptual paradigm to that required for proper compliance with the law – as outlined above there is no acceptable level of non-compliance with the law.
68. By overlooking this fundamental distinction, the proposed changes to Principle 3 would “*bake in*” the confusion between risk-based decision making and need for legal compliance to the Principles and Recommendations, with, in our submission, potentially serious adverse implications for ASX listed enterprises.
69. Moreover, conflating social responsibility with legal compliance and ethics would also be a source of confusion. Social responsibility is a political construct. Different people, different organisations, may well have different views about what it means to be socially responsible either generally or in any given situation.¹⁴ This inherent

¹⁴ On one view, acting in accordance with the law, and ethically, and providing goods or services that are required by consumers, with pricing and quality set by a well-functioning competitive market is sufficiently socially responsible. On another view, an enterprise should go further, and avoid certain activities that are thought to be socially harmful. The complication, for an enterprise required to act in the interests of shareholders, is that a requirement to act in a socially responsible manner can provide a mandate to act in the interest of third parties, at the expense of the enterprise and its shareholders. Shareholders can choose to not support an enterprise if they believe that its activities are thought to be socially harmful (by way of example so called ethical investment is wide spread phenomenon) and choose to accept potentially inferior returns. That said, in some cases, investors choosing not to support a particular activity could materially increase the cost of capital and in extreme cases finance might not be practically available. Similarly, customers and employees can choose not to deal with an enterprise that is thought to be acting in a socially harmful way. These indirect

subjectivity means, in our submission, that social responsibility *per se* is not a proper topic for regulation, even though the “soft law” of the Principles and Recommendations.

70. In our submission, the Principles and Recommendations should not be extended in this way. If it is thought appropriate to elevate the consideration of external stakeholders in corporate decision making, the Principles and Recommendations are not the appropriate vehicle to pursue such a reform – which could have significant and far reaching consequences.
71. Indeed, to the extent that the changes to Principle 3 have this effect, they may be inconsistent with the law of directors’ and officers’ duties in Australia, and such overreach could have serious adverse effects and hence should be avoided.
72. That is not to say that guidance to ASX listed entities in relation to corporate social responsibility is an inherently bad idea, in the opinion of the Committee. It is not. The Committee fully supports the giving of such guidance and the encouragement of ASX listed enterprises to give consideration to the effect of their activities on their stakeholders and the communities that they affect. However, it should not be part of the “*comply or explain*” regime, but rather a separate category of guidance.

Specific comments

Commentary to Principle 3

73. As recent events in live export, greyhound racing and commercial egg production have shown, animal welfare concerns can represent one of the biggest risks to an entity’s reputation in industries involving animals.¹⁵ The Committee accordingly recommends amending the seventh bullet point to read: “, *acting responsibly in relation to the environment and animal welfare*”.

Recommendation 3.2

74. In general terms, the Committee supports the proposed changes to Recommendation 3.2. However, there is reference to ensuring that the Board is informed of breaches of a code of conduct that call into question the culture of the organisation, and for reasons consistent with those outlined above, in our submission the Recommendation should not be tied to a vague concept of culture. What does it mean to “*call into question the culture of the organisation*”? This is a subjective matter, a matter of opinion, and not an appropriate test for a regulatory measure.
75. In Box 3.2, there is reference to not acting in a socially irresponsible manner. For the reasons outlined above, in our submission this is not a proper topic for guidance in a code of conduct. If entities choose to include reference to social responsibility in a code of conduct that should be a matter of choice, not “*comply or explain*”.

methods of “regulating” social responsibility are, in our submission, to be preferred to “soft law” requirements being imposed under the Principles and Recommendations.

¹⁵ Investors and lenders are increasingly looking at animal welfare issues and metrics; for example, Bank of Queensland, Westpac and Australian Ethical Investment al have public animal welfare policies that dictate who they will invest in/lend to.

Recommendation 3.3

76. Generally, the Committee takes the view that it is preferable not to deal with matters that are the subject of legislation through an “*if not, why not*” framework.
77. In any event, for the reasons given above, in our submission references to “*socially responsible manner*” should be removed. That should be a matter for choice by individual enterprises not effectively mandated by the ASX Corporate Governance Council. Any ASX listed company would be effectively forced to comply, because it would be untenable to be singled out as an enterprise that did not apparently wish to be “*socially responsible*” (whatever that might be taken to mean). Any measure that gives no practical alternative to compliance is not the proper subject matter for a comply or explain regime.

Recommendation 3.4

78. As with the previous recommendation, the Committee’s view is that it is preferable not to deal with matters the subject of existing laws in this way, although the policy expressed is appropriate.

PRINCIPLE 5

79. In the James Hardie case the New South Wales Court of Appeal said:

*"The continuous disclosure regime ... is designed to enhance the integrity and efficiency of Australian capital markets by ensuring that the market is fully informed. The timely disclosure of market sensitive information is essential to maintaining and increasing the confidence of investors in Australian markets, and to improving the accountability of company management. It is also integral to minimising incidences of insider trading and other market distortions".*¹⁶

80. The proposed new commentary to Principle 5 does not fully recognise the objectives of listed entities being required to make balanced and timely disclosure and, as currently stated, does not add significantly to the long form statement of the principle. The Committee submits that either a complete statement of the objectives of continuous disclosure be included or the commentary be deleted.
81. In addition, the Committee queries how proposed new Recommendation 5.2 gives effect to, or promotes, the making of timely and balanced disclosure. Recommendation 5.1 already provides that a listed entity should have, and disclose, a written policy for complying with its continuous disclosure obligations. The commentary states that a listed entity should have regard to ASX Guidance Note 8 and the 10 principles set out in ASIC Regulatory Guide 62 *Better disclosure for investors*. A listed entity however has the flexibility to design a continuous disclosure policy that best suits its circumstances. If it wishes to adopt the practice encapsulated by Recommendation 5.2 (which is already suggested by ASX in Guidance Note 8) it can choose to do so. The Committee however would submit there is little merit in elevating this practice to a recommendation and accordingly requiring if not, why not, reporting against compliance with the recommendation".

¹⁶ *James Hardie Industries NV v ASIC* ([2010](#)) 274 ALR 85; [81 ACSR 1](#); [\[2010\] NSWCA 332](#); [BC201009843](#) at [\[355\]](#).

PRINCIPLE 6

82. We support the need for listed entities to provide security holders with access to high quality and relevant information in a timely manner that is consistent with the entity's disclosure obligations under the Listing Rules and the *Corporations Act 2001* (Cth) (**Corporations Act**).
83. We support the ASX's encouragement for security holders to participate in corporate meetings and recognise the importance of providing relevant information through a variety of paper and electronic means to meet the accessibility needs of a diverse range of security holders.
84. We note however that it is also important to recognise that the focus on security holders can gloss over the phenomenon of "*empty voting*" where security holders have entered into arrangements that separate the legal and economic interest in holding securities.¹⁷ For example, a shareholder of record may have "*lent*" their shares or have entered into arrangements such as swap agreements that provide economic benefits if the share price declines, so that they do not have an economic interest in the outcome of a matter being put to a shareholder vote. The use of equity derivatives to gain exposure to large parcels of shareholdings has been commonly used by investor activists, who do not always act in the best long-term interests of security holders.
85. We support the ASX's recognition of the importance and value of effective stakeholder engagement and suggest some acknowledgement that focusing solely on legal holders of securities may ignore the different economic incentives that exist for some security holders and entities transacting with them.
86. We also query the proposal to substitute the words "*as owners*" into Principle 6 in place of "*as security holders*". Not all security holders are properly characterised as owners and the alteration is unhelpful.

Recommendation 6.1

87. We suggest that clarification be made as to the scope of "*other corporate reports*" that are recommended for inclusion on the listed entity's website. Is this limited just to reports that would be subject to continuous disclosure obligations?
88. We support the disclosure of documents and materials tabled at meetings on the listed entity's website.

Recommendation 6.2

89. We support the recommendation for listed entities to engage with a diverse range of security holders, including smaller investors. The decision about whether to monitor particular online discussion fora should be left to the listed entity as part of its investor relations program.

¹⁷ See further H Hu and B Black, 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership' (2007) 13 *Journal of Corporate Finance* 343; 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811.

Recommendation 6.3

90. We question whether the statement that “*A listed entity should choose a venue for a meeting of security holders that is reasonably accessible to security holders who wish to attend the meeting in person or by proxy*” is needed, given s 249R of the Corporations Act.
91. Further, without detracting from the importance of encouraging shareholder participation at physical meetings, it is increasingly important to shareholder engagement for listed entities to facilitate electronic means of interacting with the entity and voting. Research conducted by Computershare¹⁸ shows a 70.5% increase in shareholders voting online over the last 5 years, despite a 21.5% decline in overall voting over the same period.

Recommendation 6.4

92. We strongly support this new recommendation.

PRINCIPLE 7

Recommendation 7.4

93. Having clarity on what is meant by environmental and social risks is useful, however we query the removal of the reference to economic risk. We assume that the basis for this change is to encourage entities to report on the matters considered as going to their “*social licence to operate*”, and in a context where economic risk is covered in the entity’s annual report (by way of the requirement to include material business risks that could adversely affect the achievement of the financial performance or financial outcomes in the operating and financial report - s 299A(1)(c) Corporations Act and ASIC RG 247). We are concerned though that the separation of these (potentially) non-financial risks from consideration of the financial risks is inconsistent with the stated holistic approach to the entity’s risk framework; i.e. considering all risks. We suggest that all risks should continue to be considered together or, at a minimum, it should be clarified that calling out the environmental and social risks in the corporate government statement is only one element of the greater consideration of all risks and their impact on the financial prospects of the entity, as included by law in the operating and financial report.
94. We do not support the reference to the International Integrated Reporting Council’s International IR Framework being included in the commentary to Recommendation 7.4. At most, it should only be included with the list of other sustainability reporting frameworks examples in footnote 71. Our concern is that no one particular type of report or standard should be implicitly endorsed by the ASX Corporate Governance Council, and the CGPR should be agnostic as to the particular framework used. Elevating one type of reporting in the commentary is inconsistent with it being up to the entity to determine the most appropriate framework, or the extent to which it chooses to adopt any formal framework.

¹⁸ Computershare Intelligence Report: Insights from Annual General Meetings held in 2017. March 2108.

PRINCIPLE 8

Recommendation 8.4

95. The requirement for independent advice on consultancy-type arrangements with directors is not necessary. We already have very clear laws on related party transactions, conflicts, and disclosure of interests. They already require such contracts to be on arm's length terms and that remuneration be reasonable. There is no need or justification to overlay these new requirements.
96. In addition, the reach of the recommendation potentially captures far more than consultancy-type arrangements with directors (or effectively with the directors), as it extends to "*related parties*" of the directors. The "*related party*" concept is very broad (presuming that it uses the extended definition in the ASX Listing Rules, which captures persons acting in concert). If the recommendation is amended in this way – there should be guidance that this is not intended, in the ordinary course, to capture ordinary course advisory engagements with professional firms that are associated in some way with a director or their family members, where this is not in effect a consultancy arrangement with the director themselves.

The Committee would be pleased to discuss this submission if that would be helpful. Please contact Shannon Finch, Chair of the Corporations Committee at shannon.finch@au.kwm.com or 02 9296 2497, Professor Pamela Hanrahan at p.hanrahan@unsw.edu.au or 02 9385 9550 if you require further information or clarification.

Yours sincerely



Rebecca Maslen-Stannage
Chair, Business Law Section