CHARTERED SECRETARIES AUSTRALIA

Leaders in governance

9 February 2007

Eric Mayne
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By mail
and by email: regulatorypolicy@asx.com.au

Dear Eric

Principles of good corporate governance and good practice recommendations

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the proposed revisions to the ASX Corporate Governance Council *Principles of good corporate governance and good practice recommendations* (the Principles).

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. We are an independent, widely-respected influencer of governance thinking and behaviour in Australia and an expert commentator on issues affecting governance and legislation. We represent over 8,000 governance professionals working in public and private companies. Our members have the prime responsibility for implementing governance frameworks within their organisations, and advising boards on governance generally. Our members in public listed companies also have the prime responsibility to draft the Corporate Governance Statement in their companies' annual reports, in which reporting against the Principles is to be found.

In preparing this submission, CSA has drawn on the expertise of the members of our national policy committee, Legislation Review Committee, as well as that of our members working in public listed companies.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

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Chartered Secretaries Australia (CSA)

Submission to the
ASX Regulatory and Public Policy Unit
in relation to
the revisions to the
ASX Corporate Governance Council
*Principles of good corporate
governance and good practice
recommendations*

CHARTERED SECRETARIES AUSTRALIA

Leaders in governance

Principles of good corporate governance and good practice recommendations

Part A: Changes to the Principles and Recommendations

General comments

CSA agrees that the evolving nature of the debate on corporate governance necessitates a review of the Principles, and that a two-year period from the implementation of the first edition has provided sufficient experience to conclude that a review at this time is appropriate. CSA believes that the Principles have improved governance practices and reporting in Australia and that they have provided a sound framework to trigger board discussion of governance issues.

While accepting that a review at this time is appropriate, CSA recommends that the Council apply caution when undertaking change to the Principles. Given that the framework of the first edition has resulted in improved practice and reporting, change for change's sake to the Principles is not in the interests of either issuers or users of the resulting corporate governance statements in annual reports. While CSA accepts that some of the proposed changes will result in a more effective framework, such as merging all material on boards in one Principle, CSA has been careful not to comment and suggest amendments to the proposed changes to the Principles simply for the sake of commenting.

Reduction of Principles

CSA welcomes the reduction of the Principles from ten to eight, and believes that that the merging of all material relating to boards in one Principle, namely Principle 2, assists both issuers and users of corporate governance information. CSA also welcomes the separation of board issues from executive issues in the restructuring of the Principles, as this brings greater clarity to them.

Replacement of the term 'best practice' with 'good practice'

However, CSA is concerned that the replacement of the term 'best practice' with 'good practice' will send a wrong signal to the market in relation to Australian listed companies' willingness to engage with corporate governance. CSA notes the findings of the Implementation Review Group that the term 'best practice' creates misunderstanding in the wider community, with any other practice, no matter how sound, being implied to be second-class. The central concept of the Principles, the 'if not, why not' framework, is therefore undermined by a false belief, given rise to by terminology, that practices that differ from those in the Principles and Recommendations are by their very nature second-rate practices.

CSA is in agreement with the Council that terminology matters. On this basis, CSA finds that the term 'good practice' can be construed as too subjective, accommodating a variety of practices that might not necessarily further governance frameworks and practices. The Australian idiom of 'good enough' springs to mind.

CSA recommends that, if a change is to be made, the term '**sound practice**' be used in the Principles and Recommendations, on the basis that companies that wish to strive for excellence can do more than sound practice and set the benchmark.

Proposal to restructure the Principles into two documents

CSA does not support the proposal that the Principles be restructured into two documents: one containing a set of high-level Principles and one describing issues to consider when applying the high-level Principles.

CSA believes that it is best to have the detail in the guidelines for the following reasons:

- It is more practical to have to refer to one document only.
- The detail in the Commentary and Guidance frequently explains and clarifies the intent of a particular recommendation.
- The detail removes uncertainty and ambiguity.

A survey by CSA in December 2006 of senior governance professionals in the top 300 companies found that more than two-thirds (67 per cent) of respondents did not believe that the Principles should be restructured into two documents. There was a strong view that the 'if not, why not' overriding principle would be eroded by separating the guidance from the principles and could leave the door wide open to a whole range of interpretive issues.

CSA recommends that the Principles remain in the form of one document, as currently structured.

Structure of one document

CSA notes that a list of the Principles and Recommendations cannot be found in one place in the guidelines. In the first edition of the guidelines, the Principles were listed at the front of the document and the Recommendations were listed at the end of the document.

CSA recommends that all Principles and Recommendations be listed at the front of the document, so that a 'ready reckoner' is available to anyone looking for the high-level Principles and their reporting triggers.

This list should be followed by the Principles, Recommendations and their accompanying Commentary and Guidance as in the Exposure Draft.

Principles-based guidelines as opposed to black letter law

CSA is conscious that the Principles and Recommendations were introduced to facilitate a principles-based approach to governance, in comparison with the black-letter law approach taken in the United States with the introduction of the Sarbanes-Oxley Act.

CSA believes that it is important that the principles-based approach be retained, and that the revised Principles not take a prescriptive approach. Any prescriptive approach would undermine the underlying spirit and intent of the Principles.

Use of the imperative in the Guidance and Commentary

CSA has concern with the use of the imperative in the Guidance and Commentary. CSA has no problem with the use of the imperative in the Recommendations, where the use of the word 'should' indicates that the Recommendation sets out sound practice. However, the Guidance and Commentary was always intended as the provision of further information to assist companies to understand the intent of each Recommendation. By using the imperative in the Guidance and Commentary it transforms guidance into a formal Recommendation. CSA believes that the use of the imperative renders the Guidance and Commentary prescriptive by elevating explanatory material to the level of a recommendation.

CSA recommends that the wording in the Guidance and Commentary should change from 'Companies should' to: 'Companies should consider…'.

Introduction to Principles and Recommendations

(‘Corporate governance in Australia’)

CSA recommends two amendments to the paragraphs in the introduction to the Principles and Recommendations.

CSA recommends that, under the heading ‘How is good corporate governance achieved?’, the final paragraph read:

> The Council’s Recommendations are not mandatory and cannot, in themselves, prevent corporate losses, failure, fraud or poor corporate decision-making.

The second recommendation is to clarify that establishing the roles of the board and senior executives is different from establishing the balance of skills, experience and independence of the board.

CSA recommends that, under the heading ‘The fundamentals’, the first paragraph read:

> Fundamental to any corporate governance structure is establishing the roles of the board and senior executives (Principle 1). A balance of skills, experience and independence on the board appropriate to the nature and extent of company operations should also be considered (Principle 2).

Deleted: and the board

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Disclosure of corporate governance practices (applying the ‘if not, why not’ approach)

CSA recommends that the section ‘What disclosures are necessary?’ should be brought forward in the introduction to the Principles, as this is fundamental to the ‘if not, why not’ framework. This paragraph should come after the section ‘How to approach adoption of the good practice recommendations’ and before the section ‘Disclosure requirements’.

Recommendations on matters of general concern

1. CSA recommends that, if a change is to be made, the term ‘sound practice’ be used in the Principles and Recommendations, on the basis that companies that wish to strive for excellence can do more than sound practice and set the benchmark.

2. CSA recommends that the Principles remain in the form of one document, as currently structured.

3. CSA recommends that all Principles and Recommendations be listed at the front of the document, so that a ‘ready reckoner’ is available to anyone looking for the high-level Principles and their reporting triggers. This list should be followed by the Principles, Recommendations and their accompanying Commentary and Guidance as in the Exposure Draft.

4. CSA recommends that the wording in the Guidance and Commentary should change from ‘Companies should’ to: ‘Companies should consider…’.

5. CSA recommends that the section ‘What disclosures are necessary?’ should be brought forward in the introduction to the Principles.

CSA recommended amendments

CSA provides a narrative exposition of its recommendations in this submission. This is accompanied by a marked-up version of the revised Principles, using Track Changes to show CSA recommendations.

Please note that our reference to footnote numbers in this submission are to the footnote numbers in the Exposure Draft of changes, and not to the footnote numbers in the marked-up version of the Exposure Draft issued by the Council.

Principle 1: Lay solid foundations for management and oversight

Commentary and guidance to Recommendation 1.1

CSA believes that the use of the word 'alternatively' in the first section of the guidance 'Role of the board and management' is misleading. A delegation of authority by the board should not be considered an alternative to a board charter, but an addition to it.

CSA recommends that the section should read:

> Boards should adopt a formal statement of matters reserved to them or a formal board charter that details their functions and responsibilities. Additionally, there should be a formal statement of delegated authority to senior executives.

Deleted: lternatively

Box 1.1: Content of a director's letter upon appointment

CSA believes that superannuation arrangements are part of a remuneration package, and that it is therefore incorrect to list them as separate from remuneration and expense arrangements.

CSA recommends that the bullet point list be amended to read:

- Remuneration, including superannuation arrangements, and expenses
-

Deleted: Superannuation arrangements

Principle 2: Structure the board to add value

Change from a definition of independence to relationships affecting independent status

CSA notes that this change highlights the problems that arise through the use of the imperative in the Guidance and Commentary.

For example, the first page of this Principle notes that "Relationships which *may* affect independent status are set out in Box 2.1" (emphasis added). Yet the introductory sentence to Box 2.1 notes that "A director *should not be regarded* as independent if the director" (emphasis added).

The board should be determining if a director brings independence of mind to the role. Looking at the relationships between directors and between directors and other parties has a bearing on this determination. CSA endorses moving away from a definition of independence but suggests that the introductory sentence to Box 2.1 is still prescriptive and does not allow boards to disclose the decision-making process as to why they declare a director independent or not. CSA notes that the Explanatory Paper clarifies that: "The relationships are initial indicators of matters that could affect independent decision making. Boards should use them to trigger questioning when assessing a director's independence and as a framework for disclosure of their reasoning about a determination of independence". CSA does not believe that the use of the imperative in the introductory sentence to Box 2.1 achieves this aim.

CSA recommends that the introductory sentence should be redrafted to read: "The board should give consideration to the following relationships when determining independence".

Box 2.1: Relationships affecting independent status

CSA notes that Point 2 in Box 2.1 on employment in an executive capacity in the last three years is confusing, as the second part of the sentence appears to repeat the first part of the sentence. CSA believes that the drafting of this point in the first edition of the Principles was unclear, and does not believe that this new drafting alleviates the problem, but that, rather, it merely expands the confusion.

Drafting in first edition of Principles

In the first edition of the Principles, it states: "An independent director is a non-executive director (that is, not a member of management) and within the last three years has not been employed in an executive capacity by the company or another group member, or been a director after ceasing to hold any such employment." This can be interpreted in any of the following ways.

Example: A person became a director six years ago, within two years of ceasing to be an executive.

Interpretation 1

1. A director is not regarded as independent only if the person was an executive within the last three years.

Example: Independent.

Interpretation 2

2. A director is not regarded as independent if the person became a director within three years of being an executive, no matter how long ago they were an executive/became a director.

Example: Not independent.

Interpretation 3
3. A director is not regarded as independent if the person was ever an executive no matter how long ago they were an executive.
Example: Not independent

The first interpretation is preferable, on the basis that the policy rationale must be the connection between the director and the company and whether a director who had a recent employment relationship is capable of exercising independent judgment and objectivity. This concern would be ameliorated as time passes and the management decisions of the former executive become less relevant and the relationship with management as an executive become more distant.

Proposed change in Exposure Draft

The proposed amended ASX Corporate Governance Council guidance is as follows: "A director should not be regarded as independent if the director is employed, or within the last three years has been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board".

The Explanatory Paper notes that the sub-point "has been clarified". On this basis, it appears that the revised drafting is intended to adopt the second interpretation provided above. CSA has concerns that this adopts a more restrictive interpretation than was open in the first edition of the Principles.

While the guidance is not conclusive of a director's independence in the context of the requirements of the Principles, it raises a consideration for companies that is potentially more restrictive than needed. CSA notes that governance organisations, when assessing companies, also tend to apply the guidance in a mandatory fashion in assessing independence.

More significantly, for APRA-regulated entities, APRA treats the guidance in Box 2.1 as mandatory. APS 510.11 says:

> For the purposes of this Prudential Standard, an independent director is a non-executive director who is free from any business or other association – including those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser – that could materially interfere with the exercise of their independent judgement. In assessing whether a director is independent, the Board must apply the definition of independence set out in the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations*.

Various consequences follow from a director not being assessed as independent for APRA-regulated entities, including that the person cannot be chairman of the board (APS 510.17) or chairman of the audit committee (APS 510.35). The requirement for a majority of independent directors on the board and audit committee may also be more difficult to achieve (APS 510.16, 510.34).

Presumably APRA will change the factors in APS 510.11 to match any change to the Principles, given that the clear intention of APRA (following much debate) is to align its definition with the ASX Corporate Governance Council's definition. This is clearly the preferable position from a regulatory viewpoint, for alignment between regulatory requirements and guidance relating to the same subject matter.

However, CSA's concern remains that the revised drafting adopts a more restrictive interpretation than was open in the first edition of the Principles. CSA is not in favour of this more restrictive approach.

CSA recommends that clarity of meaning can be achieved by deleting the second limb of Point 2 in the revised Principles, without reintroducing the deleted part of the sentence from the drafting in the first edition, that is, the first limb of Point 2 stands alone and is clear in its intent. The elements of composition would thus read:

> 2. is employed, or within the last three years has been employed in an executive capacity by the company or another group member.

Deleted: , and there has not been a period of at least three years between ceasing such employment and serving on the board

Recommendation 2.4: Responsibilities

This section needs some amendment to clarify that the nomination committee is not responsible to conduct the evaluation of the board and the directors, but is responsible for developing the process for board evaluation. This also creates consistency with Recommendation 2.5, which deals with the process for board evaluation, and not the evaluation itself.

Therefore, under the heading 'Responsibilities', **CSA recommends** that the third bullet point be redrafted so that it reads

> Responsibilities of the committee should include development of a process for evaluation of the performance of the board, its committees and directors.

Deleted: each

Recommendation 2.4: Director competencies

CSA is concerned that the current drafting holds the nomination committee responsible for 'enhancing' director competencies. This is the responsibility of the board as a whole. As such it is already dealt with later in Principle 2 under the heading 'Induction and Education'.

CSA recommends deleting the word 'enhancing', so that the guidance reads:

> The nomination committee should consider implementing a plan for identifying and assessing director competencies.

Deleted: ,

Deleted: and enhancing

Recommendation 2.5: Commentary and guidance

In the Commentary and Guidance to Recommendation 2.5, it notes that the performance of the board should be reviewed against agreed measurable indicators.

CSA has concerns with this wording, as 'agreed measurable indicators' for boards are not necessarily either easy or possible to implement, as they are for executive performance, which can be pegged to financial performance.

CSA recommends that the drafting of this sentence should read:

> The performance of the board should be reviewed regularly against appropriate indicators.

Deleted: previously agreed measurable and qualitative

Recommendation 2.5: Induction and education

CSA is concerned with the prescriptive nature of the final sentence relating to director education. Furthermore, CSA notes that the intent of this sentence is picked up in the first sentence under heading 'Access to Information', which deals with the provision of information to directors.

CSA recommends deleting the sentence: "This should include education concerning key developments in the company and in the industry and environment within which it operates".

Guide to reporting on Principle 2

For the purposes of consistency, the sixth bullet point covering what needs to be reported in the corporate governance section of the annual report should include mention of board committees when discussing board evaluation.

CSA recommends that this bullet point read:

- whether a performance evaluation for the board, its committees and their members has taken place in the reporting period and whether it was in accordance with the process disclosed

Deleted: its

Principle 3: Promote ethical and responsible decision making

Introduction

CSA has concerns with the drafting of the opening paragraph.

CSA notes that the opening words 'To be successful' do not add substantively to the content. CSA also notes that shareholders should not simply be bundled in with other stakeholders, given that companies have recognisably separate legal obligations to their shareholders.

Furthermore, both the Corporations and Markets Advisory Committee (CAMAC) and the Parliamentary Joint Committee on Corporations and Financial Services (PJC) reports speak of a company's management of the environmental and social considerations relevant to its activities being part of an enlightened self-interest strategy to promote the company's continuing well being and to maximise shareholder value over the longer term. The lack of separation of the material on stakeholders in the opening paragraph does not allow for clarification of the enlightened self-interest approach in the structure of the paragraph.

CSA recommends that the opening paragraph be drafted to read:

> Companies need to have regard to their legal obligations to shareholders. This may include taking into account the interests of a range of stakeholders including employees, business partners, creditors, consumers, the environment and the broader community in which they operate. It is important for companies to demonstrate their commitment to appropriate corporate practices and decision making.

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Box 3.1: Suggestions for the content of a code of conduct

CSA has already noted that the decision to make a global change to the use of 'should' in the Guidance and Commentary has radically affected a number of areas, changing suggestions and guidance into prescription. Box 3.1 provides a perfect example of this, as each issue, acceptable and to be encouraged if offered as a suggestion, causes difficulty and concern if expressed as mandatory by the use of the imperative.

For example, Point 5 currently says: "A code of conduct should articulate the company's responsibilities to the individual". This is problematic because a company officer could find themselves in court trying to defend the company's code of conduct because it did not articulate the company's responsibilities to the individual, when this is intended merely as a suggestion for content to be considered.

CSA recommends that the wording used to introduce Box 3.1 be redrafted, so that it reads:

> A code of conduct could address the issues set out in Box 3.1.

Deleted: should

CSA also notes that, if our recommendation not to use the imperative in the Guidance and Commentary is not accepted, we would like the opportunity to make a representation to the ASX Corporate Governance Council on the difficulties caused by each use of the word 'should' in Box 3.1.

Box 3.2: Suggestions for the content of a trading policy

CSA notes the overlap between the recommendation in Point 3 concerning policies on the disclosure of hedging arrangements and the proposal in the Parliamentary Secretary to the Treasurer's *Corporate and Financial Services Regulation Review Proposal Paper* to include a provision in the *Corporations Act* on this issue. **CSA strongly supports** the inclusion of this material in the revised Principles rather than in the *Corporations Act*, and opposes any duplication.

CSA notes that the final sentence in Point 3 of Box 3.2 is currently vague and confusing, utilising as it does the words 'and the like'**. CSA recommends** that the Council clarify exactly what 'and the like' is intended to refer to, to avoid confusion and ambiguity. For example, does the Council intend to include share acquisition plans, rights issues and buybacks?

CSA also recommends that Box 3.2 should include a sentence noting that a trading policy may need to apply to the securities of other companies of which the director has inside knowledge by virtue of their position. For example, it could read:

> 9. A trading policy may need to apply to the securities of other companies of which the director has inside knowledge by virtue of their position.

Principle 4: Safeguard integrity in financial reporting

Recommendation 4.2: Technical expertise

CSA has concerns with the requirement under the heading 'Technical Expertise' that audit committee members have "…relevant qualifications and experience (that is, should be a qualified accountant or other finance professional with experience of financial and accounting matters)…".

Our concern is that audit committee members, under this definition, could be recent graduates with no experience, or could have been awarded accounting or other financial qualifications many years ago, yet have not practised for many years. Alternatively, directors with relevant experience for an audit committee could be excluded from membership, because they do not have formal qualifications. CSA believes that it is for the board to decide who is qualified for the audit committee. While CSA agrees that the statement that board members should be able to read and understand financial statements is appropriate, we oppose the demand that audit committees contain a qualified accountant.

Furthermore, CSA is concerned that the definition of technical expertise does not cover the fact that experience should be recent and relevant, which are the two most fundamental requirements.

Finally, not all audit committees concentrate solely on financial matters, as many audit committees also look at risk management and compliance (where there is no separate risk and compliance committee). Thus there may be committee members with risk and compliance expertise rather than financial expertise.

CSA recommends that the drafting be revised to read:

> The audit committee should include members who are financially literate (that is, be able to read and understand financial statements); at least one member should have relevant and recent experience (for example, someone with experience as a qualified accountant or other finance professional) and some members should have an understanding of the industry in which the entity operates.

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Deleted: qualifications

Deleted: that is, should be

CSA is also concerned that financial literacy is dealt with both in the section titled 'Technical Expertise' and Footnote 21. Moreover, the footnote notes that *all* board members should be financially literate, which is a large requirement and a strong shift from the previous edition of the guidelines, where such a requirement was not made.

CSA concerns in relation to Footnote 21 are at two levels:

1. It introduces a new demand relating to board composition that does not allow for the fact that the appropriate board skills might require someone with IT experience, or marketing experience, or engineering experience, and that such experience might mean those board members are not financially literate as specified in the text on 'Technical Expertise'.
2. It introduces a fundamental new paradigm relating to board composition in a footnote, which is not appropriate. Such a requirement, if made, should reside in Principle 2 under 'Board Composition'.

CSA recommends deleting Footnote 21.

Principle 5: Make timely and balanced disclosure

Guide to reporting on Principle 5

CSA notes that, under 'Guide to Reporting on Principle 5', the requirement has shifted from companies posting to their websites "a summary of the policies and procedures designed to guide compliance with Listing Rule disclosure requirements" (as worded in the first edition of the Principles) to a requirement that companies post to their website "The policies and procedures designed to guide compliance with Listing Rule disclosure requirements".

CSA points to the fact that many policies on such issues can run up to 50 pages in length. A large amount of information contained within these policies would not be of use to shareholders as it is directed towards management and other employees to assist them in complying with the policy.

In order to assist communication with shareholders and other stakeholders, it can be more user-friendly to post a summary of any such lengthy policies to a website.

CSA recommends that the wording be revised so that it would read:

> Policies or summaries of the policies and procedures designed to guide compliance with Listing Rule disclosure requirements should be made publicly available, ideally by posting them to the company's website in a clearly marked corporate governance section.

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Principle 6: Respect the rights of shareholders

Recommendation 6.1

CSA has concerns with the confusion in the drafting between the use of the words 'strategy' and 'policy'.

Recommendation 6.1 states that: "Companies should design and disclose a communications *strategy* to promote effective communication with shareholders and encourage their participation at general meetings" (emphasis added). Yet the first sentence under the heading 'Commentary and Guidance' states that: "Publishing the company's *policy* on shareholder communication will help investors to access the information about the company and its corporate proposals" (emphasis added).

It is not helpful to recommend disclosure of the strategy, then ask for publication of a policy. Furthermore, it may impinge on competitive areas of the company's business strategy to disclose a communication strategy.

CSA's recommends that Recommendation 6.1 be revised to state:

> Recommendation 6.1: Companies should design and disclose a communications approach to promote effective communication with shareholders and to encourage their participation at general meetings.

Deleted: strategy

Commentary and guidance

CSA is also concerned by the fact that the first sentence under the heading 'Commentary and Guidance' is:

a) irrelevant, as there is no need for a justification for Recommendation 6.1

b) repeats the information provided in 'Guide to Reporting on Principle 6', where it states that: 'The company should make a description of its arrangements for promoting communication with shareholders publicly available, ideally by posting it to the company's website in a clearly marked corporate governance section'.

CSA's final concern is with the words 'corporate proposals' in this first sentence under the heading 'Commentary and Guidance'. It suggests that each time a company makes any move in any direction, it should disclose this to shareholders, which would burden the shareholders with unwanted and irrelevant communication.

CSA recommends that the first sentence under the heading 'Commentary and Guidance' be deleted, given that it is repetitive and confusing.

Principle 7: Recognise and manage risk

Introduction

The second sentence in the Introduction states that: "Risk management is the culture, processes and structures that are directed towards taking advantage of potential opportunities while managing potential adverse effects".

CSA believes that this sentence should align with the AS/NZS4360 standard on risk management.

CSA recommends that this sentence be redrafted to read:

> Risk management is the culture, processes and structures that are directed towards realising potential opportunities while managing adverse effects.

Deleted: taking advantage of

Deleted: potential

CSA notes that the use of a subheading Risk Profile in the Introduction differs from the Introduction to each other Principle, where no subheadings are used. The use of a subheading indicates that the material should be viewed as separate from the Introduction in some way and also has the effect of marrying the material on risk profile to Recommendation 7.1, which has serious consequences, as companies may believe they are required to disclose their risk profile.

CSA recommends that the subheading Risk Profile be deleted and that the Introduction to Principle 7 take the same structure as all other Introductions.

Recommendation 7.1: Commentary and guidance

Under the heading 'Commentary and Guidance', the first sentence currently states that: "As part of its oversight role, the board is responsible for establishing the company's policy on risk, and developing and implementing its system of risk management and internal control".

Boards do not actually 'develop and implement systems of risk management and internal control'. As noted further under the heading 'Risk Management and Internal Control System', it is management that develops and implements systems of risk management and internal control. Indeed, it is specifically stated in the Principle that: "Management should design, implement and review a risk management system".

CSA recommends that this first sentence be redrafted to say:

> As part of its oversight role, the board is responsible for overseeing and reviewing the company's policy on risk, and satisfying itself that management has developed and implemented a sound system of risk management and internal control consistent with the company's risk policy.

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Under the heading 'Commentary and Guidance', there is also the statement: "The internal audit function should report to the audit committee and should have all necessary access to management and the right to seek information and explanations". A footnote, Footnote 31, has been added saying: "Despite the reporting line to the audit committee, the internal audit function is generally employed by the company".

CSA believes that this footnote confuses the 'Commentary and Guidance', as a reporting line is a management term. CSA believes that this footnote adds no value to the 'Commentary and Guidance' and has the potential to create confusion as to how the relationship between the internal audit function and the audit committee should work.

CSA recommends that Footnote 31 be deleted.

Recommendation 7.3: The chief executive officer (or equivalent) and other responsible senior executives should state to the board in writing that there is a sound system of risk management and internal control which implements the policies adopted by the board in relation to material business risks other than those covered by Recommendation 7.2 and that the system is operating effectively in all material respects.

It is a fundamental responsibility of the board to oversee risk management in a company. It is not the role of the Council nor the guidelines to determine how a board fulfils this role, nor to determine how a board should make enquiries of management on material business risk issues. CSA is concerned that the current drafting of this Recommendation is overly prescriptive and deals with operational issues, rather than governance issues.

Proper risk management in a company is a complex and sophisticated issue and cannot be captured in one sign-off. Whereas agreement can be reached on one set of financial accounts, it is not feasible to reach one certification of material business risk management. Given that risks may emerge that have not been anticipated, it would be extremely difficult for companies to attest that the system of risk management is operating in all material respects, when material business risks may include but are not limited to: operational, environmental, sustainability, compliance, strategic, external, ethical conduct, reputation or brand, technological, product or service quality and human capital.

CSA believes that a discussion of material business risks, should such risks need to be discussed, is best undertaken in the directors' report in the annual report. The corporate governance statement can deal with a discussion of how directors oversee risk but not the management of them, which is an operational issue. The corporate governance statement is also not the suitable place for disclosure of the risks themselves, which could have confidential and competitive advantage implications.

CSA believes that if Recommendation 7.3 is implemented in its current form that it will not only introduce an onerous, unacceptably prescriptive approach into the Principles, but that it will also lead to 'boilerplate' statements drafted by lawyers being published in companies' corporate governance statements. This defeats the policy objective of asking companies to disclose that risk management frameworks are in place and are regularly reviewed.

CSA recommends that Recommendation 7.3 be revised to state:

> The board should require management to regularly assess the operation of the system of risk management and internal control in place to manage the company's material business risks and to report the results of this assessment to the board.

Under the heading 'Commentary and Guidance', the material relating to a sign-off from senior executives needs to be aligned with the redrafting of the Recommendation. Thus the 'Commentary and Guidance' should read:

As part of its oversight responsibility for risk, the board retains responsibility for assessing the effectiveness of its systems with respect to material business risks which are not covered by Recommendation 7.2.

Deleted: It may be appropriate in the company's circumstances for the board to make additional inquiries and to request additional senior executives to sign off on its other material business risks.

Deleted: Each company should determine management accountability for sign-off on its other material business risks. These sign-offs should be aligned with responsibility and authority. Senior executives should be conscious of the need to obtain appropriate assurances to support these sign-offs.¶

Recommendation 7.4

CSA's comments on this recommendation are dealt with in our submission on Part B.

Guide to reporting on Principle 7

CSA notes that, if our recommended revisions to Recommendation 7.3 are not accepted, the current drafting of the 'Guide to reporting on Principle 7' poses real difficulties.

CSA refers the Council to its earlier statement on page 3 in relation to the Principles and Recommendations having been introduced to facilitate a principles-based approach to governance, in comparison with the black-letter law approach taken in the United States with the introduction of the Sarbanes-Oxley Act. We reiterate that it is important that the principles-based approach be retained, and that the revised Principles not take a prescriptive approach. Any prescriptive approach would undermine the underlying spirit and intent of the Principles.

CSA recommends that:

- the third bullet point be revised
- the final bullet point in the 'Guide to reporting on Principle 7' be deleted.

The Guide to reporting on Principle 7 should read:

> The following material should be included in the corporate governance section of the annual report:
>
> - explanation of any departures from sound practice recommendations 7.1, 7.2 or 7.3 [or 7.4 if introduced]
> - whether the board has received the statement in writing from the chief executive officer (or equivalent) and the chief financial officer (or equivalent) under Recommendation 7.2
> - an explanation of the board's approach to the oversight of the system of risk management and internal control in place to manage the company's material business risks

Deleted: best

Deleted: whether the board has received the statement in writing from the chief executive officer (or equivalent) and other responsible senior executives under Recommendation 7.3

Deleted: <#>where the board receives any qualified statement from management, the fact of the qualified statement and appropriate explanatory information should be disclosed.¶

Principle 9: Remunerate fairly and responsibly

Recommendation 9.1: Responsibilities of the remuneration committee

CSA believes that the word 'including' needs to be added to the second bullet point, as incentives are part of remuneration, not separate from it.

CSA recommends that this second bullet point read

senior executives' remuneration, including incentives.

Deleted: and

Guidance and commentary

CSA notes that there is a second subheading 'Commentary and guidance' on the second page of Principle 9, yet a second recommendation has not been introduced at this time, necessitating the new subheading.

CSA recommends deleting this second subheading.

Box 9.1: Guidelines for executive remuneration packages

CSA again notes the overlap between the recommendation in Box 9.1 concerning equity-based remuneration on the prohibition of hedging arrangements and the proposal in the Parliamentary Secretary to the Treasurer's *Corporate and Financial Services Regulation Review Proposal Paper* to include a provision in the *Corporations Act* on this issue. **CSA strongly supports** the inclusion of this material in the revised Principles rather than in the *Corporations Act*, and opposes any duplication.

CSA notes that the sentence "Consideration must be given to the consequences of an appointment not working out, and to the costs and other impacts of early termination" is repeated and that the second inclusion needs to be deleted.

Footnote 39

CSA is concerned that an integral requirement is provided in a footnote, rather than being contained in the body of the text.

Footnote 39 states that: "The vesting of any entitlements under these schemes should be timed to coincide with any trading windows under a trading policy adopted by the company for the purpose of Recommendation 3.2".

CSA recommends that, as a matter of structure and transparency, if the matter is substantive, as this footnote is, it should be contained in the body of the text, in the 'Guidance and Commentary'. When provided as a footnote, the matter reads as guidance on the guidance.

CSA also notes that the footnote misunderstands the issue. It is the timing of the exercise of entitlements and not the timing of the vesting of entitlements that needs to be in accordance with any company policy. Companies are required to have a share trading policy in place that is disclosed on their websites, and the exercise of any remuneration elements should be in accordance with that policy.

Therefore, **CSA recommends** that Footnote 39 be deleted.

Box 9.2: Guidelines for non-executive director remuneration

CSA notes that the first bullet point in Box 9.2 needs amendment to clarify that:

- the reference to equity is to salary sacrifice into equity, and
- the total remuneration must be within the total aggregate remuneration set by shareholders.

CSA recommends that the first bullet point read:

> Non-executive directors should normally be remunerated by way of fees, in the form of cash, non-cash benefits, superannuation contributions or salary sacrifice into equity; they should not participate in schemes designed for the remuneration of executives. The total remuneration must be within the total aggregate remuneration threshold approved by shareholders.

Recommendation 9.3 Companies should ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders (the old Recommendation 9.4)

CSA notes that much of the confusion relating to Recommendation 9.4 has arisen because the Listing Rule is silent or ambiguous on the question of when and why shareholder approval of equity-based remuneration is required.

CSA agrees that Recommendation 9.4 has been a source of confusion for companies, investors and investor advisory groups. Curiously, although one of the recommendations most in need of explanation, it is one of the few that is not accompanied by 'Commentary and Guidance', notwithstanding the fact that it is a recommendation that:

- can be interpreted in a number of ways depending on where the emphasis in the sentence is placed
- it deals with a subject matter – remuneration of executives – which is of particular interest and potentially emotive for shareholders
- it deals with a topic that has been the subject in recent times of a number of subtle changes to the Listing Rules – towards reduced regulation of remuneration packages – and the implications of these changes have largely gone unnoticed for many in the investment community
- it appears to contemplate shareholder approval of equity-based executive plans (which is no longer a Listing Rule or *Corporations Act* requirement) without clarifying the circumstances in which shareholder approval is actually required.

CSA notes that the *Corporations Act* is clear in s 198A that shareholders cannot interfere with management decisions, which are reserved to the board. CSA opposes taking shareholders into the boardroom to make management decisions, except under related party provisions, and opposes creating a new reporting trigger that goes beyond the law. CSA does not support the reintroduction of a requirement for shareholder approval of equity plans for executives. CSA believes that the attraction, recruitment, remuneration and appropriate incentivisation of the best persons for the job remains the responsibility of the managing director within the framework approved by the board.

CSA believes that the current difficulty being experienced with Recommendation 9.4 lies in its drafting. The ambiguities of the current wording mean that it can be interpreted in two quite different ways:

1. One is a requirement for disclosure from companies of whether the payment of equity-based executive remuneration aligns with the performance thresholds approved by shareholders (the first limb of the sentence)
2. The other is that all executive remuneration should be approved by shareholders (the second limb of the sentence).

1 Disclosure requirement

If the intention is a disclosure requirement, then the second limb of the recommendation ('…set in plans approved by shareholders') should be deleted or, if not, significantly amended. CSA notes that there is considerable investor concern with performance thresholds and whether shareholders should vote yes to remuneration reports. CSA believes that it is reasonable for companies to disclose that executives are paid in accordance with performance thresholds, and for the remuneration report to note the plan; the thresholds, and whether payment is in accordance with those thresholds. Currently the disclosure about the alignment of payment with thresholds is implied rather than stated.

2 Shareholder approval

If the intention is that shareholder approval is required for executive remuneration, CSA believes that Recommendation 9.4 should be deleted, as it conflicts both with the *Corporations Act* and the Listing Rules.

CSA response

Based on the problems outlined above in relation to the current drafting, **CSA recommends** that the approach outlined in Paragraph 105 of the Explanatory Paper accompanying the revised ASX Corporate Governance Council *Principles of Good Corporate Governance and Good Practice Recommendations* is the most appropriate approach to take to clarifying the intent of this particular recommendation.

It states that:

> Another approach would be to amend Recommendation 9.4 to clarify that where shareholder approval has been obtained for an equity-based executive remuneration plan, companies should confirm that payments to the executives are in accordance with the thresholds set in those plans. This approach would leave it open to companies to decide whether or not they should obtain shareholder approval. However, companies would be required to disclose on an "if not, why not?" basis whether payments are in accordance with plans approved by shareholders. This approach would not involve moving beyond what the law currently requires but would encourage companies to turn their minds to whether they should obtain shareholder approval.

CSA opposes the approach proposed in Paragraph 106 of the Explanatory Paper, which recommends obtaining shareholder approval for equity-based executive remuneration plans, except where directors participate in the plan, and in that case the approval would not be of the plan itself but would relate to the details of the director's equity-based remuneration. In such circumstances, CSA notes that approval is only sought because the grant of equity by way of a new issue has the potential to dilute shareholdings.

CSA does not believe it is practical for shareholders to be involved in the determination of one portion only of an executive's remuneration in the absence of consideration of the total remuneration package. The trend towards increased 'at-risk equity-based remuneration' has largely been driven by shareholders to which companies have responded accordingly. Any increased uncertainty (the uncertainty of gaining shareholder approval) in relation to this portion of the package will make it more difficult for boards to negotiate packages when recruiting new senior executives in a competitive market, and it has the potential to result in a move away from equity-based remuneration to a form of remuneration that does not require shareholder approval.

CSA believes it is sufficient for companies to be required to explain their remuneration policies and practices in expansive detail in the remuneration report and at the Annual General Meeting. Shareholders can voice their opinion initially through the non-binding vote on the remuneration report and, if their views are not taken into consideration, they have the option to vote against director re-appointments.

Listing Rule 10.14

Generally the ASX Corporate Governance Council Principles and the Listing Rules are not examined simultaneously. However, CSA believes that in this instance they need to be, and commends the Council for combining questions on the two issues in the one paper. CSA believes that the one issue cannot be reviewed without comment on the other.

At present shareholders are unclear as to when they have a role to play in approving executive remuneration. Many plans do not go to shareholders as they do not contain an issue of shares, although they may contemplate the on-market purchase of shares. The statutory obligation to submit a remuneration report to shareholders, followed by the non-binding vote on the report, have made available to shareholders a great deal of information concerning remuneration plans and it is clear that shareholders believe that, in some companies:

- performance hurdles may be set too low
- there may be a lack of symmetry between executive remuneration and shareholder return
- at-risk salaries may not really be at risk
- the value of options may be understated.

CSA notes that misunderstandings arise as shareholders vote on only portions of executive remuneration. For example, a managing director might be earning only half of what others in that particular industry are earning, but half of the managing director's package is equity. CSA believes that more immediate real-time disclosure of remuneration issues, such as the granting of performance rights (for example, a modified Appendix 3Y to cater for the granting of performance rights), would mean that shareholders would not have to wait many months to find out such issues when the remuneration report is released.

CSA response

CSA supports the second point in Paragraph 107 in the Explanatory Paper on this basis, which states that:

> There should be an exclusion based around the fact that shareholder approval should only be required where the acquisition of securities involves dilution of shareholders' existing interests. On-market share purchases do not require shareholder approval because there is no dilution of existing shareholders' interests. This is the current position in relation to Listing Rule 10.14.

CSA recommends that shareholder approval in relation to equity issues to directors should be sought only where there is the potential for dilution of existing shareholders' interests, that is, new issues.

CSA recommends that plans involving the acquisition of shares on-market do not require shareholder approval.

CSA believes that the role of shareholders in approving equity issues is one taken very seriously by shareholders and that the legal and good governance obligations relating to these should be spelled out very clearly for all parties. On this basis, CSA believes that the following amendments to the Listing Rules are required for clarity.

LR10.14 should be re-drafted to state more clearly that:

- the only issues that require approval by shareholders are those involving a new issue to directors and not those involving shares acquired on-market
- the situation should not differ for executive directors and non-executive directors.

CSA will lodge a separate submission with the ASX on Listing Rule 10.14.

Guide to reporting on Principle 9

CSA notes that the inclusion of a reference to Boxes 9.1 and 9.2 in two bullet points elevates the material contained in the boxes, which is provided as guidance, to the level of a Recommendation.

CSA recommends that the reference to Boxes 9.1 and 9.2 be deleted from these bullet points.

Part B: Reporting of material business risks and corporate responsibility/sustainability risks

Threshold question: should the ASX Corporate Governance Council be in this space?

CSA believes that sustainability/corporate responsibility is a subset of governance and therefore it is appropriate for Council to be in this space. Sustainability/corporate responsibility reporting canvasses the reputation a company wants to have and the relationships it seeks with stakeholders, and this is central to governance.

However, given that there is still a lack of agreement on definitional issues relating to corporate responsibility and sustainability, unlike governance where generally agreed standards exist and have done so for some years, CSA believes that any guidance offered by the Council on sustainability and corporate responsibility should be offered in a separate set of guidelines and not in the Principles.

Any reporting on sustainability and corporate responsibility should be a point of differentiation for a company and not contained within the 'if not, why not' framework of the Principles, which derive from a generally accepted standard.

Option A: Council releases voluntary additional guidance to Principle 7 with no additional reporting obligations for companies

CSA opposes the introduction of Option A. While CSA wishes to encourage sound sustainability/corporate responsibility reporting it does not believe that additional guidance on sustainability/corporate responsibility reporting should be contained in Principle 7, which limits any such guidance and reporting to a risk framework. This approach does not provide sufficient flexibility for companies to report to shareholders according to the corporate responsibility framework they have implemented, which could include operational and strategic issues.

CSA recommends that additional voluntary guidance on sustainability/corporate responsibility reporting should be offered by the Council in a separate set of guidelines, available on the ASX website.

Larger companies have been reporting on sustainability/corporate responsibility issues for some time (particularly those with a large impact on the environment or the community), and additional commentary and guidance that assists the breadth of listed companies to report to shareholders on these issues is desirable.

CSA's recommendation

CSA believes that the additional commentary and guidance, in a separate set of guidelines, could consist of articulating the questions a company might ask to assist in formulating its report. Thus companies could be asked to consider the following:

- Who is the audience for this report?
- What are the company's material business risks?:
  - reputation
  - environment
  - community
  - employees
  - donations
- Is the information provided aligned with the audience?
- What communication tools can the company use to ensure that one document is not being sent to all audiences?

- Who signs off on the report internally?
- What is the accuracy of the information and the verification process? CSA does not believe that such reports should be auditable, but companies need to ensure that they have the same integrity as all other reports to shareholders (which aligns with sections 1308 and 1309 of the *Corporations Act*, dealing with the offences of providing false or misleading statements or information).

Option B: Council introduces an additional 'if not, why not' reporting requirement under Principle 7, with guidance, involving additional reporting obligations for companies

CSA strongly opposes Option B, for the following reasons:

- Sustainability and corporate responsibility mean different things to different companies. Companies should have the flexibility to respond according to the circumstances of the company.
- Some companies are more advanced in this field than others (for example, the resource sector) and have been reporting on sustainability/corporate responsibility for some years. It would be unfair to impose a reporting trigger on those companies that have not yet been on the same journey as those companies well down the path of sustainability/corporate responsibility reporting.
- The level of reporting will distinguish companies. For example, if a board signs off on the sustainability/corporate responsibility report, it will signal awareness and sensitivity of the issues in the company. This again reflects the cultural issues inherent in the reporting being flexible enough to reflect the cultural journeys that companies have taken or are taking.
- A reporting trigger could produce form over substance – green wash.
- It is a very big resource commitment for a company to report on sustainability/corporate responsibility issues, and it is also very expensive. A reporting methodology that can meet a verification process requires:
  - site visits
  - meetings with stakeholders
  - the capture of data and its analysis to provide it in measurable form
  - diversified entities do not have the same issues in each stream, and unlike financial reporting where the issues are the same and can be reported under one methodology, any sustainability/corporate responsibility reporting needs to reflect the differences in each stream
  - it occupies substantial amounts of management time.
- Sustainability/corporate responsibility reporting involves a high level of subjectivity, which means that the ideal of comparability of reports by mandating reporting is automatically undermined.
- It is an evolving art, not a science.

Establishing a web-based tool for the dissemination of sustainability information

CSA recommends that the ASX further review the establishment of a web-based tool for the dissemination of sustainability information.

The benefits of ASX moving in this direction include:

- Currently power sits with a number of rating agencies, which may have their own agendas. It moves the power to one location, which increases the likelihood of a degree of objectivity.

- Currently companies are required to fill out multiple surveys from different rating agencies. For all companies, apart from the top 10, this is a massive drain on resources. It would standardise the survey methodology, resulting in:
  - efficiencies of process for the issuers
  - a greater degree of comparability for users.
- It would be helpful for companies to have an independent body providing the platform for voluntary sustainability/corporate responsibility reporting. Providing such a platform would enhance Australia's and the ASX's reputation in investment circles in relation to socially responsible investment.