

Proposed fourth edition of the ASX Corporate Governance Council's Principles and Recommendations

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Submission on the proposed fourth edition of the Corporate Governance Principles and Recommendations

King & Wood Mallesons ("KWM") welcomes the opportunity to comment on the ASX Corporate Governance Council's ("Council") proposed fourth edition of the Corporate Governance Principles and Recommendations ("Consultation Draft").

We commend the Council's aspiration to maintain strong corporate governance standards and its efforts in continuing to develop and update these standards. We generally support the Council's proposed amendments set out in the Consultation Draft however have highlighted some areas of concern for the Council's consideration.

Our submission invites the Council to consider our views in relation to amendments to Principle 1, Principle 2, Principle 3 and Principle 4.

Part one sets out a summary of all of our submissions. Part two provides further details regarding our more substantive submissions.

We welcome the opportunity to discuss our views further. If you would like further information, please contact one of the partners listed below.

Yours sincerely

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Part one: Summary of submissions

Proposed change	KWM comments
<p>Principle 1 – Recommendation 1.5</p> <p>Substantial enhancement to the diversity objectives</p>	<p>KWM supports the Council's revision to Recommendation 1.5 in applying gender diversity objectives to organisations as a whole, and supports more tangible targets for S&P / ASX 300 boards in relation to gender diversity. KWM also generally supports measures to achieve greater diversity within listed entities.</p> <p>However, we submit that this recommendation is relatively unclear as it relates to wider diversity objectives. If it is the Council's view that achieving a broad base of diversity (in respect of all of its facets) in the composition of the board, senior executive team and workforce will lead to better overall outcomes for a listed entity, as the proposed commentary suggests, Recommendation 1.5 must achieve a greater level of clarity and precision, as it has done with the requirements for gender diversity recommendations.</p> <p>In its current form, there is no evidential basis referenced in the commentary to Recommendation 1.5 which supports the proposition that by achieving a broad base of diversity, a listed entity would achieve beneficial outcomes. Recommendation 1.5 and associated commentary is also unclear regarding how diversity objectives should be prioritised and whether greater weight should be placed on candidates who assist a listed entity comply with the recommendation.</p> <p>KWM recommends that the Council considers:</p> <ul style="list-style-type: none"> ▪ expressing the diversity objectives in a more general and principled manner of tolerance, inclusion and anti-discrimination (and consequently removing the wider list of diversity "levels and facets" in the commentary and in Box 1.5), with particular targets for gender diversity; ▪ approaching the diversity objectives with an evidence based approach, by informing listed entities which diversity objectives should be prioritised and why (as the Council has done with gender diversity objectives); and ▪ providing greater guidance on the appropriate form and content of any results reported in respect of any benchmarking and audit activities conducted by the listed entity, to ensure they are readily comparable to the results of other listed entities for shareholders and other stakeholders. <p>Further details regarding our comments on this recommendation are set out in part two below.</p>

Proposed change	KWM comments
<p>Principle 2 – Recommendation 2.2</p> <p>Amendments to the commentary relating to the board skills matrix recommendation</p>	<p>The Council’s proposed commentary to Recommendation 2.2 lists “<i>new or emerging issues</i>” as a factor to address in a board skills matrix and specifies matters such as “<i>culture, conduct risk, digital disruption, cyber-security, sustainability and climate change</i>” as relevant to this category.</p> <p>KWM recommends that the Council considers including additional commentary:</p> <ul style="list-style-type: none"> ▪ to clarify that listed entities can assess whether these new additional “skills” are more important than others when considering board composition; and ▪ that it is acceptable for listed entities to cover such skills through the use of expert executives, advisers and consultants, rather than seek to appoint a board member with a particular skill but who is otherwise not useful in achieving an effective board or to the organisation.
<p>Principle 2 – Recommendation 2.7</p> <p>Proposed new recommendation regarding directors who are not fluent in the language of the listed entity’s meetings</p>	<p>The Council’s consultation paper states that this recommendation is intended to address issues associated with listed entities domiciled in foreign markets whose directors are not fluent in the language in which board or security holder meetings are held. We question whether the introduction of this new recommendation is the appropriate mechanism to address this concern. We believe it should be each director’s individual responsibility to be in a position to discharge their duties and responsibilities and add value to the board, including by being able to understand board papers and contribute to board discussions. It should not be a listed entity’s obligation or responsibility to ensure that each director discharges their duties or to put processes in place – and incur costs – to do so.</p> <p>The recommendation and associated commentary are also relatively short and do not provide sufficient clarity about the scope of the recommendation. For example, the recommendation and associated commentary do not clarify what constitutes language fluency nor what processes might be put in place by a listed entity to mitigate perceived issues. Moreover, these matters would appear to be best judged by the director rather than the listed entity (which would likely incur material costs in testing language capabilities and/or hiring translation services).</p> <p>In our view, the Council should reconsider whether the new recommendation is necessary to address the Council’s concerns or whether the issue might be better dealt with through other means, such as listing conditions being applied to non-Australian domiciled entity is admitted to the Official List.</p>

Proposed change	KWM comments
<p>Principle 3</p> <p>Substantial changes to the focus of Principle 3, to focus on instilling the desired culture</p>	<p>KWM submits that:</p> <ul style="list-style-type: none"> ▪ if the Council is going to include the word “culture” in Principle 3 and in the recommendations which support Principle 3, the Council should define what it means by “culture” or provide some examples of what it means by “culture”; and ▪ the inclusion of the words “<i>in a socially responsible manner</i>” in Principle 3 itself is unnecessary and confusing and should be deleted. <p>Further details regarding our comments on this recommendation are set out in part two below.</p>
<p>Principle 3</p> <p>Substantial changes to the commentary on Principle 3, for listed entities to have regard to a broader range of stakeholders</p>	<p>KWM submits that the amended commentary on Principal 3 should be clarified as it states that directors should “have regard” to the interests of other stakeholders in a similar manner as they currently do to shareholders’ interests. This is inconsistent with Australian law, which adheres to the shareholder primacy view of directors’ duties, which holds that directors of solvent companies must focus on the company’s interests – being the interests of the company’s shareholders as a whole – and disregard extraneous interests in favour of the shareholders’ interests where the two conflict.</p> <p>We note that, in discharging their duty to act in the best interests of the company, directors will generally have regard to a broad range of factors, including factors that influence the social licence of the listed entity to operate. However, by suggesting that in order for a listed entity to act lawfully, ethically and in a socially responsible manner, the directors of that entity <i>must</i> take into account a range of stakeholders, the Council elevates the status of these extraneous interests to a level which does not exist at law. Such an elevation risks creating legal duties to those stakeholders.</p> <p>We have included additional commentary in part two below suggesting why we consider a change to the law would also be unlikely to effectively achieve its stated purpose of promoting “socially responsible” corporate conduct.</p>

Proposed change	KWM comments
<p>Principle 3 – Recommendations 3.3 and 3.4</p> <p>Proposed new recommendations to have, disclose and monitor compliance with a Whistleblower Policy and Anti-Bribery and Corruption Policy</p>	<p>KWM submits that:</p> <ul style="list-style-type: none"> ▪ Recommendations 3.3 and 3.4 unnecessarily duplicates existing legal requirements which will lead to inconsistent obligations; ▪ in particular, the board reporting recommendations in limb (b) to both Recommendations 3.3 and 3.4 are inconsistent with law; and ▪ Recommendations 3.3 and 3.4 should be removed or, at the least, amended so that limb (b) to both recommendations is expressed to be “<i>to the extent permitted by law</i>”.
<p>Principle 4 – Recommendation 4.4</p> <p>Proposed new recommendation to validate corporate reports released to the market</p>	<p>In our view, Recommendation 4.4 has the potential to create unduly onerous obligations for listed entities in relation to the validation of all reports and publications they produce. This may, in effect, require entities to engage independent services (at additional time and cost) in order to obtain an assessment of whether reports are “balanced” and to ensure an appropriate level of “validation” is applied.</p> <p>While larger listed entities will already undertake this exercise in practice, this will represent a significant cost of compliance for smaller listed entities. In our view, this recommendation will act as a disincentive for entities to produce reports which are not legally mandated but are otherwise useful, such as an annual review or a sustainability report. These “additional” reports are generally not prepared, and are not intended to be used, for investment decision purposes and it is consequently inappropriate to apply a verification standard to them.</p> <p>Key reports required under Australian legislation or regulation such as annual and half year financial reports are already subject to external review and audit. It can also be reasonably expected that listed entities which have equivalent reporting requirements under foreign legislation or regulation must produce these reports to a standard mandated by that law or regulation.</p> <p>KWM submits that Recommendation 4.4 should either be removed or include commentary clarifying that external “validation” is not required in order to meet the recommendation, and that it is sufficient for directors to certify that any reports prepared meet any applicable statutory requirements.</p>

Part two: Further details

Principle 1 - Recommendation 1.5 (Diversity)

Summary of comments and recommendations

We recommend that Recommendation 1.5 be structured in a more general and principled manner of tolerance, inclusion and anti-discrimination (and therefore removing the wider list of diversity “levels and facets” in the commentary and in Box 1.5), with particular targets for gender diversity.

We also recommend that the Council considers:

- approaching the diversity objectives with an evidence based approach, by informing listed entities which diversity objectives should be prioritised and why (as the Council has done with gender diversity objectives); and
- including additional commentary, which aims to ensure consistency and comparability of any reports based on audits conducted over the reporting period.

Concern with Recommendation 1.5

Whilst the Council’s recommendations and commentary with respect to gender diversity appears relatively well developed and comprehensive, little guidance in respect of other diversity objectives and initiatives has been offered. In our view, it is not clear how a listed entity should comply with these recommendations and what tangible benefit compliance may provide to that entity.

For example, footnote 29 of the commentary on Recommendation 1.5 refers only to research in relation to the positive impact on gender diversity on corporate revenue, profitability and shareholder returns. It is unclear to what extent diversity in some other areas mentioned by the Council – such as

“having directors of different ages and ethnicities” delivers a tangible benefit to listed entities. No evidence is cited. Further, no guidance is provided on the extent to which achievement of diversity is to be prioritised over a focus on an appropriately skilled board under Principle 2.

While there is a need for boards to (in the words of the Council) “avoid ‘groupthink’ in decision making” it is paramount and mandatory under Australian law that every director has sufficient skills and experience to discharge their statutory and general law duties of reasonable care, skill and diligence.

If the Council is in fact advocating a requirement to commit to achieve diversity across all the areas listed, KWM submits that the Council should reconsider because that approach would not be practicable, and there is a serious question as to whether it is truly in the interests of shareholders and other stakeholders of listed entities to focus on the achievement of diversity to this extent on the board, in senior management, and across other levels of the organisation. Recommendations with respect to diversity outcomes (in addition to gender) should be more specific, be able to be achieved without unduly compromising other requirements for the composition of the organs and workforce of the listed entity, and be supported by evidence.

Comparative outlook

Recommendation 1.5 takes a fairly comprehensive and detailed approach to diversity objective recommendations, which can be contrasted with the approach in other markets such as the UK, Singapore, Hong Kong and New Zealand.

In particular, the UK Financial Reporting Council has considered the importance of diversity in its recent refresh of its published guidance of board effectiveness and the UK Corporate Governance Code. There is a clear need to establish a link between diversity and inclusion and the specific circumstances of an organisation's business, the markets in which they operate, the workforce on which they rely and the customers and communities which they serve.¹ In our view, this may be achieved in Australia through a more general and principled approach to Recommendation 1.5.

Benchmarking and reporting

We also recommend that the Council provide further guidance on the proposed reporting format and quality of information of any benchmarking and audit activities conducted, so that shareholders and stakeholders can readily use and compare results provided. This will assist in reducing the risk of unduly onerous compliance costs and reporting asymmetry, potentially created where listed entities take differing approaches to the conduct of audits or the manner in which reports are produced.

¹ UK Financial Reporting Council, Consultation 25, "Proposed Revisions to the UK Corporate Governance Code" (December 2017) para 60.

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

Introduction

In our view, the requirement in Principle 3 to "*reinforce a culture across the organisation of acting ... in a socially responsible manner*" is concerning.

Nowhere in the Principles or Recommendations is culture defined. We accept that the concept of culture is inherently nebulous however, if listed entities are to be required to report against the Principles and Recommendation on an "if not, why not" basis, we believe that ASX should either define culture or include examples of what it means by culture and how to measure and assess culture.

UK approach

The recently released revised corporate governance code by the UK Financial Reporting Council and the associated Guidance on Board Effectiveness is helpful in this regard including by providing:

- examples of common attributes of a healthy culture;
- examples of signs of a possible culture problem;
- suggestions on sources of culture insights; and
- questions which boards can discuss and consider regarding culture.

If this cannot be done, we submit that references to culture should be removed from the Principles and Recommendations and should, where appropriate, be replaced with references to "social license to operate". This is because the current draft of the Principles and Recommendations includes an explanation of what ASX means by "social license to operate".

For example, Recommendation 3.2 could be rewritten to state “A listed entity should ... ensure that the board is informed of ... any other material breaches of that code that call into question the organisation’s social license to operate”.

Acting in a “socially responsible manner”

We also do not believe that the reference to “a socially responsible manner” adds anything to the requirement to act lawfully and ethically. Inherently, acting ethically means acting in a socially responsible manner. Further, it is very difficult to measure whether a listed entity is acting in a socially responsible manner as what is required for an entity to act in a socially responsible manner changes on a day to day basis. For example, would a listed entity which owns coal mines be required to cease operating on the basis that coal mining is not considered socially responsible anymore? We assume that this is not the intended outcome of the Council.

As such, we submit that the reference to “a socially responsible manner” should be deleted.

Principle 3 – Having regard to broader stakeholders

Potential for conflict between the Proposed Commentary Change and current law

KWM submits that the commentary on Principle 3 which asserts that listed entities must “have regard to the views and interests of a broader range of stakeholders than just its security holders, **including** employees, customers, suppliers, creditors, regulators, consumers, taxpayers and the local communities in which it operates” should be clarified. We think this statement (the “**Proposed Commentary Change**”) should be omitted or redrafted for the reasons set out below.

The Proposed Commentary Change is inconsistent with the general law governing directors’ duties, namely section 181 of the *Corporations Act 2001* (Cth). The Proposed Commentary Change suggests that directors should “have regard” to the interests of other stakeholders in a similar manner as they currently do to shareholders’ interests. In contrast, section 181 requires directors to act in the interests of the company only. There is no obligation on the directors to consider the interests of other stakeholders in order to comply with their legal duty under section 181 of the Corporations Act.

The interpretation of section 181 of the Corporations Act corresponds with the shareholder primacy view of directors’ duties, which holds that that directors of solvent companies must focus on the company’s interests – being the interests of the company’s shareholders as a whole – and disregard extraneous interests in favour of the shareholders’ interests where the two conflict. By requiring that directors of listed entities take into account a broader range of stakeholders, the Council elevates the status of these extraneous interests.

The Proposed Commentary Change risks confusing a board's priorities and placing directors in a difficult position, requiring them to justify how they have taken into account and balanced the often competing interests of specific stakeholders when the law does not require them to do so. Given that shareholders' interests would ultimately take precedence in circumstances of conflict, without a change in law, the suggested commentary itself is unlikely to achieve the stated outcome and is therefore of limited effect.

The Proposed Commentary Change will also place a practical obligation on directors, which does not exist under law, to expressly note what additional extraneous considerations they took into account above those of the company's shareholders.

In our view, the Proposed Commentary Change should be replaced with commentary recognising that, in acting in the best interests of the company, directors will often take into account a range of issues which are relevant to a listed entity's social licence to operate. This may include the views and interests of a broader range of stakeholders than just its security holders.

Commentary on potential issues with implementing such a change legally

We consider that a change in the law that expressly requires directors to "have regard" to other stakeholders in addition to shareholders, would also be unlikely to effectively achieve its stated purpose of promoting "socially responsible" corporate conduct.

We consider that requiring directors to place greater emphasis on the long-term consequences of their decisions may be a more productive way to enhance "socially responsible" corporate decision-making.

Additional guidance required

"Having regard" to the interests of other stakeholders

It is not clear what directors would be required to do to in order to satisfy their obligation to "take into account the views and interests of other stakeholders". Specifically, it is unclear whether merely noting the views and interests of other stakeholders would be sufficient or whether more would be required to comply with such a change. The Parliamentary Joint Committee has previously recognised inadequate guidance on what directors must do to comply with an obligation to "have regard" to the interests of other stakeholders as a key reason for rejecting the introduction of such a change.²

Balancing the competing interests of various stakeholders

Additional guidance would also be required to address how directors should balance the competing interests of various stakeholders where they conflict. For example, such a proposed change would in practice require companies to devote additional time and resources to enable directors to consider other stakeholders' interests over and above the interests of the shareholders. The costs of imposing these obligations on the company would arguably be to the detriment of the company's shareholders for whom no additional benefit would be derived.

This lack of guidance on how directors are to weigh, prioritise and reconcile competing interests was identified by both the former Corporations and Market Advisory Committee and the Parliamentary Joint Committee as a

² Parliamentary Joint Committee on Corporations and Financial Services, "Corporate Responsibility: Managing Risk and Creating Value" (June 2006) pp 55 – 56.

salient reason for rejecting the introduction of a non-exhaustive catalogue of interests to be taken into account by directors.³

Unlikely to achieve purpose

A change to the law is unlikely to effectively achieve its stated purpose of promoting ‘socially responsible’ corporate conduct given that the introduction of a similar change in the UK, through a direct legal obligation, has not had a demonstrable positive impact on corporate decision-making.

Section 172 of the *Companies Act 2006* (UK) (“UK Act”) has been amended to impose a direct legal obligation on directors to promote the success of the company for the benefit of its members as a whole, and in so doing have regard to the interests of various other stakeholders. Based on limited judicial consideration and commentary on section 172 of the UK Act, it appears that section 172 has both added little to the pre-existing law on directors’ duties and muddled the decision-making framework for boards.

In 2017, the House of Commons Business, Energy and Industrial Strategy Committee acknowledged the ineffectiveness of section 172 of the UK Act in changing the conduct of company directors. The Committee concluded that *“the requirement for directors to ‘have regard to’ other stakeholders and considerations is lacking in clarity and strength and is not realistically enforceable by shareholders in the courts.”*⁴

If the Proposed Stakeholder Change proceeds, the recommended standard of conduct for directors of listed Australian entities will be materially similar to the obligations imposed on UK directors under section 172 of the UK Act (albeit it

will not be enforceable under Australian law). We expect that if the Proposed Stakeholder Change proceeds, the Australian experience will mirror the UK experience in this area. This is because the Proposed Stakeholder Change suffers from the same three defects as section 172 of the UK Act:

- lack of clarity;
- immaterial change to the pre-existing law; and
- lack of enforceability.

We note that the UK’s Financial Reporting Council’s July 2018 “Guidance on board effectiveness” merely notes that “an effective board will appreciate the importance of dialogue with shareholders, the workforce and other key stakeholders” and does not impose additional obligations or requirements over and above those contained in the law.

Alternative Change: Encourage Longer-Term Decision-Making

Encouraging directors to consider the longer-term implications of their decisions will likely point directors towards the interests of other stakeholders. The 2006 Corporations and Market Advisory Committee report “The Social Responsibility of Corporations” suggests that long-term shareholder profitability generally depends on meeting the legitimate expectations of other stakeholders, such as employees, customers, suppliers and members of the communities in which the corporation operates.⁵ To affect this change, the commentary to Principle 3 could be altered to recommend that directors take into account the longer-term interests of their corporation when engaging in corporate decision-making. This change would be consistent with the obligations of section 181 of the Corporations Act.

³ See footnote 2. See also Corporations and Market Advisory Committee, Australian Government, “*The Social Responsibility of Corporations*” (Report, December 2006) p 111.

⁴ House of Commons, Business, Energy and Industrial Strategy Committee, Corporate Governance (House of Commons Paper No 702, Session 2016-17) p 17.

⁵ Corporations and Market Advisory Committee, Australian Government, “*The Social Responsibility of Corporations*” (Report, December 2006) p 111.