Law School

CRICOS Provider No. 00126G
MBDP M253
The University of Western Australia
35 Stirling Highway, Crawley WA 6009

Phone +61 8 6488 2945
Fax +61 8 6488 1045

Review of the ASX Corporate Governance Council's Principles and Recommendations Public Consultation 2 May 2018

Submission to ASX Corporate Governance Council

From Professor John Chandler
Centre for Mining, Energy and Natural Resources Law
School of Law
University of Western Australia
Contact: john.chandler@uwa.edu.au
Telephone (08) 6488 1907

Submission and suggested changes

This submission supports, and agrees with, the intent of proposed Principle 3 that "A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and in a socially responsible manner". Two amendments are suggested in this submission, which it is submitted would make it more effective.

In this submission the Public Consultation document of 2 May 2018 is referred to as "the ASX Consultation" and the Consultation Draft of the 4th edition of the Corporate Governance Principles and Recommendations as "the Draft 4th Edition".

It is submitted that the following changes should be made to the proposed wording:

- Principle 3 should have the words "to create long-term and sustainable value" inserted at the end so it reads:

A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and in a socially responsible manner to create long-term and sustainable value.

- Recommendation 3.1 should have the words "and its process for evaluating its performance in implementing them" inserted at the end so it reads

A listed entity should articulate and disclose its core values and its process for evaluating its performance in implementing them

Reasons

The proposition at page 6 of the ASX Consultation that it is important to address the governance issues arising from poor conduct or culture and perceived lack of accountability in corporate values and culture to arrest loss of trust in business is correct, but also vital. A significant driver of corporate governance is maintaining confidence of investors and good functioning of financial markets (G20/OECD Principles of Corporate Governance 2015 (OECD Principles).[1] This driver supports the proposition.

However, it should also be recognised that Australians are entitled to expect companies operating in Australia which rely on the facilities and support provided by Australian society to act lawfully and ethically, which includes acting in a socially

[1] At 10 and 13. Available at <[http:www.oecd.org.>.

responsible manner. Although it is perhaps surprising that this needs to be stated, the recent history of corporate behaviour suggests that it is both timely and essential to do so. But also some of Australia's leading companies, which no doubt would consider they hold these values, are failing to implement them, so there needs to be an emphasis on implementation. It is suggested that the examples of these failures are so numerous and so extreme that corporate governance is at a tipping point which requires a clear signal from the Council such as the proposed Principle 3.

This brings us to the suggested changes.

Dealing with the second change first, the reasons for incorporating reference to the process for evaluating performance in implementing core values into Recommendation 3.1 are as follows:

- It is the recommendation that is reported against and not the Principle.
- There is an implementation issue as demonstrated, for example, by evidence before the Hayne Royal Commission. Many companies already have codes of conduct, but apparently they are not working.
- Without an evaluation process this Recommendation would not require any follow-up action. Accordingly it is less likely that the Council's objective of rebuilding trust would be met.
- The commentary to the Recommendation (see page 26 of the Draft 4th Edition) considers implementation action, so this should be emphasized in the body of the Recommendation. Incidentally, that commentary does not refer to the board monitoring or evaluating performance, and it is suggested that it should.
- An approach similar to that suggested here is contained in the recently published Guidance on Board Effectiveness published by the UK's Financial Reporting Council (UK Guidance). This says:
  "The board is expected to assess and monitor culture for alignment with purpose and values. The first step is to establish a benchmark against which future monitoring can take place. One approach to monitoring culture might be to identify and track core characteristics that are typical features of a positive

culture, such as those in Figure 1, and link this to commitment to company values.”[2]

- This is not dealt with under Recommendation 3.2 (Code of Conduct) which is the other place it could possibly be dealt with. However, as the commentary to the Draft 4th Edition points out at page 26, the code of conduct is “a more prescriptive statement of dos and don’ts” so this would not be appropriate. The commentary wording there is not suggestive of an overall evaluation. Its suggested wording currently reads:

“To improve transparency and promote investor confidence, The Council would encourage a listed entity to disclose in general terms the actions taken to enforce its code of conduct (recognising that legal and other constraints may prevent it disclosing specific details of any individual action).”

- It is also not dealt with under Recommendation 7.4 which requires disclosure of “any material exposure to environmental or social risks”. While there is some correspondence between core value implementation and disclosing material exposure to certain risks and how the entity “manages or intends to manage those risks”, there is no requirement that reporting under Recommendation 7.4 covers failure to implement core values, or indeed that it be treated as a risk.

The first change lifts the words “to create long-term and sustainable value” from the second paragraph of commentary on page 25 into the Principle itself. The reasons are:

- There should be an emphasis both on the long-term and sustainability for overall cultural improvements to be effective.
- The insertion is necessary to clarify what is meant by social licence to operate”. This also assists the interpretation of “social risks” as defined in the glossary.

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[2] At page 6. Available at< https://www.frc.org.uk/>. See also page 7.

The succeeding sections look at how companies can define what is material in this context and also why company law supports Principle 3 and the suggested changes. In outline they deal with the following:

- The directors' duty of care requires them to consider all matters which may have a material negative impact on the interests of the company and take steps to prevent that impact.
- As a means of defining those matters in the context of Principle 3, directors (and/or management) can engage in a two-stage process which would involve defining core values and then engaging with their stakeholders to clarify what is material (for example what are serious reputational matters). This is a process of engaging with stakeholders, not giving directors a duty to stakeholders.
- The example is given of international petroleum companies, many of whom use this process in producing sustainability or social responsibility reports.

Discussion and further analysis

Directors' duty to ensure a company behaves in a socially responsible manner

It is clear that the duties of directors require them to consider whether the company will act lawfully and in a socially responsible manner. This relies on the directors' duty of care. A convincing analysis can be found in the judgement of Edelman J in *ASIC v Cassimatis* [2016] FCA 1023. In considering the duty of directors under Section 180(1) of the Corporations Act to exercise their powers and discharge their duties with "the degree of care and diligence that a reasonable person would exercise..." his Honour adopted the test used by Ipp J in *Vrisakis v ASIC* that the "question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question". Edelman J found (at para 483) "that the foreseeable risk of harm which falls to be considered in s 180 (1) is not confined to financial harm. It includes harm to all the interests of the corporation. The interests of

the corporation, including its reputation, include its interests which relate to compliance with the law."

There have been numerous demonstrations in recent times across a number of industries of the severe harm that can be done to a company's business and shareholder value if directors do not consider their legal and ethical position and implement and monitor correct practices. Examples range from Volkswagen across a wide spectrum of financial institutions. It is difficult to envisage any company where the potential foreseeable risk of harm resulting from incorrect practices on a significant scale is not so material that there is no matching duty on the directors to take steps to avoid it.

A somewhat similar discussion has occurred in relation to climate change and other sustainability risks. Some have argued that there is no obligation on directors to consider these risks. This discussion has put the matter more on a risk basis, with the view being expressed that there is no legal obstacle to directors taking those risks into account, where those risks are, or may be, material to the interests of the company.[3] But in fact the basis of the opinion that there is no reason why directors should not take climate change risks into account shares the same foundation as the analysis of Edelman J: directors must consider all matters which may have a material impact on the interests of the company.

In relation to climate change risks, there is a clear example provided by international petroleum companies, and discussed below, of disclosing those risks. Given this growing international practice and the potential seriousness of the consequences of climate change, this submission supports the proposed commentary to Recommendation 7.4.

[3] Noel Hutley SC and Sebastian Hartford-Davis, 'Memorandum of Opinion- Climate Change and Directors' Duties', Centre for Policy Development and The Future Business Council, October 2016 , https://cpd.org.au/wp-content/uploads/2016/10/Legal-Opinion-on-Climate-Change-and-Directors-Duties.pdf> accessed 10 October 2017. Rory Sullivan, Will Martindale, Elodie Feller Anna Bordon, 'Fiduciary Duty in the 21st Century',< http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf>.

Dealing with the question that directors only owe a duty to shareholders

It can be anticipated some opposition to the proposed Principle 3 will rest on two ideas- the first that directors do not owe a duty to other stakeholders and second that Principle 3 will cause confusion. This and succeeding sections deal with these points.

An example of the first is the commentary from the legal firm King & Wood Mallesons.[4] They take issue with the idea expressed at ASX Consultation 6 that directors "*must have regard to the views and interests of a broader range of stakeholders than just the entity's security holders*", on the basis that this "while well-intended – is inconsistent with directors' statutory and general law duties".[5] It is made clear by Edelman J in *Cassimatis* that he accepts that the directors owe a duty to the company, and with respect to the authors at King & Wood Mallesons, that is not the point here. The point is that directors should consult other stakeholders to get a picture of what is material to the interests of the company. This is a process recommended by IPIECA and others, as to which see the section on petroleum companies.

It is also worth noting that the OECD Principles recognise the contribution made by employee and other stakeholders to the long-term success and performance of companies (OECD Principles, 10). They go on to say that where the rights of stakeholders are not protected by law that "many firms make additional commitments to stakeholders, **and concern over corporate reputation and corporate performance often requires the recognition of broader interests**". [6] The UK Guidance also recognises the importance of dialogue with stakeholders, stating that:

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[4] ' Proposed fourth edition of ASX Corporate Governance Principles'<http://www.kwm.com/en/au/knowledge/insights/proposed-fourth-edition-asx-corporate-governance-principles-20180606>.

[5] The commentary explains that "It is axiomatic that the duty of a company director under section 181 of the *Corporations Act* (and the equivalent general law duty) is to act in good faith in the *listed entity's* best interests. Unlike section 172 of the UK Companies Act, section 181 of the *Corporations Act* does not require mandatory consideration of other stakeholders such as customers, suppliers and the environment."

[6] Emphasis added. OECD Principles, 37

"An effective board will appreciate the importance of dialogue with shareholders, the workforce and other key stakeholders, be proactive in ensuring that such dialogue takes place and that the feedback is taken into account in the board's decision-making. How the board approaches this will provide useful insight into the company's culture."[7]

There is currently no general legal requirement on directors to act sustainably.[8] However the writer would argue that it is only a matter of time before this becomes the case, and based on *Cassimatis* one could argue that it is already the case in relation to maintaining a company's reputation. Failure to do so is likely to resonate in an action for breach of directors' duties under section 180(1).

The meaning of social licence to operate and sustainability

One of the problems with terms like "social licence to operate" and "sustainability" is that they are capable of different interpretations and so a company may require a process to clarify its objectives in relation to them. This relates closely to how it determines its core values. This relationship is emphasized in the commentary to Recommendation 3.1 which refers to the core values statement including "a commitment by the entity to acting ethically and in a socially responsible manner". Clearly the Council contemplate that defining what is socially responsible will involve some discussion with stakeholders. So how might that work?

The starting point is the concept of social licence to operate. It has its origins in mining projects in developing countries. After several environmental incidents in the 1990s, the mining industry suffered from a greatly diminished reputation in local communities surrounding project areas.[9] In 1997, at a meeting with World Bank personnel in Washington, D.C., Jim Cooney, then Director of International and Public Affairs with Placer Dome, proposed that the mining industry act to address

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[7] UK Guidance, 11.
[8] James McConvill and Joy Martin,'The interaction of Directors' Duties and Sustainable Development in Australia: Setting Off on the Uncharted Road', [2003] Melbourne University Law Review 116.
[9] Don Smith and Jessica Richards, 'Social License to Operate: Hydraulic Fracturing-Related Challenges Facing the Oil & Gas Industry' (2015) 1(2) Oil and Gas, Natural Resources, and Energy Journal 81, 91.

diminishing reputations by obtaining a social license to operate. Cooney's comments were largely based on his concerns with governments in developing countries not only halting major mining projects, but also failing to include local communities affected by such projects in the decision-making processes. Thus, the social licence concept emerged to include local communities in decision-making processes while paralleling the legal licensing process.[10] The notion that companies should earn a social licence to operate stuck, soon becoming part of the common vernacular in many corporate sustainability programs and implemented as an offensive tactic in preventing community mistrust.[11] According to the International Council on Mining and Metals, by 2012, 'the concept of social license to operate has been widely accepted by the mining industry'.[12]

It is interesting that the Draft 4th Edition refers at page 25 (footnote 29) to the guidance provided by ISO 26000 on how businesses and organisations can operate in a socially responsible way that contributes to the health and welfare of society. ISO 2600 sets out "sustainable development" as one of the aims of social responsibility. This is defined in the standard as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs". Commentary on ISO 2600 is illustrative of the different views as to the meaning of "social responsibility" and that its meaning has changed over time.[13]

There is an overlap between sustainability, social licence to operate and corporate social responsibility. What unifies these different ideas is the broad expectations that society has of those it allows to conduct business in that society. This has led to approaches like the following in relation to minerals:

> The [minerals] industry has recognised that … corporate social responsibility is not an adjunct to our business, it is our business - our core function is to convert natural endowment to societal capital, and that can only be achieved sustainably when there are real mutually beneficial considerations of the

[10] Ibid.
[11] Ibid.
[12] Ibid.
[13] See for example Chapter 2 of Lars Morata and Timo Cochius *ISO 26000 The Business Guide to the new Standard on Social Responsibility*, Routledge 2011.

environment, our host communities, and the rights and interests of Indigenous peoples ...[14]

The United Nations Sustainable Development Goals are often referred to as a guide to the meaning of sustainability. These are 17 aspirational goals with targets, some of which are seemingly in conflict. On the one hand there are goals to improve growth and development, which require continuing to supply energy and increasing the access of poor nations to it, encapsulated in Goal 7: 'Ensure access to affordable, reliable, sustainable and modern energy for all'.[15] On the other hand there are goals to manage and mitigate the environmental and social costs, such as Goal 13: 'Take urgent action to combat climate change and its impacts' and Goal 14: 'Conserve and sustainably use the oceans, seas and marine resources'.

But as a World Bank publication points out, it is important to note that these two sets of goals are not mutually exclusive or independent of each other. It goes on to say that 'Successful environmental and social policies, for example, underwrite positive and sustainable impacts on growth and development. Environmental protection puts the sustainable element into development'.[16] But as two commentators point out, the approach can be characterised as a business-as- usual model. It permits capitalist production methods and does not require a whole rescaling of society.[17] Therefore "Sustainable development inherently accommodates companies continuing to go about making money for their shareholders through production and development, so long as systems and policies are implemented which provide for improvements in resource efficiency and ecological impact over time".[18]

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[14] Minerals Council of Australia, Submission: Annual Review of Regulatory Burdens on Business (Canberra June 2007), quoted in John Southalan, *Mining Law & Policy: International Perspectives* (The Federation Press 2012) 25.
[15] See <http://www.un.org/sustainabledevelopment/energy/> .
[16] Peter Cameron and Michael Stanley *Oil, Gas and Mining: A Sourcebook for Understanding the Extractive Industries,* World Bank 2017, 241. <https://openknowledge.worldbank.org/handle/10986/26130>
[17] James McConvill and Joy Martin,'The interaction of Directors' Duties and Sustainable Development in Australia: Setting Off on the Uncharted Road', [2003] Melbourne University Law Review 116

[18] Ibid, 118.

Defining issues of relevance to the company: the example of the major oil companies

As part of other research undertaken by the writer and the Centre a review was undertaken of the latest annual reports and published governance documents of eight of the largest international oil companies to see what they have to say about their strategy, sustainability and climate change.[19] The companies selected were: BP, Chevron, ConocoPhillips, Eni, ExxonMobil, Shell, Statoil (which is now called Equinor) and Total. All of them report on sustainability in one form or another. BP, ConocoPhillips, Eni, Shell, Statoil and Total use the word sustainability to describe their reports. Chevron produces corporate responsibility reports and ExxonMobil produces a corporate citizenship report. These cover much of the same ground as the sustainability reports of the others. There is useful guidance available which can assist a company with its reporting but also in defining what is material. A number of companies report in accordance with the Global Reporting Initiative G4 Sustainability Reporting Guidelines prepared by Global Reporting Initiative (GRI).[20] This is referred to in relation to Recommendation 7.4 (Footnote 71 on page 43 of the 4th Edition).

Many companies (for example Shell) also report in line with the guidelines prepared by IPIECA with API and IOGP.[21] IPIECA's guidance is voluntary. It does not set minimum requirements or predetermine stakeholder needs. Instead, it encourages companies to make informed choices on what is important for reporting by engaging with their stakeholders and understanding their needs. Then, to support these choices, companies can include relevant data and information that benefit from the consistency of industry consensus on the issues.[22] GRI makes similar comments.

It is important to recognise some key ideas. First, sustainability reporting is part of a trend to integrated reporting, which includes sustainability with financial information. Second, it is also driven by companies' desire to make their operations sustainable, including components of social justice and protecting the environment. Thirdly, there

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[19] This research will be published in October 2018: John A Chandler *Petroleum Resource Management- how countries manage their offshore petroleum resources* Edward Elgar. See https://www.e-elgar.com/shop/petroleum-resource-management.
[20] For example Eni, Shell and Statoil.
[21] IPIECA Sustainability Guidance available at www.ipieca.org.
[22] Ibid 9.

is an emphasis on reporting topics that are material to their business and key stakeholders.[23] This requires a process of defining those issues. But fourthly there is no consistency in the selection of the KPIs which companies report, and independent audit of them is not generally a requirement.[24]

IPIECA suggests a process beginning with the context for the report by outlining the company's high-level vision and strategy, together with governance and management systems. This is followed by determining the issues to include by using a materiality process that identifies the complete set of issues of relevance to both the company and its stakeholders. Finally, the process involves selecting indicator data to be collected within the company's reporting boundary and incorporated into the narrative. From the survey of the recent sustainability reports of the major oil companies it appears that all of them broadly follow this approach. All of them deal with climate change.

Companies may undertake the process described here for the purposes of Recommendation 7.4 and producing sustainability, corporate social responsibility reports or social risk reports. However, they can also use a very similar process for establishing their core values and how they are implemented. They could combine the two exercises. This is the kind of process that this submission has in mind when it suggests that Recommendation 3.1 requires a process for evaluating a company's performance in implementing core values. However, it would be up to each company to decide what process is appropriate.[25]

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[23] GRI, 'G4 Sustainability Reporting Guidelines' (2015) 3 <https://www.globalreporting.org/resourcelibrary/GRIG4-Part1-Reporting-Principles-and-Standard-Disclosures.pdf> .

[24] KPMG Survey of Corporate Responsibility Reporting 2015 < https://home.kpmg.com/xx/en/home/insights/2015/11/kpmg-international-survey-of-corporate-responsibility-reporting-2015.html> .

[25] Compare the UK Guidance at pages 6 to 8.