Governance Institute of Australia

T +61 2 9223 5744 **F** +61 2 9232 7174
E info@governanceinstitute.com.au
Level 10, 5 Hunter Street, Sydney NSW 2000
GPO Box 1594, Sydney NSW 2001
W governanceinstitute.com.au

17 February 2017

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
3rd Floor Spur 1
1 Victoria Street
London
SW1H 0ET
United Kingdom

By email: corporategovernance@beis.gov.uk

To the Corporate Governance Reform Team

Corporate governance reform: Green paper

Governance Institute of Australia (Governance Institute) is the only Australian independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members hold primary responsibility within Australian listed entities for developing governance policies, ensuring compliance with the Australian Securities Exchange (ASX) listing rules and supporting the board on all governance matters. Our members have a thorough working knowledge of the operations of the markets and the needs of investors. Their familiarity with the practical aspects of how to implement best practice governance frameworks and ensure sound reporting to shareholders has informed the comments in this submission.

Governance Institute is also a founding member of the ASX Corporate Governance Council that develops and issues the *Corporate Governance Principles and Recommendations* (Principles and Recommendations), against which all listed entities in Australia must report. The Principles and Recommendations are the governance code in Australia.

Governance Institute welcomes the opportunity to comment on the *Corporate governance reform: Green paper* (green paper). We do not comment on all aspects of the green paper, such as the detail of the regulatory framework — we leave others more familiar with this to provide feedback on these matters. Our comments stem from our knowledge of governance frameworks, our familiarity with and support of a principles-based approach to governance and our knowledge of the detail and impact of the 'two-strikes rule', which is referenced in the green paper.

General comments

Our governance code — the Principles and Recommendations — has played a vital role in improving corporate governance in Australian listed companies since the release of the first edition in 2003. It has served Australia well in lifting and maintaining its standing as a country with a high-performing corporate governance environment.

The model of our governance code is similar to the 'comply or explain' framework of the UK Corporate Governance Code. In Australia, it is an 'if not, why not' model. The last decade and more has shown that the approach taken by the ASX Corporate Governance Council in its

Principles and Recommendations is key to the manner in which governance has been heightened and strengthened in Australia. The approach is that governance cannot be a 'one-size-fits-all' and that if an entity considers a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it, which is a flexibility tempered by the requirement to explain why.

This approach, similar to the 'comply or explain' approach taken in the UK Governance Code, allows for listed entities at different stages of the life cycle of a company to put in place the governance framework most appropriate to their circumstances.

Governance Institute therefore supports a principles-based approach to corporate governance reform in the first instance, rather than legislative reform. While we recognise that legislative reform is appropriate in some circumstances, our view is that a principles-based approach is well suited to bringing meaningful change to governance practice and behaviour and that the success of governance codes around the world are evidence of this.

Detailed comments

Executive pay

We note that shareholders in the UK already have extensive voting powers in relation to pay, including:

- a binding vote on remuneration policy (at least once every three years)
- an annual advisory vote on how the pay policy was implemented during the last financial year and is to be implemented in the year ahead
- an annual binding vote on the election of directors, including those who serve on the remuneration committee, and
- a binding vote on long-term equity incentive plans.

In the UK, the binding vote on pay policy is subject to a simple majority vote. The annual advisory vote on the remuneration report is also subject to a simple majority vote.

We also note that the UK Corporate Governance Code has a requirement that, if a significant percentage of shareholders vote against the implementation report, that fact must be disclosed in the following year's report, together with an explanation of how the company intends to engage with shareholders.

The green paper notes that most quoted companies have received large shareholder votes in favour of both their pay policies and their annual remuneration reports, with only a small number of votes against pay policies and remuneration reports. The green paper states that 'To date, only one company has lost a binding vote on its pay policy, and six companies have lost advisory votes on their remuneration reports'.

As noted in the green paper, in Australia the 'two-strikes rule' was introduced in 2011. The *Corporations Act 2001* (Cth) provides that:

- if 25 per cent of the votes cast at an annual general meeting (AGM) oppose the adoption of the remuneration report, and shareholders make comments at the AGM on the report, then in the following year the board must report in the annual report, on any proposed responses to those comments, or explain why it does not propose any response
- if 25 per cent of the votes cast at two consecutive AGMs oppose the adoption of the remuneration report, then at the second AGM the company must put a resolution to shareholders to 'spill' the board

- if 50 per cent or more of votes cast are in favour of a ‘spill’, the entire board (except the managing director) must stand for re-election at a further general meeting. This meeting must take place within ninety days.

The two-strikes rule has had both positive and negative impacts in Australia since its introduction. Due to the negative impacts, which we discuss below, we do not advocate the introduction of this rule in the UK. However, we are of the view that the lower threshold for a vote against the remuneration report has facilitated greater shareholder engagement, to the benefit of companies and shareholders and we therefore comment in further detail below on why the matter of thresholds in voting could be given consideration.

Disadvantages of the two-strikes rule

It is in the interests of good governance to find a mechanism that strengthens shareholders’ capacity to hold directors accountable for remuneration.

However, the two-strikes rule has been used to express a vote of no confidence in the board on matters unrelated to remuneration, or to destabilise or uproot incumbent boards in the interests of only some shareholders, again on matters unrelated to remuneration. While the exercise by investors of the voting right attached to the shareholding represents the most visible tool available to them to exert influence over the governance practices of companies in which they invest, Governance Institute does not believe that this use of the two-strikes rule is the best way to achieve the expression of shareholder dissatisfaction with the board’s stewardship.

For example, one board received a takeover offer that it rebuffed and a large shareholder was able to muster the numbers to vote against the remuneration-report resolution to show displeasure with the board decision. Another company had a new shareholder with 19 per cent of the shares who used the first strike as a means of exercising power as it sought to build a larger controlling interest in the company.

On remuneration-related matters, for which the two-strikes rule was introduced, there are many variables in the remuneration report, yet it could be only one aspect that is being voted against. Shareholders who approve of a company’s overall remuneration strategy can feel compelled to vote against the remuneration report because they dislike a single element in it (most frequently the CEO remuneration). For example, at particular points in the economic cycle, shareholders may hold concerns with an issue such as capital raising, and shareholders seek to exercise a protest vote through the vote on the remuneration report.

It could be argued that the impact of the two strikes rule has had a higher impact on smaller listed companies which often have small shareholder bases and a higher percentage of shares held by directors and senior management (key management personnel). Due to the prohibition on key management personnel voting on the remuneration report resolution combined with lower levels of voting at AGMs this can result in a minority of vocal discontented shareholders recording a strike against the company, which is not desirable.

Advantages of higher threshold in two strikes rule

Boards’ engagement with investors on remuneration since the introduction in Australia of the two-strikes rule has seen marked changes in the remuneration structures at companies where shareholders had concerns with remuneration plans as well as improved disclosure in the majority of instances. If the remuneration report is rejected by 25 per cent of the votes cast by shareholders, boards clearly need to engage with their investors to ascertain their reasons for giving the company a first strike and their views on what changes would be acceptable to avoid a second strike. Institutional and retail investors and directors and companies in Australia have noted that the introduction of a binding shareholder vote on a company’s remuneration report that triggers a ‘first strike’ was one of the single biggest catalysts for improved levels of engagement between shareholders and company directors.

Although the remuneration report advisory vote does not ‘fail’ unless 50% of votes cast are against it, the facilitation of shareholder engagement on remuneration arises from the lower voting threshold of 25 per cent to trigger a ‘strike’. This lower threshold has resulted in boards keen to engage with their shareholders on remuneration structures. A great many boards and remuneration committees have implemented regular engagement with shareholders and their intermediaries (proxy advisory firms) since the introduction of the rule to gain their feedback on proposed remuneration frameworks. These discussions facilitate greater understanding on both sides. Boards that have received a first strike reach out to shareholders to discuss the reasons for the strike, which has resulted in amended structures and strong shareholder support of the remuneration report in subsequent years. Pay-performance linkages have been strengthened and more transparency about remuneration structures has been provided.

It should, however, also be noted that first strikes have eventuated in some instances even when domestic shareholders who are happy with the remuneration frameworks have voted in favour of the remuneration report, but a proxy advisory firm’s recommendation is an ‘against vote’, with the negative recommendation arising from a misunderstanding of the remuneration framework. This can result in offshore investors, who do not engage with the company as do domestic shareholders, following a proxy firm’s recommendation which in turn influences the vote.

First strikes under two-strikes rule

2011	Following the introduction of the two-strikes rule, 108 listed companies received a first strike. Among the ASX top 200, 14 boards received a first strike, rising to 26 boards among the ASX top 300 and 82 outside the largest 300 listed companies.
2012	124 companies received a first strike, but only three companies in the ASX 100 received a first strike.
2013	102 companies received a first strike, but only three companies in the ASX100 received a first strike. Across the three years, there were eight companies that earned a strike each year for three years (a first strike in 2011, a second strike in 2012 and a first strike again in 2013, as the spill resolution was not successful).
2014	93 listed entities received a first strike. Only three companies in the ASX 100 received a first strike against their remuneration report in 2014 (the same number as in 2013).
2015	101 companies received a first strike, with four companies in the ASX 100 receiving a first strike against their remuneration report (one more than in each of 2013 and 2014).
2016	44 listed companies received a first strike.

When considering the numbers above, it is important to note that, currently, there are 2,207 entities listed on ASX. Although the number fluctuates, the number of entities listed on ASX has remained close to approximately 2,200 for many years.

It also needs to be understood that the size of the key management personnel holdings in many of the companies outside the ASX300 means that only a small percentage of capital is voted.

Compared to the UK experience of one company losing a binding vote on its pay policy, and six companies losing advisory votes on their remuneration reports since 2013, the capacity for shareholders to engage the board on remuneration frameworks has increased since the introduction of the lower voting threshold on a non-binding resolution. We note that in the majority of the first strike events noted above, the advisory vote on the remuneration report still would have passed, because the against vote would not have met the 50 per vote threshold.

Governance Institute stresses that we *do not* recommend or support the introduction of a two-strikes rule in the UK. However, we are of the view that voting thresholds could be reviewed to facilitate shareholder engagement.

However, Governance Institute stresses that in Australia, no actual consequences (for example, the spill of the board) arise unless a 50% resolution is passed. The 25% voting threshold is, in essence, advisory, or a protest vote. We do not recommend that binding consequences attach to any resolution with a voting threshold lower than a simple majority. We note that although Australia has seen a number of first strikes, and even a few second strikes, the number of spill resolutions that have passed is tiny and, so far as we are aware, no incumbent directors have been removed (ie even when a spill has occurred, the incumbent directors have been re-elected to the board).

Strengthening the employee, customer and wider stakeholder voice

Employee and stakeholder representation on the board
While we recognise that it has been successful for some companies to appoint employees to the board, Governance Institute strongly recommends that this should be left to the discretion of the particular company and board and not be mandated.

Employees or stakeholders appointed to the board are likely to consider that they have been appointed to represent the interests of employees or the stakeholders who appointed them. However, directors have fiduciary and common law duties to exercise their powers in good faith, for a proper purpose and in the best interests of the company as a whole. While an employee or stakeholder appointee, like a nominee director, can control or influence, as well as monitor, the activities of the company to which they are appointed, this is subject to the employee or stakeholder-appointed director ensuring that at all times they comply with their directors' duties and other obligations. They owe the same duties of loyalty and confidentiality as other directors. There is a real risk that an employee or stakeholder appointee to the board is placed in an invidious position when they and fellow employees or other stakeholders are of the view that their role is to protect the interests of employees and/or stakeholders. Employee or stakeholder-appointed directors would need to be more than usually alive to the possibility of a conflict between the interests of the company to which they are appointed and not only their own personal interests, but also the interests of their appointer. To the extent of conflict in exercising their powers as a director they must prefer the interests of the company to which they have been appointed.

Significant potential conflict of interest issues can also arise in the event the company terminates the employee director's employment, either as part of a broader restructure program within the company or because of the individual's own poor performance or misconduct. A provision in the employee director's contract that provides for automatic cessation of the directorship in the event the employee director's employment is terminated, could leave the company open to an allegation that the employment termination was improperly driven by the desire to remove the individual from the board. Alternatively, company management may be reluctant to take action against a poorly performing employee who is on the board or management may 'favour' that employee in terms of incentives awards, remuneration or promotions.

It is for these reasons that we recommend that any decision to appoint an employee or stakeholder to the board should be at the discretion of the board and the company in question and not be mandated.

Taking into account stakeholder interests

As it stands, the law generally links the corporate interests to those of the shareholders, and only derivatively with those of the community, consumers, employees and other stakeholders. It is important to clarify that corporations legislation does not state that directors and other officers must exercise their powers and discharge their duties in the best interests of shareholders, although case law has tended to grant primacy to shareholders' interests. The legislation foregrounds the promotion of the success of the company for the benefit of the members as a whole. The phrase 'the benefit of the members as a whole' under the common law of directors' duties means the financial wellbeing of the shareholders as a general body.

It has been pointed out that shareholder primacy is a social norm rather than law. As noted in a project being undertaken by a multi-jurisdictional team of legal academics, 'No system of corporation law insists that boards should focus only on shareholder value'. The project further states that 'This norm springs out of the historically contingent focus of company law on the position of shareholders (albeit one that varies across jurisdictions). Shareholder primacy has been allowed to develop because the law contains neither an explicit statement of what the societal purpose of companies is, nor of what the interests of the corporation are'.[1]

Concern has been expressed over decades with the shareholder primacy view. The argument against it is that the proper purpose of the corporation (and the proper goal of corporate managers) is not confined to making money for shareholders, but also includes more secure jobs for employees, better quality products for consumers, and greater contributions to the welfare of the community as a whole. The argument against a shareholder primacy approach is that it is a corporate governance model that puts the private interest ahead of the public interest. Commentators have noted that in the shareholder primacy view '… the interests of shareholders are considered paramount by directors, over and above those of other stakeholders, such as employees. At its most extreme, this perspective suggests that directors will tend to favour the short-term financial interests of shareholders (shareholder value), being driven in that direction by capital markets fixed on share price and short-term returns'.[2]

Heightened public scrutiny of corporate activity, aided by social media channels, and increased concern about the sustainability of the environment and the negative impacts of corporate activity on particular segments of the community have added to the agitation for changes to directors' duties to accommodate stakeholder interests.

The UK responded to these concerns by introducing s 172 that permits directors to have regard to the interests of stakeholders other than shareholders. Section 172(1) provides that directors owe their fiduciary duty to the 'members as whole' but then provides a broader context for this duty by listing other stakeholders to whom directors need to have regard to fulfil their duties. That is, s 172 may be said to impose a duty on directors to require them to be more inclusive in their decision-making in respect of seeking to benefit the members. The purpose behind s 172 was primarily to emphasise the fact that directors should not run a company for short-term gains alone, but to take into account long-term consequences.

Given that in the UK directors already have a statutory obligation to take into account the interests of stakeholders other than shareholders, there is no argument to support further statutory amendment in this regard.

In the twenty-first century, the relationship between business and society is considered an implicit social contract. Social issues are not tangential to the business of business but

---

[1] Sjåfjell, B, Johnston, A, and Sørensen, L-A, News release, 'Shareholder Primacy: The Main Barrier to Sustainable Companies', 2014, p 2, http://www.jus.uio.no/ifp/english/research/projects/sustainable-companies/news/sustainablecompanies2pagesummarycompanylaw.pdf. The Sustainable Companies Project commenced in 2010 and has involved a team of more than 40 legal scholars mapping the law in 26 jurisdictions across the globe.

[2] Anderson, M, Jones, M, Marshall, S, Mitchell, R and Ramsay, I, Evaluating the shareholder primacy theory: Evidence from a survey of Australian directors, University of Melbourne Legal Studies Research Paper No. 302 <http://www.law.unimelb.edu.au/files/dmfile/Evaluating_the_shareholder_primacy_theory_-__evidence_from_a_survey_of_Australian_directors__20_11_07_11.pdf>, p 1

fundamental to it. For reasons of ethics and enlightened self-interest, those companies alert to the long-term impact of social issues and in a constant dialogue with their stakeholders have a competitive advantage. Shifts in social issues that ultimately feed into the fundamental drivers of corporate performance generate value-creation opportunities. Focusing on a ‘business is business’ approach can lead managers to emphasise short-term company performance, while neglecting longer-term opportunities and issues. There is, therefore, considerable incentive for a company to conduct its business in a socially responsible manner.

There are also powerful social rewards and sanctions associated with responsible behaviour. Acting responsibly generates trust, loyalty and goodwill among customers and employees, not to mention business partners. Corporate irresponsibility, on the other hand, can result in disapproval and suspicion, public criticism, damage to customer loyalty, loss of brand equity and a tarnished corporate reputation. Responsible behaviour creates a sense of satisfaction and self-respect among employees, whereas irresponsible behaviour can result in feelings of embarrassment, guilt, shame, cynicism and poor morale and loss of commitment from employees. Disincentives, therefore, can include loss of reputation, incapacity to attract and retain good staff, shocks to the share price for listed companies, boycotting of products and services by customers and penalties imposed by regulators.

At the heart of changing expectations of the role of the corporation is a view that generating profit must not come at cost to the common good. Yet the central role of the corporation in providing financial prosperity has not changed.

Governance Institute notes that there is a global discussion taking place that is questioning shareholder value maximisation as the sole purpose of a company. This global discussion is expanding the idea of the purpose of the corporation beyond shareholder value maximisation and is a work in progress. We are of the view that this work in progress is also a matter of changing social norms, rather than changing the law. The current green paper is part of the discussion that fosters this shift in social norms.

As noted in the report issued by the Financial Reporting Council in the UK on boards and culture:[3]

> There needs to be a concerted effort to improve trust in the motivations and integrity of business. Rules and sanctions clearly have their place, but will not on their own deliver productive behaviours over the long-term. This report looks at the increasing importance which corporate culture plays in delivering long-term business and economic success. … Strong governance underpins a healthy culture, and boards should demonstrate good practice in the boardroom and promote good governance throughout the business. The company as a whole must demonstrate openness and accountability, and should engage constructively with shareholders and wider stakeholders about culture. … Establishing a company’s overall purpose is crucial in supporting the values and driving the correct behaviours. The strategy to achieve a company’s purpose should reflect the values and culture of the company and should not be developed in isolation. Boards should oversee both.

Governance Institute does not recommend that the purpose of the corporation be enshrined in law. Rather, we note that a movement is already underway that encompasses the purpose of the corporation far more broadly than shareholder value maximisation alone. The law in the UK already permits directors to take this broader view in the best interests of the company and its members. How boards facilitate that is best left to their discretion. A stakeholder advisory board could be advantageous for some companies, while other companies may prefer alternative channels of stakeholder engagement. Boards already seek independent advice on many matters and bring in experts from different fields to inform their decision-making. It should be a

[3] Financial Reporting Council, *Corporate Culture and the Role of Boards*, July 2016, p 2

matter for boards to decide how best to engage with stakeholders and have regard to their interests.

Corporate governance in large, privately-held businesses

Governance Institute notes that large, privately-held business frequently have shareholders with holdings of sufficient size to be able to have their views taken into account by boards. We therefore do not see that any further shareholder rights need to be granted in this regard.

However, the issue of stakeholder concerns — as set out above in the previous section — are as relevant to large, privately-held businesses as they are to listed companies. Indeed, it is possible that some large, privately-held businesses can affect the employment rate of one town, and therefore stakeholder interests are extremely relevant to these businesses.

Currently, however, the disclosure to stakeholders of the company's governance arrangements, business model and future prospects can be opaque.

Governance Institute recommends that greater transparency to stakeholders would be of benefit and that this can best be facilitated through enhanced reporting.

We are of the view that mandatory reporting concerning governance arrangements should be introduced, but that it could be modelled on the UK Corporate Governance Code, whereby large, privately-held businesses are asked to report on a 'comply or explain' basis as to their governance arrangements.

Yours sincerely

Steven Burrell
Chief Executive