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ASX Corporate Governance Council
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Submission to the Consultation on Fourth Edition of Corporate Governance Principles and Recommendations

This submission is made by Dr. Anita Foerster and Professor Jacqueline Peel, Melbourne Law School, University of Melbourne. It draws specifically on the authors' current research exploring the potential for corporate law to promote companies' and investors' identification and management of climate risks and transition to clean energy practices.[1] As such, the submission focuses on issues related to the governance of environmental and social risks and particularly the identification, disclosure and management of risks posed to business by climate change.

The Corporate Governance Principles and Recommendations are integral to the overarching corporate governance framework in Australia and provide important guidance around reporting and risk disclosure obligations and expectations. Since the third edition was published in 2014 with the specific inclusion of recommendation 7.4 under Principle 7, the document has helped to underscore the importance of identifying and managing environmental and social risks and to frame approaches to their disclosure.

However, since 2014, the attention given to these risks by investors, regulators and other financial stakeholders has increased considerably. In particular, the serious financial risks posed by climate change to companies and asset owners have been widely recognised, with a range of initiatives emerging to ensure the full disclosure of these risks and their proper consideration in financial decision-making.[2] It is therefore timely and appropriate that the proposed Fourth Edition of the Principles and Recommendations addresses these developments and includes a number of specific new references to climate change related risks.

The comments below address some of the changes proposed to the Principles and Recommendations and accompanying guidance. We also highlight a number of areas where further clarification and additional guidance for stakeholders would enhance the contribution made by this document to the

[1] This research is funded by the Australia Research Council (DP160100225, *Devising a Legal Blueprint for Corporate Energy Transition*).

[2] This is well illustrated by the publications and activities of major financial institutions such as the Financial Stability Board and the Bank of England, as well as regulators, including the Australian Prudential Regulatory Authority. See, Mark Carney, 'Breaking the tragedy of the horizon—climate change and financial stability' (Speech delivered at Lloyd's of London, September 29, 2015); TCFD *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures* (2017); Geoff Summerhayes, 'Australia's new horizon: Climate Change Challenges and Prudential Risk' (Speech delivered to the *Insurance Council of Australia Annual Forum 2017*, Sydney, 17 February 2017); Geoff Summerhayes, 'The Weight of Money: A business case for climate risk resilience' (Speech delivered to the Centre for Policy Development, 29 November 2017).

identification, disclosure and management of climate-related and other environmental and social risks by Australian companies.

Recommendation 2.2 – to have and disclose a board skills matrix setting out the mix of skills that the board currently has or is looking to achieve in its membership

The authors support the additional guidance provided for this recommendation and particularly the acknowledgement that boards are increasing being called upon to address new or emerging issues, including in relation to 'sustainability and climate change.' We also support the recommendation that boards should therefore ensure that they are well equipped to address such issues, through both the appointment of directors with specific skills and experience and professional development activities for existing directors.

The importance of directors being well-informed about the potential impacts of climate risk to their business has been underscored recently by prominent legal opinions that recognise that directors who fail to consider the impact of foreseeable climate change risks on their business properly could be held personally liable for breaching the duty of due care and diligence they owe to their companies.[3] Further, asset owners and asset managers are increasingly calling for company directors to demonstrate their climate competency. For example, Blackrock Inc, the world's largest asset manager, has made climate change a central engagement priority with investee companies, and has publicly called for company directors in highly exposed sectors to 'have demonstrable fluency in how climate risk affects the business' and how they will address these risks.[4]

Principle 3 - A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and in a socially responsible manner.

In the commentary accompanying this important new principle, there is useful discussion of how corporations can ensure that they conduct business as 'good corporate citizens' to maintain their social license to operate consistent with the increasing expectations of investors and other stakeholders. The commentary includes a list of examples of behaviours or standards which could be taken to demonstrate good corporate citizenship, including 'respecting the human rights of employees' and 'acting responsibly towards the environment.'

An additional factor that demonstrates good corporate citizenship and which could be added to the list of examples within the commentary to Principle 3 relates to corporate lobbying activities and corporate political donations. This is an issue which has been raised in the context of energy and resource companies by recent shareholder resolutions brought to major Australian mining companies BHP Billiton and Rio Tinto. These resolutions called on the companies to review their political

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[3] Noel Hutley SC and Sebastian Hartford-Davis, *Climate Change and Director's Duties* (Memorandum of Opinion prepared for the Centre for Policy Development and the Future Business Council) (7 October 2016). The opinion finds that climate change risks would be regarded as foreseeable by courts and relevant to a director's duty of care and diligence to the extent that those risks intersect with the interests of the company; that company directors are not legally restricted from taking into account climate change and related environmental and social risks where they are material to the interests of the company; and that company directors can, and in some cases should be considering the impact on their business of climate change risks. It concludes that directors who fail to consider the impact of foreseeable climate change risks on their business properly could be held personally liable for breaching the duty of due care and diligence they owe to their companies.
[4] Blackrock, *Blackrock Investment Stewardship Engagement Priorities for 2018*, (2018), 3-4.

lobbying activities, including indirect lobbying carried out through their membership of various industry associations that have been involved in obstructive lobbying against climate change mitigation regulation (such as the Minerals Council of Australia). Further, the resolutions requested the companies to identify any inconsistencies between the political advocacy and lobbying activities of these associations and the company's own stated policy positions on energy and climate change, and to consider terminating these memberships where such inconsistencies were identified.[5] Both resolutions received significant levels of the shareholder vote,[6] despite the legal obstacles to bringing non-binding advisory resolutions of this nature in Australia.[7] Both companies have since committed to address the issue, with BHP Billiton taking substantive steps to address identified inconsistencies by withdrawing from the World Coal Association and entering into dialogue with the Minerals Council of Australia on their climate policy positions.[8]

In light of this increased focus on corporate lobbying activities and shareholder concern about inconsistencies between indirect lobbying and the stated positions of companies, we suggest that the Council consider adding the following additional example to the discussion of measures or behaviours that reflect good corporate citizenship:

- *Ensuring that direct and indirect corporate lobbying activities (including political donations and corporate membership of industry associations which engage in government lobbying activities) are consistent with the company's stated policy positions and long-term interests.*

Recommendation 4.4 - A listed entity should have and disclose its process to validate that its annual directors' report and any other corporate reports it releases to the market are accurate, balanced and understandable and provide investors with appropriate information to make informed investment decisions.

This new recommendation is a welcome addition to the Principles and Recommendations. Corporate reporting beyond the financial report included in the Annual Report is an important source of information for investors and other stakeholders on how a range of risks, including environmental and social risks, potentially impact on the financial prospects of a company. As noted in the commentary to this recommendation, there are specific legal requirements for listed companies to include a discussion of the main internal and external risk sources that could adversely affect the entity's prospects for future financial years within the the Operating and Financial Review [OFR] in the Director's Report.[9] However the Director's Report is not subject to the same degree of independent

[5] The resolution brought to BHP Billiton's Australian AGM is available at: https://www.bhp.com/-/media/documents/investors/annual-reports/2017/bhpnoticeofmeetingltd2017.pdf?la=en. The resolution brought to Rio Tinto's Australian AGM is available at: https://www.asx.com.au/asxpdf/20180314/pdf/43sf7h344xgrbd.pdf

[6] The BHP resolution received almost 10% of the vote (almost 15% abstentions). The Rio Tinto resolution received 18.3% of the vote (almost 20% with abstentions).

[7] The federal court decision in *Australasian Centre for Corporate Responsibility v Commonwealth Bank of Australia* [2016] FCAFC 80, confirmed that shareholders cannot bring a non-binding advisory resolution to the AGM as this would be inconsistent with the proper division of powers between the board and the general meeting of members. As a result, recent shareholder resolutions addressing climate change (including those brought to BHP Billiton and Rio Tinto) have been structured as special resolutions for constitutional change, with a secondary, conditional resolution addressing the substantive climate change matter.

[8] James Thomson, 'BHP formally leaves World Coal Association over climate change stance' *Financial Review* (5 April 2018)

[9] Corporations Act 2001 (Cth), s 299A. See also, ASIC, *Regulatory Guide 247 - Effective disclosure in an operating and financial review*, para 60-64.

scrutiny as the financial statements by reason of the fact that the company's auditors have limited obligations to review and provide assurance on such 'other information.'[10]

The Director's Report is a particularly important avenue through which a listed entity can identify climate risks and outline its approach to their management. It is clear that where climate change poses material financial risks to an entity, these risks should be disclosed and discussed within the OFR as well as being reflected, as needed, in an entity's financial statements.[11] In their final report, the Taskforce on Climate-related Financial Disclosures [TCFD] has recommended that entities, for which climate change poses material financial risks, should be disclosing these risks within mainstream financial filings, as well as engaging in detailed, forward-looking consideration of how these risks may impact the entity going forward through climate change scenario analysis.[12] These recommendations underscore the importance of listed entities ensuring that climate risks are not only reflected in the financial statements, but that the commentary and discussion in the OFR also reflects this forward-looking climate risk analysis.

The proposed new recommendation advises companies to disclose the processes they have used to validate Director's reports and other forms of corporate reporting, in circumstances where these reports have not been subject to the independent oversight and assurance of appointed auditors.

In light of the importance of the OFR and Director's Report in particular to the full disclosure of climate risks consistent with recommendations of the TCFD, we would argue that this recommendation could be significantly strengthened by providing some additional guidance on what types of oversight processes would be considered to be appropriate.

We note that the legal regime in comparative jurisdictions such as the UK establishes far more rigorous oversight processes for the equivalent of the Director's Report and OFR, requiring specific assurance by auditors of this 'other information'.[13] Given this is not currently required in Australia by law, providing some further, more detailed guidance to ensure the quality of this reporting and its consistency and relevance to the financial information would be a very useful addition to the Principles and Recommendations.

Recommendation 7.4 - A listed entity should disclose whether it has any material exposure to environmental or social risks and, if it does, how it manages or intends to manage those risks.

The proposed rephrasing and simplification of this recommendation is an important improvement and clarifies that the recommendation is addressing environmental or social risks that are material for an

[10] Australian Auditing Standard 720 *The Auditor's Responsibilities Relating to Other Information*, provides that a listed entity's annual report will generally be subject to review by its auditor but this review is undertaken for limited purposes and is not an assurance of the annual report (see paragraph 8 of that Standard).
[11] This view has been expressed in a number of recent publications and submissions including: ASIC, *Submission to the Australian Senate Inquiry into Carbon Risk Disclosure* (2016); Anita Foerster, Jacqueline Peel, Hari Osofsky and Brett McDonnell, 'Keeping Good Company in the Transition to a Low Carbon Economy? An Evaluation of Climate Risk Disclosure Practices in Australia' (2017) 35(3) *Company and Securities Law Journal*; Noel Hutley and Sebastian Hartford-Davis, above n 3.
[12] TCFD *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures* (2017).
[13] In the United Kingdom and much of the European Union, auditors must now also review and provide assurance on 'other information' included in the annual report in addition to their obligations in relation to financial statements. This includes the strategic report and director's report which correlate to the Australian director's report and OFR. See for example, *Companies Act 2006* (UK) ss 496 and 497A. See also discussion in ClientEarth, *Risky Business – Climate Change and professional liability risks for auditors* (2017), 14-18.

entity – i.e. that pose material financial risks. It is also a welcome improvement to draw a strong link in the commentary between an entity's social license to operate and ensuring they conduct their business in a way that is socially and environmentally responsible.

The new definitions of environmental and social risks in the glossary, however, in our view, do not match well with the wording or intent of the recommendation. For example, environmental risks are defined as '*the potential negative consequences to a listed entity arising from its impact or perceived impact on the natural environment. It includes the risks associated with pollution, environmental degradation, adding to the carbon levels in the atmosphere, and threats to a region's biodiversity or cultural heritage*.' We argue that it is important to clarify in the definition that these risks may be financially material. It is not enough to refer to 'negative consequences.' Rather the definition should refer to 'the legal obligations, liabilities, reputational damage and other consequences' and should also note that these consequences may manifest as financial impacts on an entity.

The guidance states that an entity may (but does not need to) meet these disclosure requirements by preparing an 'integrated report' or a 'sustainability report' in accordance with best practice guidelines. In our view this statement introduces some ambiguity around the underlying legal obligations to ensure that material financial risks (including environmental and social risks that are deemed to be material to the entity's interests) are reflected in the financial report and reported in the OFR (as part of the Director's Report) as required by the *Corporations Act*.[14] Further, the guidance goes on to encourage entities with a material exposure to climate change risks to consider implementing the recommendations of the TCFD. Considering one of the core recommendations of the TCFD is that climate change risks should be disclosed within mainstream financial filings, it appears incongruous to suggest in the guidance to recommendation 7.4 that these disclosure requirements can be met via additional reporting in the form of a sustainability report. We submit that the Council should make it clear in the guidance to this recommendation that any additional reporting on social and environmental risks through sustainability reports would be in addition to the legally required disclosure of any material financial risks posed by climate change within mainstream financial filings as required by the *Corporations Act* and as recommended by the TCFD.

Finally, the discussion of the particular nature of business risks posed by climate change and the reference to the TCFD recommendations is a welcome improvement to the Principles and Recommendations. It is particularly useful to provide some discussion of the nature of climate risks as well as the caution that 'many listed entities will be exposed to these types of risks, even where they are not directly involved in mining or consuming fossil fuels' and 'entities that believe they do not have any material exposure to environmental or social risks should consider carefully their basis for that belief and benchmark their disclosures in this regard against those made by their peers.' It may be beneficial to add a further caution with regard to climate risks that advises entities against concluding prematurely that climate-related risks are not material based on perceptions of the longer-term nature of some climate risks and associated uncertainties.[15]

Leading Australian companies are now committing to implement the recommendations of the TCFD, including through the disclosure of climate change scenario analysis.[16] Investors also increasingly

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[14] *Corporations Act 2001* (Cth), s 299A; ASIC, *Regulatory Guide 247 - Effective disclosure in an operating and financial review*, para 60-64.

[15] This would align with the approach taken by the TCFD. See, TCFD *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures* (2017), 35.

[16] An analysis completed in late 2017 by Market Forces found that 14% of ASX50 companies had at this point in time already disclosed scenario analysis and a further 24% had made specific commitments to review or implement the TCFD recommendations in 2017/18, including using scenario analyses. See, Will Van del Pol,

regard the TCFD recommendations as a best practice benchmark for disclosure.[17] In this context, we would submit that the Council should provide a stronger endorsement of the TCFD as a framework for approaching climate risk disclosure, as well as explicitly note the core recommendations within the TCFD report.

As such, we suggest the following wording be used to replace the proposed reference to TCFD:

The Council would encourage entities that have a material exposure to climate change risk ***to implement*** *the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD),* ***including by ensuring these risks are reflected in mainstream financial reports and in any discussion of business risks, prospects and other forward-looking risk analysis within the Director's Report.***

Finally, we understand the desire to ensure that the Principles and Recommendations are applicable to a range of different corporate contexts, allow for entities to adopt the recommendations as relevant for the nature of their business and corporate structure, and do not expand into a lengthy, overly detailed and prescriptive document. However, we also note the specific recommendation of the TCFD Country Review paper for Australia which proposes a number of practical actions for achieving better TCFD compliant climate risk disclosure in Australia,[18] including that the:

ASX should continue to enhance corporate reporting and consider the development of guidance that specifically addresses how to implement the TCFD recommendations. Specifically, ASX should consider providing guidance on the circumstances in which a listed entity's exposure to carbon risk requires disclosure under Recommendation 7.4 of the ASX Corporate Governance Principles and Recommendations.[19]

In this light, we suggest that the proposed changes in the Fourth Edition only go part of the way to addressing the lack of guidance on climate risk disclosure for Australian entities and that separate and additional, more detailed guidance should be developed by the ASX to supplement the Principles and Recommendations under Principle 7. This should be coordinated with efforts by corporate and prudential regulators to provide additional guidance in this area.[20]

New Research: How have ASX50 companies responded to the TCFD recommendations? *Superswitch News* (5 Dec 2017), available at: http://superswitch.org.au/news/asx50-tcfd/

[17] For example, Climate Action 100+ is a five-year initiative led by investors to engage with the world's largest corporate greenhouse gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures. To date, 279 investors with nearly USD $30 trillion in assets under management have signed on to the initiative. One of the key engagement priorities is to seek a commitment from companies to 'Provide enhanced corporate disclosure in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and sector-specific GIC Investor Expectations on Climate Change (when applicable) to enable investors to assess the robustness of companies' business plans against a range of climate scenarios, including well below 2-degrees and improve investment decision-making.' See, https://climateaction100.wordpress.com/companies/

[18] Baker Mackenzie and Principles for Responsible Investment, *Recommendations of the Task Force on Climate-related Financial Disclosures – Review of Local Relevance, Australia* (2017).

[19] Ibid at 19.

[20] We note the ongoing work of APRA and ASIC in this area, including the initiatives outlined by John Price, Commissioner of the Australian Securities and Investments Commission in a speech to the Centre for Policy Development on 18 June 2018: https://asic.gov.au/about-asic/media-centre/speeches/climate-change/

We hope that the above comments and suggestions are useful to the Council in their finalisation of the Fourth Edition of the Corporate Governance Principles and Recommendations.

Yours faithfully,

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