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Dear Council

Submission: ASX Corporate Governance Council Principles & Recommendations Exposure Draft 4th Ed

Background

Thank you for the opportunity to comment on the exposure draft for the 4th edition of the ASX Corporate Governance Principles and Recommendations. I am pleased that Council has initiated the update and continued to build on the excellent work of prior editions.

As a former member of Council with involvement in two editions of the Principles and Recommendations and a practitioner who was worked with implementation since the first edition I have a strong interest in the efficacy of Council's work and in the success of its endeavours. This is my first consultation period in the last decade where I do not have an official role with Council and hence it provides an opportunity to provide an independent view.

As someone who has studied and contributed towards corporate governance in Australia and abroad since the early 1990's, my submission is against a broader backdrop of corporate regulation and evaluation of standards in governance, risk and assurance since that time.

In 2018 we are seeing a current wave of corporate behaviour in Australia that is widespread and pervasive. Given the level of reputational damage being done to once well-respected companies and brands this causes pause for thought – is there something systemic in the way that organisations are led and managed, and is there anything peculiar to Australia?

In reflecting on this, I am reminded of the old saying that generals are always doomed fight the last war. It takes great foresight from regulators and standard setters to prepare for the next waves of business and not be limited to the issues of the day. Sarbanes-Oxley was a great example of point-in-time regulation that focused on the risk of financial statement fraud without dealing with the underlying behaviours and motivations. Each time that we set our sights too narrow or too much in the near term we lose an opportunity to get to a better place. We can do better than this. And we must.

Peculiarities in the Australian market that should be at the forefront of Council's mind

Australia has a series of relatively unique and highly concentrated characteristics that should influence Council's thinking on how to regulate listed companies.

The Australian economy and share index are characterised by a very high concentration of large cap companies that have capitalised on market and political power and natural competitive advantage. Perhaps it is due to these advantages and a long period of economic growth that commercial skill in value creation and business model innovation is poor in many large listed companies. In my view the index presents a number of characteristics of an end-of-cycle economy with major structural problems and hence it is prudent for Council to focus on risks to the downside. No doubt I will be proven right or wrong on this in the next 5-10 years, but I thought it important to put these views on the record.

Juxtaposed against this, as Council will be well aware, Australia has a very high concentration of self-funded retires (through superannuation funds or other means) whose future prosperity is highly dependent on our local index. Their exposures are largely unhedged and often not well diversified, and at last count the value of superannuation funds exceeded the total market capitalisation of the ASX.

The asymmetric nature of risk should be at the forefront of Council's mind. A double-digit decline in percentage terms for a large capitalisation stock can take many years to regain in an individual stock or across a diversified portfolio, and may not be regained prior to the drawdown period of an investment fund. Council should be cognisant that baby boomers are now in retirement / drawdown phase and therefore sustained material declines (more than 5%) in share price or sustainable dividends will have a real impact across the entire economy. This is most likely a systemic risk across the economy and the index.

The business models of many large caps and long-standing institutions are under great strain. Over the past 20 years government and corporate profit targets have been achieved in many cases by systemic shifting of risk and financial burden to households. Households are now required to self-fund education, healthcare, health insurance, utilities, childcare or other essentials in life. While CPI has remained within RBA ranges, there has been a structural shift in the basket of goods. While prices of consumer discretionary and lifestyle goods and services have been going down due to the impacts of offshoring to low cost economies, many non-discretionary expenses have generally been going up by double CPI for multiple consecutive cycles. Council should note that those efficiency gains from offshoring are also largely complete and facing many structural headwinds.

Short term profits have also been sustained and propped up by insecure work, restructuring, offshoring, re-baselining and cost and risk shifting in a way that is systemic. This goes to the heart of social license and has now been going on for such a long time that this has been normalised as the Australian way of doing business and as a learned set of patterns and behaviours. Short term performance at the expense of others is now mainstream thinking for many, and perhaps is normalised to such an extent that many can no longer see it. Moral compass is regularly off and mismatch with community expectations is common. This goes to the heart of social license and one of the poorest trust index results on record for companies, company leaders and entire industries.

I am concerned that the widespread corporate scandals that we see every week are no longer an isolated set of behaviours. I fear this is now generationally normalised and entrenched such that the current generation of managers are no longer aware that there is another or better way, or what is fair and decent. This carries systemic risk to the economy and also to our values as a nation.

There are two key issues that arise out of this:

1. While upside is important, downside hurts. This poeses a systemic risk in the next 5-10 years and should be the primary focus of Council for this round. Double digit percentage declines in market capitalisation or dividend yield pose a systemic risk for the index and the economy, particular for those of large caps which now have a social responsibility to provide future earnings stability for their shareholders.
2. Corporate scandals are now a weekly occurrence. How do we avoid the next AMP, another CBA, Cricket Australia, Essendon Football Club? And what is the role of ASX Listed companies as a contributor to social cohesion, values, ethics and behavioural norms?

The consultation draft goes deeper into addressing some of the points, but in my view has been distracted by some of the other issues of the day. In my view, Council should be bold and go further.

While I'm working with many organisations in tackling these challenges, I don't profess to have the solutions for the issues above in a way that falls neatly as recommendations for Council. This requires good old-fashioned quality policy work of the standard that Council has produced in prior editions. Nonetheless I have provided a number of suggestions that I hope Council will find useful.

I encourage Council to pause and deeply consider the issues raised and to get to the heart of the underlying drivers and causes before responding to the fine detail in individual submissions. These are the issues of the coming decade. We will all benefit from Council's collective wisdom. Conversely, I suspect history will not be kind if these issues are left begging.

I wish Council well with these important challenges. This is important work and worthy of Council's close attention.

Specific suggestions

1. Clearer and more stringent reporting against the recommendations

The Principles and Recommendations were developed on the assumption that informed investors could seek to invest or chose to avoid companies with poor governance. The reality is slightly different.

In practical application many companies adopt a "comply or spin" approach. While there's nothing untruthful in most of these disclosures, it is difficult for the average retail investor or small advisor to form a view on their approaches and whether any short cuts have been taken. Even as a former member of Council I now find the language impenetrable without doing extensive legwork and analysis.

For a comply-or-explain approach to operate as intended, the table summarising compliance against recommendations and cross referencing must form part of the entity's corporate governance disclosures and not sit as an unreferenced filing to the ASX. By keeping a summary table as a separate filing, it reduces the summary to a discussion between the entity and the Exchange, instead of with its investors and stakeholders as intended. This needs to be remedied either by listing rule or sharpening the expectations in the Principles and Recommendations.

The exposure draft also refers to pedantic or a legalistic compliance. The reality is that for many organisations that they default to a legalistic approach with strict reporting against the specific wording of the reporting triggers (recommendations) without reference to the underlying principle. This is a rules-based approach that is not Council's intention. I would encourage Council to rewrite this section to require entities to address the spirit of the underling principles and supporting guidance and not just address the specific wording of the recommendations.

2. A higher standard for blue chips and large market capitalisation entities?

There is also the question of whether an if-not, why-not regime still works on an index that is dominated by superannuation funds and the levels of systemic risk and economic dependency as described in my submission above. Superannuation funds tend to hug the index, so the reality is that funds may still have an underweight position in a bad company with a high market capitalisation. In the reality of universal share ownership, an if-not, why-not approach to large capitalisation companies may no longer make sense. Blue chip companies and those with high market capitalisation should be held to a higher standard than others which is reflective of their asymmetric risk profile and impact. This is a matter for government and the ASX but will be of great interest to Council.

I would also strongly caution Council to not dilute their work or provide carve-outs or wiggle room for small cap companies. The if-not, why-not regime is intended to be a race to the top and not a race to the bottom. If a small cap cannot comply or chooses not to, this is the very type of disclosure that the framework is designed to surface. I'd urge Council to stay strong on this.

In particular I note the updated recommendation 8.4 and the other references peppered throughout the document. In 2016 in its annual director education, AICD strongly encouraged directors to never put themselves in a position of directing and also advising the same company. Similarly, it is generally understood that directors should not play dual roles or generate potential conflicts. Recommendation 8.4 looks odd, and that Council would sanction or enable this practice is incongruent with the rest of the document. Simply if this happens it should be a non-conformance and require disclosure as opposed to being sanctioned as good practice.

Lastly in paragraph 3, Council notes that the Principles and Recommendations are designed by for the ASX but may be helpful for others. I am aware of very few parts of the economy (government, not for profit, APRA-regulated) that don't refer to the Principles and Recommendations as their key benchmark. Council should be aware of this, and if encouraging others to use the principles in this way that this holds their work to a higher standard. I encourage Council to be aware of this context and consider lifting the bar for companies that are systemically important to the index and the Australian economy.

3. Reintroduce the material business risk requirements as a reporting trigger

The 2nd edition rightly pointed out that the point of Principle 7 was to focus directors and officers on the most material risks to the organisation (usually defined as those risks that could move the share price or earnings by more than 5% on a sustained basis) and not get buried in risk minutia.

In the years after the release of the 2nd edition many large companies implemented very good process and discussion on material business risks that drove the right discussions at board level, supported by considered thought and analysis. Based on my benchmarking internationally this resulted in world-leading practice in this area and moving risk beyond a box-ticking or handle-turning exercise. I have no doubt in my mind that this was a source of competitive advantage and strength by those who did it well as it forced the right sort of discussions at board level. This was excellent principles-based regulation and something I've been proud to showcase internationally. For me this one of Council's best achievements.

This reporting trigger was removed in the 3rd edition without consultation. It came as a surprise to many, including those who had invested heavily to implement the requirement and I see this as a serious misstep by Council. For many, momentum on focusing at the right level has diminished and risk work is at serious risk of turning back into tick-box exercise focused on the issues of management and not of the board.

Council should also be aware of research by the Corporate Executive Board that shows that the largest declines in market capitalisation are generally in the areas of strategic risk, and not in the areas of operational, reporting and compliance risk as normally surfaced by bottom-up risk processes. This is consistent with my firm's analysis of sustained double-digit market declines (%) by entities listed on the ASX. The previous reporting trigger generated a lot of focused discussion on strategic risk and this is the right level of discussion for boards. It also addresses the complaint of overregulation or burying of boards in compliance.

I note that Council has re-inserted the requirement, but not as a reporting trigger. Notwithstanding the intention of reporting against the spirit of the principles and not the letter of the recommendations, Council should be aware of the weight of the recommendations as reporting triggers as a force for driving exemplary practice.

Given the downside risk issues as outlined early in my submission, I would strongly encourage a reporting trigger on material business risks, as it is for all prudentially regulated entities under APRA CPS 220.

I'd also suggest aligning the narrative in Principle 7 with APRA CPS 220. CPS 220 has become the defacto standard for many of these matters, filling some of the gaps left by the 3rd Edition of the Principles and Recommendations.

I'd also encourage clearer and more prominent disclosure of the organisation's material / principal business risks. I note that this is largely addressed in the Corporations Act, but the linkages and disclosure requirements could be clearer and highlighted more strongly (not by footnote) and more clearly encouraged in substance and form. In doing so I'd encourage alignment with the disclosure requirements under the UK and New York stock exchanges for consistency and easing regulatory burden and reporting complexity for dual listed entities.

I also note that many of the behavioural issues in corporate scandals since the 3rd edition were caused by (often large) pockets of managers attempting to address short term performance issues. In turn these performance issues were often generated by not addressing material business risks at the right levels. While I do not have published data to support this, in my experience strong performance on material risk helps avoid these sort of performance issues and responses. A strong business model is a great enabler, and desperate times call for desperate measures. (See more on culture, conduct below).

Council will also note international developments in the UK in particular that now refer to creating and protecting value. This language may be appropriate as an extension of the wording in Principle 2 to underscore value protection as a role for the board and not something to be left to the risk people.

4. Culture, values and conduct

I applaud Council for putting a sharper focus on these issues. As indicated above I believe Council needs to go further and do some deep policy work to consider and address underlying drivers.

I do not profess to have expertise in these areas, but when asked for a risk response to current conduct issues this is my first avenue. This area would benefit from clearer guidance. APRA and ASIC's recent work and speeches in this area are instructive.

5. Remuneration

I congratulate Council for pushing further into this space and making the linkages with risk taking and performance. This needs to go further.

Like previous periods, the period of the 3rd edition continued with a pattern of sustained double digit percentage drops in market capitalisation, asset values and future earnings with limited consequences for Directors and Officers other than a reduction in bonuses, and in very rare cases an early retirement and short-lived adverse publicity.

I would encourage Council to consider what would happen if they were to hire someone to go to the casino and pay them a percentage of winnings with no penalty for loss of capital. While this is a deliberately absurd example, it is not dissimilar to many incentive schemes. Even more absurd is the situation where executives may receive a benefit due to irrationalities in the market (such as speculation or take-over rumours) rather than good performance. The whole area needs a revisit and closer alignment of upside and downside, noting the asymmetric impacts of losses of capital.

Council will wish to pay particular attention to takeover periods. It will not be lost on retail shareholders that when boards and management destroy capital and sell the company at a discount that they are rewarded handsomely for doing so. There are many examples of this. This is abhorrent and is not addressed in the current discourse.

Similarly paying of bonuses during periods of reputational damage and poor ethical behaviour has not been suitably addressed. ASIC's work in this area is instructive, but Council should go further.

While I don't profess to have any particular solutions on remuneration, it is an area requiring focus.

I also remind Council of risks to the downside in the coming decade which underscores the importance of this area.

6. Reframe the diversity debate and broaden the requirement

Large cap companies are doing analysis on the performance impacts of diversity (including but not limited to gender). The data that I'm seeing on this is diverse teams nearly always outperform non-diverse teams on all performance metrics (safety, throughput, financial performance) but with a particularly big jump in engagement and retention. Diversified teams consistently outperform single gender teams (either male or female), or any team with a narrow base. In addition to performance and healthy workplaces, diverse teams are far better at avoiding blind

spots, and in my experience as an expert on emerging risk and "black swans", highly diverse inputs and perspectives are the only thing that avoids blind spots. This is particularly the case in areas of systemic risk and social license.

The current public discourse is framed as a "battle or the sexes" discussion, which is unhealthy, polarising and counterproductive. If we have learned anything from the referendum on marriage equality, it is that putting any group in a position where they have to argue their respective merits is polarising, counterproductive and crass. It devalues, infuriates and alienates the advocate group and those seeking to justify why they still make a meaningful contribution. I would encourage Council to remove cases for any particular group as it weakens the argument and portrays Council has pandering to particular groups.

Diversity needs to be reframed as a governance issue that drives good performance and not as a demographic or equity issue. The current framing has opened Council up in ways in which it is poorly equipped to operate and as I predicted to Council at the time has generated a discussion on demographic group by demographic group. If we have to wait for every group to have their turn to be represented, activated and offended (gender, race, age, world view, knowledge etc), we will be waiting a very long time to achieve diverse boards and leadership groups.

Much of the debate on diverse perspectives (cognitive diversity, diversity of background and viewpoint) sits more comfortably as part of the skills matrix discussion and requirements. I note that Council has narrowed the skills matrix to that of skill and not broader attributes in cognitive ability and constructive discourse. I believe this is a mistake. If a director group or executive group comes from the same locations, business backgrounds, schooling, universities, worldviews and data points then that group is not diverse. This causes blind spots, loss of connection with community sentiment and generally being out of touch with the stakeholder base. This also plays into social license (see below).

I'd suggest a rewrite of this recommendation so that the emphasis is on value creation and preservation, and that diversity is a means to this end (with many benefits). This is the appropriate role for Council and in doing so Council may help propel the debate in a constructive, rational and energising manner that generates the desired results.

Council should also note that this recommendation is now 5 pages long, which is double the length of the next longest recommendation. Given the fundamental importance of some of the other recommendations, Council may wish to look at length if only for the messaging that it intends to send. Rebalancing this with the section on skills matrix may help achieve the desired aims.

7. Environmental and social risk

Recommendation 7.4 is a compromised recommendation and needs to be reframed.

By limiting social and environmental risks to their impact to the company and not to other stakeholders, this reasserts the notion of shareholder supremacy and social license impacts are ignored. By intention or otherwise it reinforces the view that externalities are okay as long as they don't have any direct blowback to share price. This ignores the shift in the public and regulatory debate on shareholder supremacy, circular economy, natural capital, social capital, social license etc.

This is a very narrow and unenlightened view, particularly in 2018 given as much as 80% of the valuation of big caps is attributable to intangibles (loosely defined as goodwill, reputation, future dealings, social license).

The recommendation could be reframed as a discussion on building social capital, and risks to social and natural capital beyond their own balance sheet. Most likely it sits more naturally under Principle 6 if framed this way.

If it is purely a focus on harm and not building of social capital, then it should remain under Principle 7 but needs more thought. In particular the destruction of social and natural capital that is rife in Australian business.

I would also draw Council's attention to the practice of externalising risk and burden to an organisation's value chain and the boarder economy, particularly during a period of universal share ownership. ESG agencies are better placed to make these arguments, but the addition that I would make is that making short term profits while depleting social and ecological capital is a very risky strategy. It is also widespread as indicated in my comments above.

8. Assurance and downside protection

The ASX still remains an anomaly amongst its peers when it comes to assurance requirements. In most comparator exchanges, internal audit is a non-negotiable listing rule in the same way as audit committees are for ASX listed entities. By contrast, recommendation 7.3 is a flimsy recommendation that includes an out in part (b) where an entity can say that they are compliant without an internal audit function. This results in all sorts of cute explanations that really don't get to the sprit or intent. There is much practice across the index that does not meet the spirit nor intent of this recommendation as a result, including in the ASX 200.

It appears that the Institute of Internal Auditors (IIA) has been left to push its own barrow on this area, and this shows a lack of leadership by Council and the Exchange individually and collectively. This must be remedied and brought into line with comparator Exchanges, particularly for large caps.

When doing so, protections for independence of this function are critical. A change in external auditors requires a shareholder resolution. A change in company secretary requires board approval. A change in internal auditors can be done by a whim of management without board advice or public disclosure despite the difficult, insecure and occasionally untenable position that they hold. In my view this approach is delinquent and allows boards to abrogate their responsibilities for a high performing high standard internal audit function. If Council is to be taken seriously as an alternative to regulation, this needs to be remedied.

9. Independent directors

Page 23 includes a suggestion for there to be more than one independent director. Having been an independent non-executive for much of the last eight years I support this view. Being in the minority on critical issues is never a good place to be, particularly as the voice on critical governance matters within the board.

The way that this is framed however reminds me of the early arguments on gender diversity ie. one is token and more than one provides enough basis to influence. I think we've moved a long way beyond the "more than one" argument. I assume the 30% figure for gender diversity is based on literature around critical mass of influence. I would assume that such an important area as independent-directors should be subject to the same logic and metrics as a minimum for consistency and credibility. It is fundamental.

10. Accountability and specificity

Throughout the document efforts have been made to be more specific (eg. referring to executive management instead of just management) and clarity of language. Some of this weakens the requirements.

I'd particularly refer to page 9 and the introduction of a senior executive team concept. This is too detailed for this document. From a governance perspective it is management collectively that is responsible for various aspects and not a sub-set of it.

I'd also encourage Council to review the document to see if there is an unintended shift from outcomes and accountabilities to inputs and activities. For example, Principle 3 refers to instilling the desired culture. This is important is an input and is less strong than an accountability for ensuring the entity acts ethically and responsibly. I am well aware of the need to avoid words like "ensure" but some of the language has gone too far the other way. This dulls the requirements. There are various examples of this throughout the document.

Also, in recommendation 4.1 there is a requirement for accounting and financial expertise. This is critical and the anchor for audit committees, but their work today is far broader than this and is worth noting in the guidance. I encourage Council to review and refence the Qualified Risk Director Guidelines that are more in keeping with modern audit and risk committees.

Conclusion

None of the above comments are meant to be critical of Council. They are merely observations based on a range of viewpoints and an ongoing commitment to the efficacy of Council's work. I hope that some of the observations and suggestions generate deeper policy thought, discussion and response.

I wish Council well and look forward to seeing the fruits of these discussions in due course.

Sincerely,

Todd Davies FCA PFIIA MAICD
Founder, Todd Davies & Associates

About Todd Davies & Associates

Todd Davies and Associates is a boutique advisory firm that helps companies optimise their efforts and investment in governance, risk and assurance. Our vision is to work at a scale and pace that is worthy of the challenges and opportunities of our times. We work with many of Australia's best recognised companies across the entire economy which puts us in a privileged position of understanding how companies apply Council's Principles and Recommendations. More information on who we are, who we work with and what we do can be found on our website.