ASX Corporate Governance Council

Review of the Corporate Governance Principles and Recommendations

Public Consultation

ASX Corporate Governance Council

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Contents

Introduction

1. As announced on 4 December 2012, the ASX Corporate Governance Council (the 'Council') is proposing to update and issue a third edition of its *Corporate Governance Principles and Recommendations* (the '*Principles and Recommendations*').

2. Accompanying this consultation paper are:

   - a draft of the third edition of the *Principles and Recommendations;*
   - a copy of the current edition of the *Principles and Recommendations*; and
   - translation tables showing the linkages between the proposed new recommendations in the third edition and the existing recommendations in the current edition, and vice versa.

3. The *Principles and Recommendations* last underwent a major review prior to the release of the second edition in 2007.[1]

4. Since 2007, the GFC has brought to the fore a number of governance issues. Internationally, deficiencies in corporate governance practices, particularly in relation to risk management, have been identified as significant contributors to both the cause and severity of the GFC. This in turn has led to questions about the effectiveness of the self-regulating corporate governance codes that apply in many jurisdictions and calls for further regulation to address perceived weaknesses in those codes.[2]

5. While Australia emerged relatively unscathed by the GFC and did not experience the same level of governance-related failures as elsewhere, the ASX Corporate Governance Council (the 'Council') determined in 2012 that it would be appropriate to review and update its *Principles and Recommendations* to incorporate the lessons of the GFC and other local and international developments on the corporate governance front since the second edition was published in 2007.

6. The Council strongly believes that the pressure points that have emerged in recent years in the area of corporate governance can be effectively and flexibly addressed within the "if not, why not" framework of the *Principles and Recommendations*. It also believes that it is important that they are in fact addressed, to ensure that the *Principles and Recommendations* remain contemporary and continue to deliver good corporate governance outcomes for ASX listed entities and investors and other stakeholders in those entities. Otherwise, the pressures being felt overseas for a more prescriptive legislative response to the governance failures that emerged during the GFC will inevitably extend to Australia.

[1] Amendments were made in 2010 to add 3 diversity-related recommendations and a recommendation on the composition of the remuneration committee, as well as to make some changes to the commentary, but these amendments did not involve a major review of the Principles and Recommendations.

[2] See, for example, the OECD Steering Group on Corporate Governance publications *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009), available online at http://www.oecd.org/daf/ca/corporategovernanceprinciples/43056196.pdf, and *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles* (24 February 2010), available online at http://www.oecd.org/daf/ca/corporategovernanceprinciples/44679170.pdf.

Overview of the draft third edition of the *Principles and Recommendations*

7. The draft third edition of the *Principles and Recommendations* seeks to capture and reflect developments, both in Australia and internationally, in corporate governance matters since the second edition was published in 2007. It also seeks to afford greater flexibility to listed entities to make their corporate governance disclosures on their website rather than in their annual report. This should help listed entities streamline their annual reports and also promote better access by stakeholders to information about a listed entity's governance practices.

8. The draft third edition is built around the existing 8 principles in the current edition of the *Principles and Recommendations*, although the Council has slightly modified some of the principles to clarify the drafting and/or to establish a stronger linkage between the principle and the supporting recommendations.

9. In common with the current edition, the draft third edition also has 30 recommendation intended to give effect to these 8 underlying principles. The recommendations in the draft third edition, however, have been substantially revised in a number of ways and for a number of purposes:

- Building on the lessons of the GFC, the issue of risk management has received much closer attention in the third edition. The third edition now includes a recommendation that a listed entity should establish a risk committee, either on a stand-alone basis or as part of the responsibility of the audit committee, or otherwise disclose its processes for overseeing risk (see recommendation 7.1). It recommends risk management reviews at board or board committee level at least annually (see recommendation 7.2). It also elevates to a recommendation some of the commentary in the current edition regarding the important risk management role played by internal audit (see recommendation 7.3).

- The third edition seeks to address, in a measured and non-prescriptive manner, the increasing attention being given by the investment community to environmental and social issues and the investment risks they raise. To that end it is proposed to include in the third edition of the *Principles and Recommendations* a recommendation that a listed entity disclose whether, and if so how, it has regard to economic, environmental and social sustainability risks (recommendation 7.4).

- The third edition also seeks to draw attention to concerns that the Australian Government and others have raised with the Council about the difficulty that people with disability face in securing meaningful employment and the role that listed entities can play in helping to address this. The Council is seeking to raise the level of awareness of this issue amongst listed entities via the commentary to Principle 3 on acting ethically and responsibly and also via the commentary to recommendation 1.5 on the issues that a listed entity's diversity policy should address.

- The criteria for a director to be considered "independent" set out in Box 2.1 of the *Principles and Recommendations* have been amended:

    - to expand the references to "a material supplier or customer of the entity or any of its related entities, or an officer of, or otherwise associated directly or indirectly with, such a supplier or customer" to cover such relationships going back 3 years;

    - to include close family ties in the Box rather than in the commentary; and

    - to include service on the board for more than 9 years as an indicator that a director may not be independent.

- The diversity-related recommendations have been amended:

    - to give entities the flexibility to report their "Gender Equality Indicators" under the Workplace Gender Equality Act 2012, instead of reporting the respective proportions of men and women on the board, in senior executive positions and across the whole organisation; and

- to provide that where an entity chooses to report the latter information, it should disclose how it has defined "senior executive" for these purposes,

and the related commentary has been enhanced to give greater guidance on the meaning of "measurable objectives" and on the steps a listed entity can take to measure its achievements against the diversity objectives set by its board.

- A number of practices or disclosures recommended in the commentary in the current edition have been elevated into actual recommendations in the third edition, which will trigger an obligation for listed entities to report against those matters under Listing Rule 4.10.3. The Council believes, in each case, that these matters should no longer be regarded as mere guidance but rather as contemporary governance standards that, if not followed, warrant an explanation as to why they are not being followed.

  The recommendations in the third edition derived from commentary in the current edition include recommendations 1.2(b), 1.3, 1.4, 2.4 (in so far as it relates to the composition of the nomination committee), 2.6, 4.3, 6.1, 6.3, 6.4 and 7.3. The detailed discussion of the proposed new *Principles and Recommendations* below, as well as the translation tables that accompany this consultation paper, highlight which recommendations in the draft third edition are derived from parts of the commentary in the current edition and identify where that commentary is located in the current edition.

- A number of recommendations have had alternatives added to recognise that some listed entities, particularly smaller listed entities with smaller boards, may legitimately have different governance practices to larger listed entities and to enable them to report that they comply with the Council's recommendations rather than report that they do not comply and give an explanation why. For example:

  - the recommendations in the third edition on nomination, audit, risk and remuneration committees (recommendations 2.4, 4.1, 7.1 and 8.1 respectively) all have alternatives that recognise that the boards of smaller listed entities may reasonably decide not to have such committees and instead adopt alternative practices to address the issues that those committees would typically address in larger listed entities; and

  - the new recommendation in the third edition regarding internal audit (recommendation 7.3) has an alternative that recognises that smaller listed entities may not have an internal audit function and that allows them instead to report the processes they employ to evaluate and continually improve the effectiveness of their risk management and internal control processes.

- The dichotomy that exists in the current edition of the *Principles and Recommendations* between substantive recommendations and reporting recommendations (as embodied in the last recommendation under each principle headed "Guide to Reporting on Principle [X]") has been dropped. Instead, the reporting requirements for each recommendation in the third edition are "self-contained" within the recommendation, so that it is clear what has to be disclosed by a listed entity for it to be able to report that it follows that recommendation under Listing Rule 4.10.3.

  The separation of the substantive recommendations and the reporting recommendations in the first and second editions of the *Principles and Recommendations* has led to confusion, with listed entities often reporting against the substantive recommendation but neglecting to report against all of the items relevant to that recommendation in the related "Guide to Reporting" recommendation.

  This change to the structure of the *Principles and Recommendations* should benefit listed entities by making it much easier for them to report under Listing Rule 4.10.3 which of the recommendations they follow and which they do not follow and why. It should also benefit readers of corporate governance statements through clearer, more easily understood corporate governance disclosures.

- Some recommendations have been re-located within the *Principles and Recommendations*. For example:
    - the diversity-related recommendations have been relocated from principle 3 (ethical and responsible decision-making) to principle 1 (lay solid foundations for management and oversight);
    - the recommendation concerning board reviews has been relocated from principle 2 (structure the board to add value) to principle 1 (lay solid foundations for management and oversight), to sit alongside the recommendation concerning management reviews; and
    - the recommendation about CEO and CFO certification of financial statements has been relocated from principle 7 (recognise and manage risk) to principle 4 (safeguard integrity in financial reporting).

    In each case, the Council feels that the recommendation in question has a stronger link to the principle to which it has been assigned in the third edition than the one to which it is assigned in the current edition.
- A number of related recommendations in the current edition have been amalgamated into a single recommendation in the third edition. This is intended to aid listed entities in understanding the scope of what is expected under the recommendations and to facilitate reporting against the recommendations in a more holistic manner. For example:
    - the three separate diversity-related recommendations (recommendations 3.2, 3.3 and 3.4);
    - the two separate recommendations about the independence of the chair and the separation of the roles of chair and CEO (recommendations 2.2 and 2.3);
    - the three separate recommendations on audit committees (recommendation 4.1, 4.2 and 4.3); and
    - the two separate recommendations on remuneration committees (recommendation 8.1 and 8.2),

    in the current edition have been combined into single recommendations in the third edition (recommendations 1.5, 2.3, 4.1 and 8.1 respectively).
- Some recommendations have been modified or expanded to recognise that not all ASX listed entities are incorporated in Australia and therefore subject to the Corporations Act,[3] and to recommend that listed entities incorporated outside Australia comply with some of the governance practices that entities incorporated in Australia must conform to under the Corporations Act. This includes, for example:
    - recommendation 4.2 that the board of a listed entity should, before it approves the entity's financial statements for a financial period, receive from its CEO and CFO a declaration that the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity; and
    - recommendation 4.3 that a listed entity should ensure that its auditor is available at its AGM to answer questions from security holders relevant to the audit.

[3] Some 5% of ASX listed entities are incorporated in overseas jurisdictions and therefore are not generally subject to the Corporations Act 2001 (Cth) other than the continuous disclosure requirements in section 674 and, if and to the extent that they offer securities in this jurisdiction, to the prospectus or PDS requirements in Chapters 6D or Part 7.9 (as applicable).

- Externally managed listed entities are treated differently in the third edition compared to the current edition. Instead of having the individual sections that appear in the current edition under each principle headed "Application of Principle [X] in relation to trusts and externally managed listed entities", the third edition now has a separate section at the end of the recommendations dedicated to externally managed listed entities that explains in a more complete manner which recommendations apply (with or without modifications) to such entities and which do not. It also includes two additional recommendations applicable to such entities, derived from the commentary in the current edition.

10. In common with the current edition, the draft third edition also has commentary on the various recommendations intended to provide additional guidance to listed entities. The commentary does not form part of the recommendations and therefore does not trigger any reporting obligations under Listing Rule 4.10.3. The Council has taken the opportunity to streamline much of the commentary accompanying the recommendations, recognising that the level of understanding of governance issues in 2013 is substantially higher than when the *Principles and Recommendations* were first adopted in 2003. This has helped to reduce the overall length of the *Principles and Recommendations* by around 20%.

11. Throughout this consultation paper, references are made and comparisons are drawn to the corporate governance codes operating elsewhere, including those in the UK,[4] Singapore,[5] Hong Kong,[6] South Africa,[7] Canada,[8] NYSE's Corporate Governance Rules[9] and the International Corporate Governance Network's Global Corporate Governance Guidelines (Revised 2009).[10] These codes were chosen on the basis that they apply to major and comparable markets to the Australian market and are written in English.

This consultation

12. The primary purpose of this consultation is to seek feedback from listed companies, their advisers, security holders and other stakeholders on the draft third edition of the *Principles and Recommendations* accompanying this consultation paper. The Council wishes to ensure that the third edition of the *Principles and Recommendations* strikes the right balance between the needs and interests of all stakeholders.

13. The Council is especially interested to receive comments on:

- whether stakeholders support the move by the Council to afford greater flexibility to listed entities to make their corporate governance disclosures on their website rather than in their annual report;
- whether the structural changes proposed to the *Principles and Recommendations*, particularly:
  - the dropping of the separate reporting recommendations headed "Guide to Reporting on Principle [X]" under each of the 8 principles in the current edition in favour of "self-contained" recommendations in the third edition, each of which includes any applicable reporting requirements that need to be met for an entity to "follow" that recommendation for the purposes of Listing Rule 4.10.3; and
  - the dropping of the separate sections "Application of Principle [X] in relation to trusts and externally managed entities" under each of the 8 principles in the current edition in favour of

[4] The UK Corporate Governance Code, September 2012 ("UK Code").

[5] Code of Corporate Governance, May 2012 ("Singapore Code").

[6] Corporate Governance Code and Corporate Governance Report in Appendix 14 of the Stock Exchange of Hong Kong Limited Listing Rules ("Hong Kong Code").

[7] King Code of Governance for South Africa 2009 ("SA Code").

[8] TSX Guide to Good Disclosure incorporating National Instrument 58-101 Disclosure of Corporate Governance Practices and Multilateral Instrument 52-110 – Audit Committees ("Canada Code") as at January 2006.

[9] Referred to in this consultation paper as the "NYSE Rules".

[10] Referred to in this consultation paper as the "ICGN Code".

a unified section at the back of the draft third edition dealing with that issue in a more complete manner across all of the principles and recommendations,

will make it easier for listed entities to understand and report against the *Principles and Recommendations*;

- where the Council is proposing to elevate items of commentary in the current edition (which do not trigger any reporting obligations) into recommendations in the third edition (which listed entities must report against under Listing Rule 4.10.3 on an "if not, why not" basis), whether stakeholders agree with that treatment and, if not, why not;
- where the Council is proposing wholly new recommendations, whether stakeholders agree with those recommendations and, if not, why not;
- whether compliance with any of the new recommendations (be they elevated from commentary in the current edition or wholly new) might have any unforeseen consequences or give rise to undue compliance burdens for listed entities;
- whether the level of commentary in the draft third edition is appropriate and whether stakeholders would like more guidance on any particular recommendations; and
- whether there are any other gaps or deficiencies in the *Principles and Recommendations* that have not been addressed by the proposed changes in the draft third edition.

14. If you wish to provide comments on the draft third edition of the *Principles and Recommendations*, please do so by Friday, 15 November 2013 to the following email address: mavis.tan@asx.com.au.

15. The Council is proposing to make the submissions it receives in response to this consultation paper publicly available on its webpage unless a respondent clearly indicates that they wish their submission to remain confidential.

16. The Council will consider all submissions it receives in response to this consultation before finalising the third edition of the *Principles and Recommendations*. It is envisaged that the final version of the third edition will be released in early 2014 and will take effect for an entity's first full financial year commencing on or after 1 July 2014. Accordingly, entities with a 30 June balance date will be expected to measure their governance practices against the recommendations in the third edition commencing with the financial year ended 30 June 2015. Entities with a 31 December balance date will be expected to measure their governance practices against the recommendations in the third edition commencing with the financial year ended 31 December 2015.

Related ASX consultation – Listing Rule and Guidance Note changes

17. ASX has released a separate consultation paper, contemporaneously with this consultation paper, proposing changes to its Listing Rules and Guidance Note 9 *Disclosure of Corporate Governance Practices*. Those changes are intended to complement and give effect to the changes proposed in the third edition of the *Principles and Recommendations*. ASX's consultation paper can be viewed or downloaded at: http://www.asxgroup.com.au/public-consultations.htm.

18. Parties are welcome to send a combined submission to the Council addressing its consultation on the third edition of the *Principles and Recommendations* and to ASX addressing its proposed Listing Rule and Guidance Note changes.

Explanation of proposed changes by principle and recommendation

Principle 1 - Lay solid foundations for management and oversight. A listed entity should establish and disclose the respective roles and responsibilities of the board and management and how their performance is monitored and evaluated.

19. Council proposes to expand principle 1 to include a reference to the disclosure of how the performance of the board and management is monitored and evaluated. This is to provide a better linkage to the recommendations about board and management reviews in recommendations 1.6 and 1.7.

Recommendation 1.1: A listed entity should have and disclose a charter which:

(a) sets out the respective roles and responsibilities of the board, the chair and management; and

(b) includes a description of those matters expressly reserved to the board and those delegated to management.

20. Proposed recommendation 1.1 effectively mirrors current recommendation 1.1 and the final paragraph in the Guide to Reporting on Principle 1 (recommendation 1.3).

Recommendation 1.2: A listed entity should:

(a) undertake appropriate checks before appointing a person, or putting forward to security holders a candidate for election, as a director; and

(b) provide security holders with all material information relevant to a decision on whether or not to elect or re-elect a director.

21. Proposed recommendation 1.2(a) is a new recommendation and gives effect to a view of the Council that a listed entity, as a matter of due care, should be conducting appropriate checks before its board appoints someone to fill a casual vacancy or as an additional director, or puts someone forward to security holders as a candidate for election as a director.

22. Council believes that most listed entities would be using specialized search firms to locate potential appointees to their boards and those firms would normally undertake appropriate checks as a matter of course. If a listed entity chooses not to use such a firm, it should ensure that it obtains those checks for itself.

23. Proposed recommendation 1.2(b) is derived from the commentary under the heading "*Election of directors*" following current recommendation 2.4, which gives guidance about providing security holders with sufficient information to assist them in making an informed decision on whether to elect or re-elect a director. The UK,[11] Singapore,[12] Hong Kong[13] and South Africa[14] have similar recommendations and the Council proposes to elevate the commentary to a recommendation to align with international practice.

Recommendation 1.3: A listed entity should have a written agreement with each director and senior executive setting out the terms of their appointment.

24. Proposed recommendation 1.3 is derived from the commentary under the heading "*Allocation of individual responsibilities*" following current recommendation 1.1, which gives guidance on letters of appointment for directors. The Council is proposing to elevate that commentary into a recommendation, and to expand it to cover senior executives, to reflect the importance of having a proper written record of the terms of

[11] UK Code Provision B7.1.

[12] Singapore Code Guideline 4.7.

[13] Hong Kong Code Provision A.5.5.

[14] SA Code Recommended Practice 2.19 - South Africa also recommends that background and reference checks are performed before the nomination and appointment of directors (2.19.2).

appointment of a director or senior executive. This is also recommended practice for directors in the UK[15] and South Africa.[16]

Recommendation 1.4: The company secretary of a listed entity should have a direct reporting line to the chair of the board.

25. Proposed recommendation 1.4 is derived from the commentary under the heading "*The board and the company secretary*" following current recommendation 2.5 (board reviews). The Council proposes to elevate that commentary into a recommendation.

26. Proposed recommendation 1.4 aligns with international codes. Both the UK[17] and Singapore[18] codes contain provisions that the company secretary should be "under the direction of the chairman". Hong Kong recommends that the company secretary reports "to the board chairman and/or chief executive".[19]

Recommendation 1.5: A listed entity should:

(a) have a diversity policy which includes requirements for the board:

  (1) to set measurable objectives for achieving gender diversity; and

  (2) to assess annually both the objectives and the entity's progress in achieving them;

(b) disclose that policy or a summary of it; and

(c) disclose as at the end of each reporting period:

  (1) the measurable objectives for achieving gender diversity set by the board in accordance with the entity's diversity policy and its progress towards achieving them;

  (2) either:

    (A) the respective proportions of men and women on the board, in senior executive positions and across the whole organisation (including how the entity has defined "senior executive" for this purpose); or

    (B) the entity's "Gender Equality Indicators", as defined in the Workplace Gender Equality Act 2012.

27. The diversity-related recommendations are currently included under principle 3 (promote ethical and responsible decision making) as recommendations 3.2, 3.3 and 3.4. This has led to some confusion that the diversity recommendations were added to the *Principles and Recommendations* for ethical reasons, even though the associated commentary outlined the economic and business drivers for promoting diversity. The Council considers that the diversity-related recommendations in fact sit better under principle 1 (lay solid foundations for management and oversight) and is therefore proposing to consolidate them and move them to recommendation 1.5.

28. Two changes are proposed to the current diversity recommendations. Both relate to the suggestion in existing recommendation 3.4 that an entity should report the proportion of women employees in the whole organisation, in senior executive positions and on the board ("gender diversity statistics").

[15] UK Code Provision B.3.2 states that the terms and conditions of appointment of non-executive directors should be made available for inspection.

[16] SA Code Recommended Practice 2.19.3.

[17] UK Code Supporting Principle under"B.5 Information & Support".

[18] Singapore Code Guideline 6.3.

[19] Hong Kong Code Provision F.1.3.

29. First, in their analysis of the disclosures on diversity made by a significant cross-section of listed entities, KPMG[20] observed "that clearer and more transparent definitions of the organisational and senior executive categories are required from entities disclosing this information. If progress is to be measured through reporting against Recommendation 3.4, consideration needs to be given to the definition of senior executives. There is a variation in the level of roles including in this group, with few entities providing a clear, transparent explanation." To address this issue, the Council proposes to include in recommendation 1.5(c)(2)(A) a statement that an entity should disclose how it has defined "senior executive" for the purpose of reporting its gender diversity statistics.

30. Secondly, non-public sector employers in Australia with more than 100 or more employees are now required by the Workplace Gender Equality ("WGE") Act 2012 to report annually on six "Gender Equality Indicators".[21] These reports are made to the WGE Agency and published on its website. To reduce the administrative burden on listed entities, it is proposed to allow those entities that are covered by the WGE Act, to choose under proposed recommendation 1.5(c)(2)(B) to treat their filings with the WGE Agency as meeting the requirement to publish their gender diversity statistics under the *Principles and Recommendations*.

31. In addition, it is proposed to upgrade the commentary to the diversity-related recommendations to give greater guidance on the meaning of "measurable objectives" and on the steps a listed entity can take to measure its achievements against the diversity objectives set by its board.

Recommendation 1.6: A listed entity should:

(a) have and disclose a process for periodically evaluating the performance of the board, its committees and individual directors; and

(b) disclose in relation to each reporting period, whether a performance evaluation was undertaken in the reporting period in accordance with that process.

32. Proposed recommendation 1.6 mirrors current recommendation 2.5 and the 8th bullet point in the Guide to Reporting on Principle 2 (recommendation 2.6).

Recommendation 1.7: A listed entity should:

(a) have and disclose a process for periodically evaluating the performance of its senior executives; and

(b) disclose in relation to each reporting period, whether a performance evaluation was undertaken in the reporting period in accordance with that process.

33. Proposed recommendation 1.7 mirrors current recommendation 1.2 and the 2nd bullet point in the Guide to Reporting on Principle 1 (recommendation 1.3).

Principle 2 - Structure the board to add value. A listed entity should have a board of an appropriate size, composition, skills and commitment to enable it to discharge its duties effectively.

34. The Council has modified the drafting of this principle to recognise the need for the Board to have an appropriate mix of skills, as well as an appropriate composition, size and commitment. The principle now also speaks in terms of the Board discharging its duties "effectively" rather than "adequately".

[20] The KPMG report *Analysis of ASX Corporate Governance Principles and Recommendations disclosures on diversity in calendar year 2012* is available online at http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/asx-corporate-governance-council-principles-diversity.pdf. The report was commissioned and funded by ASX's Education and Research program.

[21] See the summary of the Gender Equality Indicators published online at http://www.wgea.gov.au/report/gender-equality-indicators.

Recommendation 2.1: A listed entity should disclose:

(a) the names of the directors considered by the board to be independent directors;

(b) if a director has an interest, position, association or relationship of the type described in Box 2.1 but the board is of the opinion that it does not compromise the independence of the director, the nature of the interest, position, association or relationship in question and an explanation of why the board is of that opinion; and

(c) the length of service of each director.

35. Proposed recommendation 2.1 combines the disclosure recommendations in the 2nd, 3rd and 6th bullet points in the current Guide to Reporting on Principle 2 (recommendation 2.6).

36. Proposed recommendation 2.1 is in line with similar provisions in the UK,[22] Singapore,[23] South Africa,[24] Hong Kong,[25] Canada[26] and in NYSE's Rules[27] and the ICGN Code.[28]

37. The requirement in paragraph (b) of proposed recommendation 2.1 to disclose interests, positions, associations or relationships that could affect a director's independence references *Box 2.1 – the defining characteristics of an independent director*, in the same manner as the corresponding disclosure recommendation in the 3rd bullet point in the current Guide to Reporting on Principle 2 (recommendation 2.6). However, it is proposed to update Box 2.1 in a number of respects.

38. Box 2.1 in the current edition provides as follows:

Box 2.1: Relationships affecting independent status

When determining the independent status of a director the board should consider whether the director:

1. is a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company
2. is employed, or has previously 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
3. has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
4. is a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
5. has a material contractual relationship with the company or another group member other than as a director.

The commentary underneath Box 2.1 in the current edition also mentions that family ties and cross-directorships may be relevant in considering interests and relationships which may affect independence, and should be disclosed by directors to the board.

[22] UK Code Provision B.1.1.

[23] Singapore Code Guideline 4.7.

[24] SA Code Recommended Practice 2.18.9.

[25] Hong Kong Code Provisions A.3.1 and A3.2.

[26] Canada Code 1(a) and (b) - Board of Directors in Form 58-101F1.

[27] The Board of Directors must disclose its determinations on director independence in its Form 10-K, annual proxy statement or other annual disclosure report filed with the SEC or in its annual report.

[28] ICGN Code Section 2.4.3 on independence.

39. It is proposed that Box 2.1 in the third edition will read as follows:

Box 2.1 – the defining characteristics of an independent director

A director of a listed entity should be characterised and described as an independent director only if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, his or her capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.

Examples of interests, positions, associations and relationships that might cause doubts about the independence of a director include if the director:

- is, or has been, employed in an executive capacity by the entity or any of its related entities and there has not been a period of at least three years between ceasing such employment and serving on the board;
- is, or has within the last three years been, a partner, shareholder, director or senior employee of a professional adviser or consultant to the entity or any of its related entities;
- is, or has within the last three years been, a material supplier or customer of the entity or any of its related entities, or an officer of, or otherwise associated directly or indirectly with, such a supplier or customer;
- is a substantial shareholder of the entity or an officer of, or otherwise associated directly or indirectly with, a substantial shareholder of the entity;
- has a material contractual relationship with the entity or its related entities other than as a director;
- has close family ties with any person who falls within any of the categories described above; or
- has been a director of the entity for more than 9 years.

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.

40. As will be seen, the new Box 2.1:

- expands the references to "a material supplier or customer of the entity or any of its related entities, or an officer of, or otherwise associated directly or indirectly with, such a supplier or customer" to cover such relationships going back 3 years;
- specifically includes close family ties in the Box rather than in the commentary; and
- includes service on the board for more than 9 years as an indicator that a director may not be independent.

41. On this last point, the Council notes that length of tenure was included as a factor that could influence a director's independence in *Box 2.1 Assessing the independence of directors* in the first edition of the Principles and Recommendations. That edition also noted that 10 years had been nominated in the UK Higgs' Report as the period of tenure giving rise to concerns about the independence of a director but at that time had not been adopted in the UK and therefore the Council proposed to monitor developments in other jurisdictions in this area. Tenure was subsequently dropped from Box 2.1 in the second edition. Since then, the UK,[29] Singapore,[30] South Africa[31] and Hong Kong[32] codes have all been amended to

[29] UK Code Provision B.1.1.

[30] Singapore Code Guideline 2.4.

[31] SA Code Recommended Practice 2.18.8.

[32] Hong Kong Code Provision A.4.3.

recommend that there should be a rigorous review of the independence of those directors who have served more than 9 years.

42. It should be noted that a director having an interest, position, association or relationship of the type described in Box 2.1 does not automatically mean that the director is regarded as not being independent for the purposes of the Principles and Recommendations. However, it does require the board to consider whether the interest, position, association or relationship in question is such as to compromise the independence of the director and, if the board forms the opinion that it is not and the director should therefore be regarded as independent, to explain to security holders why the board is of that opinion.

Recommendation 2.2: A majority of the board of a listed entity should be independent directors.

43. Proposed recommendation 2.2 mirrors current recommendation 2.1.

Recommendation 2.3: The chair of the board of a listed entity should be an independent director and, in particular, should not be the same person as the CEO of the entity.

44. Proposed recommendation 2.3 is a combination of current recommendations 2.2 and 2.3.

Recommendation 2.4: The board of a listed entity should:

(a) have a nomination committee which:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director,

and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have a nomination committee, disclose that fact and the processes it employs to address board succession issues and to ensure that the board has the appropriate balance of skills, experience, independence and knowledge of the entity to enable it to discharge its duties and responsibilities effectively.

45. Proposed recommendation 2.4(a) is a combination of the current recommendation 2.4 on nomination committees, the commentary to that recommendation about the suggested composition of the committee, and the disclosures about the nomination committee set out in the 7th bullet point in the Guide to Reporting on Principle 2 (recommendation 2.6).

46. The recommended composition of the nomination committee is in line with the UK,[33] Singapore[34] and Hong Kong.[35] Canada[36] and NYSE's Corporate Governance Rules[37] go further and require that the nomination committee be comprised entirely of independent directors.

[33] UK Code Provision B2.1: the same composition requirements but does not stipulate minimum size.

[34] Singapore Code Guideline 4.1 - at least three members; majority including chair should be independent.

[35] Hong Kong Code Provision A.5.1 - composition requirements are the same but do not stipulate minimum size.

[36] Canada Code 3.10 – although this does not stipulate a minimum size for the nomination committee.

[37] NYSE Rule 4(a) – although again this does not stipulate a minimum size for the nomination committee.

47. Proposed recommendation 2.4(b) has been added to recognise that some listed entities, particularly smaller ones with smaller boards, may legitimately decide not to have a nomination committee and institute alternative processes to address board succession issues and to ensure that the board has the appropriate balance of skills, experience, independence and knowledge to enable it to discharge its duties and responsibilities effectively. Provided they disclose these alternative practices, recommendation 2.4(b) allows them to report that they comply with the Council's recommendations on this matter. In the absence of recommendation 2.4(b), those entities without a nomination committee would have to report under Listing Rule 4.10.3 that they do not comply with the Council's recommendation on nomination committees and give an explanation why.

48. In this regard, the Council considers that the positive disclosure of the measures a board has implemented to address board succession issues and to ensure that the board has the appropriate balance of skills, experience, independence and knowledge to enable it to discharge its duties and responsibilities effectively is likely to lead to a better disclosure outcome than a negative disclosure as to why a board does not have a nomination committee.

Recommendation 2.5: A listed entity should have and disclose a statement as to the mix of skills and diversity that the board is looking to achieve in its membership.

49. Proposed recommendation 2.5 mirrors the disclosures currently contained in the 5th bullet point in the Guide to Reporting on Principle 2 (recommendation 2.6).

Recommendation 2.6: A listed entity should:

(a) have a program for inducting new directors and providing appropriate professional development opportunities for continuing directors to develop and maintain the skills and knowledge needed to perform their role as a director effectively; and

(b) disclose a summary of the main features of that program.

50. Proposed recommendation 2.6 is derived from the commentary headed "*Induction and education*" following current recommendation 2.5. The Council's proposed recommendation is in line with similar provisions in the UK,[38] Singapore,[39] Hong Kong,[40] Canada[41] and South Africa.[42]

Principle 3 - Promote ethical and responsible decision-making: A listed entity should actively promote ethical and responsible decision-making, consistent with creating long-term value for security holders.

51. The Council proposes to expand principle 3 to acknowledge the link between ethical and responsible decision making and the creation of long-term value for security holders.

52. As mentioned in the overview above, the commentary to Principle 3 also seeks to draw attention to concerns that the Australian Government (and others) have raised with the Council about the difficulty that people with disability face in securing meaningful employment and the role that listed entities can play in helping to address this. The Australian Government (and others) asked the Council to consider including a recommendation, similar to the reporting recommendation on gender diversity statistics, that listed entities report the number of people they employ with a disability. The Council acknowledges that this is a very

[38] UK Code B.4: Main Principle – All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

[39] Singapore Code Guideline 1.6 also includes disclosure in the annual report about the induction, orientation and training provided to new and existing directors.

[40] Hong Kong Code Provision A.6.1.

[41] Canada Code clause 3.7 on continuing education of the board.

[42] SA Code Principle 2.20 – induction and ongoing training and development of directors should be conducted through formal processes.

important social issue. However, it does not believe that it is properly characterised as a matter of "corporate governance" and therefore does not consider that it is appropriate to include a recommendation of this kind in the *Principles and Recommendations*. It also believes that such a recommendation would raise very serious privacy issues, as well as prove extremely difficult to implement in practice. Nevertheless, the Council is seeking to raise the level of awareness of this issue among listed entities via the commentary to Principle 3, as well as in the commentary to recommendation 1.5 on the issues that a listed entity's diversity policy should address.

Recommendation 3.1: A listed entity should:

(a) have a code of conduct for its directors, senior executives and employees; and

(b) disclose that code or a summary or it.

53. Proposed recommendation 3.1 mirrors current recommendation 3.1.

Principle 4 - Safeguard integrity in financial reporting: A listed entity should have formal and rigorous processes that independently verify and safeguard the integrity of its financial reporting.

54. The Council is modifying the drafting of principle 4 to refer to a listed entity having "*formal and rigorous processes* that independently verify and safeguard the integrity of its financial reporting", rather than "*a structure* to independently verify and safeguard the integrity of [its] financial reporting".

Recommendation 4.1: The board of a listed entity should:

(a) have an audit committee which:

(1) has at least three members, all of whom are non-executive directors and a majority of whom are independent directors; and

(2) is chaired by an independent director, who is not the chair of the board,

and disclose:

(3) the charter of the committee;

(4) the relevant qualifications and experience of the members of the committee; and

(5) in relation to each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have an audit committee, disclose that fact and the processes it employs that independently verify and safeguard the integrity of its financial reporting.

55. Proposed recommendation 4.1(a) is a combination of current recommendations 4.1, 4.2 and 4.3 and the disclosure requirements with respect to the audit committee in the 1st, 2nd and 4th bullet points in the Guide to Reporting on Principle 4 (recommendation 4.4).

56. Proposed recommendation 4.1(b) has been added to recognise that some listed entities, particularly smaller ones with smaller boards, may legitimately decide not to have an audit committee and institute alternative processes to independently verify and safeguard the integrity of their financial reporting. Provided they disclose these alternative practices, recommendation 4.1(b) allows them to report that they comply with the Council's recommendations on this matter. In the absence of recommendation 4.1(b), those entities without an audit committee would have to report under Listing Rule 4.10.3 that they do not comply with the Council's recommendations on audit committees and give an explanation why.

57. In this regard, the Council considers that the positive disclosure of the measures a board has implemented to independently verify and safeguard the integrity of its financial reporting is likely to lead to a better disclosure outcome than a negative disclosure as to why a board does not have an audit committee.

Recommendation 4.2: The board of a listed entity should, before it approves the entity's financial statements for a financial period, receive from its CEO and CFO a declaration that the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity.

58. Proposed recommendation 4.2 effectively replaces current recommendation 7.3. It is being moved to principle 4 from principle 7 as it is more directly related to safeguarding the integrity of an entity's financial statements than to the management of risk.

59. Current recommendation 7.3 merely requires the board to disclose whether it has received an assurance from the CEO and CFO in accordance with section 295A of the Corporations Act. The proposed recommendation is expressed differently and recommends that the board of a listed entity, before it approves the entity's financial statements for a financial period, should receive a declaration from the CEO and CFO that the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity. This is effectively the declaration that a board of an Australian listed company must receive from the CEO and CFO in relation to the annual financial statements under section 295A of the Corporations Act before approving those statements.

60. Expressing the recommendation in the manner proposed, however, serves two purposes. It means that boards should be receiving the recommended declaration from the CEO and CFO before they approve the financial statements for any financial period, not just for the financial year, as required under section 295A of the Corporations Act. It also ensures that the recommendation applies to entities incorporated overseas that are not otherwise covered by section 295A of the Corporations Act.

Recommendation 4.3: A listed entity that has an AGM should ensure that its external auditor attends its AGM and is available to answer questions from security holders relevant to the audit.

61. Proposed recommendation 4.3 is a new recommendation, although it has its genesis in the current commentary on the "Application of Principle 6 in relation to trusts and externally managed entities".

62. The opportunity for security holders to question a listed entity's auditor at the AGM is an important safeguard for the integrity of the financial reporting process that is afforded to security holders in listed companies established in Australia by sections 250PA, 250RA and 250T of the Corporations Act. The effect of the proposed new recommendation is to extend that opportunity to the security holders in listed entities established outside of Australia, that are not otherwise subject to these provisions in the Corporations Act.

Principle 5 - **Make timely and balanced disclosure:** A listed entity should make timely and balanced disclosure of all matters concerning it that a reasonable person would expect to have a material effect on the price or value of its securities.

63. Proposed principle 5 is essentially the same as the current principle 5, with some minor drafting changes to conform to the wording of the disclosure requirements in Listing Rule 3.1 (ie to refer to the timely and balanced disclosure by a listed entity of "matters concerning it that a reasonable person would expect to have a material effect on the price or value of its securities" rather than "all material matters").

Recommendation 5.1: A listed entity should:

(a) have a written policy for complying with its continuous disclosure obligations under the Listing Rules; and

(b) disclose that policy or a summary or it.

64. Proposed recommendation 5.1 mirrors current recommendation 5.1 and the Guide to Reporting on Principle 5 (recommendation 5.2).

Principle 6 - **Respect the rights of security holders:** A listed entity should respect the rights of its security holders by providing them with appropriate information and facilities to allow them to exercise those rights effectively.

65. Proposed principle 6 is essentially the same as the current principle 6, with the addition of the words "by providing them with appropriate information and facilities to allow them to exercise those rights effectively". These additional words are intended to explain, and give substance to, the phrase "respect the rights of security holders".

Recommendation 6.1: A listed entity should provide information about itself and its governance to investors via its website.

66. Proposed recommendation 6.1 effectively elevates the commentary under the heading "*Website*" following current recommendation 6.1 into a reporting recommendation. In the digital age, security holders expect information about listed entities to be freely and readily available on their websites.

67. The Council is also proposing to provide greater guidance in the commentary to this recommendation on the types of information that security holders would generally expect to find on a listed entity's website.

Recommendation 6.2: A listed entity should design and implement an investor relations program to facilitate effective two-way communication with investors.

68. Proposed recommendation 6.2 effectively replaces that part of current recommendation 6.1 calling for listed entities to "design a communications policy for promoting effective communications with shareholders". In the Council's experience, the communication policies disclosed by most listed entities have tended to be "boilerplate" disclosures that often duplicate the disclosures made under recommendation 5.1 (disclosure policy). They have also tended to focus on one-way disclosure of information by a listed entity to its security holders rather than two-way communication between a listed entity and its security holders.

69. The Council is not proposing to require any specific disclosures in relation to a listed entity's investor relations program, other than the general disclosures required under Listing Rule 4.10.3 on whether or not the entity has such a program and, if not, why not. In this regard, the Council is not proposing to take this recommendation as far as the UK and Singapore codes,[43] which state that a board should disclose in the annual report the steps it took to solicit and understand the views of shareholders, for example, through analyst/investor briefings, face to face contact and/or surveys of shareholder opinion. The Council believes that such a requirement again would tend to elicit "boilerplate" disclosures.

Recommendation 6.3: A listed entity should disclose the policies and processes it has in place to facilitate and encourage participation at meetings of security holders.

[43] UK Code E.1.2 and Singapore Code Guideline 15.4.

70. Proposed recommendation 6.3 effectively replaces that part of current recommendation 6.1 calling for listed entities to "design a communications policy … encouraging [the participation of security holders] at general meetings. It also effectively elevates the commentary under the heading "*Meetings*" following current recommendation 6.1 into a reporting recommendation.

71. The Council's proposals do not go as far as those in the UK[44], Singapore[45] and Hong Kong[46] codes, which have separate sections and a number of specific recommendations covering the conduct of the AGM. For entities established in Australia, the conduct of the AGM is substantially regulated by the Corporations Act and the Council does not see a need to supplement the Corporations Act in this area. The Council also notes that CAMAC is currently undertaking a review of the AGM and shareholder engagement and that this could lead to law reform in this area.

Recommendation 6.4: A listed entity should give security holders the option to receive communications from, and send communications to, the entity and its security registry electronically.

72. This recommendation effectively elevates the commentary under the heading "*Electronic Communication*" following current recommendation 6.1 and also in Box 6.1 "*Using electronic communication effectively"*, into a reporting recommendation.

73. Security holders generally appreciate the speed, convenience and environmental friendliness of electronic communications, compared to more traditional methods of communication. They expect to have the option to receive communications from, and send communications to, a listed entity and its security registry electronically.

Principle 7 - **Recognise and manage risk:** A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.

74. The Council is making some minor changes to the wording of this principle to mention the need for a listed entity to periodically review the effectiveness of its risk management framework. This is to provide a link to proposed recommendation 7.2.

Recommendation 7.1: The board of a listed entity should:

(a) have a risk committee which:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director,

and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) include within the responsibilities of the audit committee the responsibilities normally undertaken by a risk committee; or

[44] UK Code E.2 *Constructive use of the AGM* where the main principle underscores the use of the AGM to communicate with investors and to encourage their participation is supported by four provisions.

[45] Singapore Code Principle 16 on the *Conduct of shareholder meetings* that is supported by five guidelines.

[46] Hong Kong Code Principle E.1 on *Effective communication* contains provisions on AGMs and the communication policy.

(c)	if it does not have a risk committee (whether as a stand-alone committee or as part of the responsibilities of the audit committee), disclose that fact and the processes it employs for identifying, measuring, monitoring and managing the material business risks it faces.

75. One of the most important lessons from the GFC was the critical need for listed entities to have robust processes to identify, measure, monitor and manage risk. The OECD in their report *Corporate Governance and the financial crisis – Conclusions and emerging good practices to enhance implementation of the Principles* noted in their key findings:[47]

> "*Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company. …*
>
> *Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered good practice to involve the Board in both establishing and overseeing the risk management structure. …*
>
> *With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation.*"

76. The Council is proposing to replace current recommendation 7.1 that "companies establish policies for the oversight and management of material business risks and disclose a summary of those policies" with a new and strengthened recommendation 7.1 calling in paragraphs (a) and (b) for the establishment of a stand-alone risk committee or a combined audit and risk committee.

77. Proposed recommendations 7.1(a) and (b) are in line with international developments in this space. The South African code explicitly recommends that the board appoint a committee responsible for risk,[48] while the UK code states that in the absence of a separate board risk committee composed of independent directors, the audit committee should review the company's internal control and risk management systems.[49] The NYSE[50] and Hong Kong[51] have also included the review of risk management within the audit committee's terms of reference.

78. Proposed recommendation 7.1(c) has been added to recognise that some listed entities, particularly smaller ones with smaller boards, may legitimately decide not to have a risk committee and institute alternative processes for identifying, measuring, monitoring and managing the material business risks they face. Provided they disclose these alternative practices, recommendation 7.1(c) allows them to report that they comply with the Council's recommendations on this matter. In the absence of recommendation 7.1(c), those entities without a risk or audit and risk committee would have to report under Listing Rule 4.10.3 that they do not comply with the Council's recommendations on risk committees and give an explanation why.

79. In this regard, the Council considers that the positive disclosure of the measures a board has implemented to identify, measure, monitor and manage the material business risks it faces is likely to lead to a better disclosure outcome than a negative disclosure as to why a board does not have a risk committee.

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[47] Bullet points 1, 3 and 7 from Box 2: *Key Findings and Main Messages: Effective implementation of risk management*.

[48] SA Code Principle 4.3 – the risk committee or the audit committee should assist the board in carrying out its risk responsibilities.

[49] UK Code C3.2.

[50] NYSE Rule 7(c)(iii)(D).

[51] Hong Kong Code C3.3 (f).

Recommendation 7.2: The board or a committee of the board should:

(a) review the entity's risk management framework with management at least annually to satisfy itself that it continues to be sound, to determine whether there have been any changes in the material business risks the entity faces and to ensure that they remain within the risk appetite set by the board; and

(b) disclose in relation to each reporting period, whether such a review has taken place.

80. Current recommendation 7.2 is based on an assurance model under which management designs and implements the entity's risk management and internal control systems and reports to the board on the effectiveness of those systems in managing the entity's material business risks. All the board is required to do under the current recommendation is to disclose whether management has provided such a report.

81. The Council considers that such a model is no longer appropriate, given the issues around the management of risk highlighted by the GFC. The Council therefore proposes to strengthen this recommendation to suggest that the board of a listed entity review its risk management framework with management at least annually so as to satisfy itself that the framework is sound and whether there have been any changes in material business risks to ensure that they remain within the risk appetite of the board.

82. The Council's proposed recommendation aligns with both the UK[52] and Singapore[53] codes, which state that the board should at least annually conduct a review of the effectiveness of the company's risk management and internal control systems and report to shareholders that they have done so. It does not go as far as the South African code, which recommends that the board should ensure that risk assessments are performed on a continual basis and that management considers and implements appropriate risk responses.[54]

Recommendation 7.3: A listed entity should disclose:

(a) if it has an internal audit function, how the function is structured and what role it performs; or

(b) if it does not have an internal audit function, the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes.

83. Proposed recommendation 7.3 effectively elevates the commentary about the internal audit function following current Recommendation 7.2 to a reporting recommendation.

84. This aligns with the ICGN[55], South Africa[56] and Singapore codes,[57] recommending that companies should establish and maintain an effective internal audit function. The ICGN further states that, if they don't, boards should disclose in the annual report the reasons why this is the case and how adequate assurance has been maintained in its absence. The UK code also recommends that audit committees consider annually whether there is a need for an internal audit function and that the reasons for the absence of such a function should be explained in the annual report.[58]

Recommendation 7.4: A listed entity should disclose whether, and if so how, it has regard to economic, environmental and social sustainability risks.

[52] UK Code C2.1.

[53] Singapore Code Principle 11 and Guideline 11.2.

[54] SA Code Principles 4.5, 4.7 and 4.8.

[55] ICGN Code Principle 6.6.

[56] SA Code Principle 7.1.

[57] Singapore Code Principle 13.

[58] UK Code C.3.6.

85. As mentioned in the overview above, proposed new recommendation 7.4 seeks to address, in a measured and non-prescriptive manner, the increasing attention being given by the investment community to environmental and social issues and the investment risks they raise.[59]

86. Assets under management by the approximately 1200 asset owners, investment managers professional services partners who have signed up to the *Principles of Responsible Investment* stand at more than $34 trillion (approximately 15% of total global investable assets). These investors expect the listed entities in which they invest to be making "ESG" disclosures.

87. Other material developments in this space on the international front include:

- South Africa now has an "if not why not" requirement for the production of an "integrated report" that addresses material sustainability issues.
- Hong Kong Exchange has produced a guide on ESG disclosure, which it has made recommended best practice from December 2012. Subject to further consultation, HKEx plans to raise the guide to 'comply or explain' requirement by 2015.
- Singapore Exchange issued a non-mandatory Guide to Sustainability Reporting in June 2011.
- In the UK, legislation came into effect in October 2007 that introduced the concept of an "enlightened shareholder value" duty. This duty broadly replaced the former duty to act in the company's best interests and requires directors to have regard to the longer term and to various 'corporate social responsibility' factors, including the interests of employees, suppliers, consumers and the environment.
- From 2012, Brazil's BM&F Bovespa "report or explain" initiative recommends that listed companies disclose whether they publish a regular sustainability report or similar document and where it is available, or if not, explain why. The exchange makes available on its website, the list of the companies that either publish or do not publish sustainability reports or equivalent.

88. Notwithstanding these developments internationally, the Council considers that it would be premature to expect listed entities in Australia to adopt integrated reporting until the international framework for such reporting is much better developed than it currently is. Amongst other things, the Council believes that the framework needs to adequately address issues such as relevance, materiality, time-frame, exclusion of commercially sensitive information, compliance burden and assurance before listed entities across the board can reasonably be expected to adopt integrated reporting.

Principle 8 - **Remunerate fairly and responsibly:** A listed entity should endeavour to pay remuneration that is sufficient to attract, retain and motivate high quality directors and senior executives and that is aligned to the creation of value for security holders.

89. Council is proposing to amend this principle to clarify what is meant by "sufficient and reasonable" remuneration and to emphasise that remuneration should be aligned to the creation of value for security holders.

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[59] See, for example, the joint publication by the Australian Council of Superannuation Investors and the Financial Services Council entitled *ESG Reporting Guide for Australian Companies: Building the foundation for meaningful reporting* (June 2011), available at http://acsi.org.au/images/stories/ACSIDocuments/esg_reporting_guide.pdf.

See also the UN Global Compact's ten principles on human rights, labour, the environment and anti-corruption; the OECD's Guidelines for Multinational Enterprises; the Global Reporting Initiative; and the various publications of the International Integrated Reporting Council respectively at:

http://www.unglobalcompact.org/aboutthegc/thetenprinciples/index.html
http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises
http://www.globalreporting.org
http://www.theiirc.org

Recommendation 8.1: The board of a listed entity should:

(a) have a remuneration committee which:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director,

and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings;[60] or

(b) if it does not have a remuneration committee, disclose that fact and the processes it employs for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive.

90. Proposed recommendation 8.1(a) is a combination of current recommendations 8.1 and 8.2 and the disclosure requirements with respect to the remuneration committee in the 1st and 4th bullet points in the Guide to Reporting on Principle 8 (recommendation 8.4).

91. The composition of the remuneration committee is in line with the corresponding provisions in the UK,[61] Singapore,[62] South Africa,[63] Canada[64] codes and the NYSE Rules.[65]

92. Proposed recommendation 8.1(b) has been added to recognise that some listed entities, particularly smaller ones with smaller boards, may legitimately decide not to have a remuneration committee and institute alternative processes for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive. Provided they disclose these alternative practices, recommendation 8.1(b) allows them to report that they comply with the Council's recommendations on this matter. In the absence of recommendation 8.1(b), those entities without a remuneration committee would have to report under Listing Rule 4.10.3 that they do not comply with the Council's recommendations on remuneration committees and give an explanation why.

93. In this regard, the Council considers that the positive disclosure of the measures a board has implemented for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive is likely to lead to a better disclosure outcome than a negative disclosure as to why a board does not have a remuneration committee.

Recommendation 8.2: A listed entity should separately disclose its policies and practices regarding the remuneration of non-executive directors and the remuneration of executive directors and other senior executives and ensure that the different roles and responsibilities of non-executive directors compared to executive directors and other senior executives are reflected in the level and composition of their remuneration.

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[60] An Australian listed company subject to section 300(10) of the Corporations Act must also include in its annual report information about each director's attendance at a remuneration committee meeting.

[61] UK Code D2.1 - at least 3 or in the case of smaller companies, 2 independent non-executive directors.

[62] Singapore Code Guideline 7.1 - at least 3 non-executive directors, the majority of whom, including the chairman should be independent.

[63] SA Code 2.23.7 – the remuneration committee should comprise a majority of non-executive directors, of which the majority should be independent.

[64] Canada Code NP58-101 3.15 – the compensation committee should be composed entirely of independent directors and, if there is no compensation committee, the steps taken to ensure an objective process for determining compensation should be disclosed.

[65] NYSE Rule 5(a) - the compensation committee should be composed entirely of independent directors.

94. Proposed recommendation 8.2 is a slightly modified version of existing recommendation 8.3, which emphasises that the different roles and responsibilities of non-executive directors compared to executive directors and other senior executives should be reflected in the level and composition of their remuneration.

Recommendation 8.3: A listed entity should:

(a) have a "clawback" policy which sets out the circumstances in which the entity may claw back performance-based remuneration from its senior executives;

(b) disclose that policy or a summary of it; and

(c) disclose as at the end of each reporting period:

(1) whether any performance-based remuneration has been clawed back in accordance with the policy during the reporting period; and

(2) where performance-based remuneration should have been clawed back in accordance with the policy during the reporting period but was not, the reasons for this.

95. In February 2012, the Australian Government announced that it would be introducing amendments to the Corporations Act to require a listed company to disclose to shareholders, on an "if not why not" basis, the steps it had taken to claw back bonuses and other remuneration from senior executives where there had been a material misstatement of financial results in the company's financial statements. Under the proposed changes, these disclosures were to be made in the entity's remuneration report. If shareholders were not satisfied with the company's actions, they would then able to use their powers under the "two-strikes rule" to vote down the remuneration report.

96. In the consultation process relating to these proposed amendments, the Council submitted to the Australian Government that these matters were best dealt with in the *Principles and Recommendations* rather than in legislation, especially as they were framed on an "if not why not" basis. The Council is aware that a number of other respondents made similar submissions. The Australian Government has since announced that, in light of the upcoming election, it has postponed the proposed amendments for the time being.

97. Proposed recommendation 8.3 seeks to tackle the concerns that the proposed amendments to the Corporations Act were intended to address, but within the framework of the *Principles and Recommendations* rather than in legislation.

Recommendation 8.4: A listed entity which has an equity-based remuneration scheme should:

(a) have a policy on whether participants are permitted to enter into transactions (whether through the use of derivatives or otherwise) which limit the economic risk of participating in the scheme; and

(b) disclose that policy or a summary of it.

98. Proposed recommendation 8.4 mirrors the 5th bullet point in the existing Guide to Reporting on Principle 8 (recommendation 8.4).

Application of the recommendations to externally managed listed entities

99. A number of the Council's recommendations require modification when applied to externally managed listed entities. The Council is proposing to include a separate section in the *Principles and Recommendations*, immediately after the recommendations, explaining how externally managed listed entities should apply and make disclosures against the recommendations. This section notes that recommendations 1.1, 1.2, 1.3, 1.4, 1.5, 1.6, 1.7, 2.2, 2.3, 2.4, 2.5, 2.6, 8.1, 8.2 and 8.3 do not apply to an

externally managed listed entity. It also identifies two further recommendations (4.3 and 6.3) that may or may not apply to an externally managed listed entity, depending on its circumstances. Where a recommendation is noted as not applying to an externally managed listed entity, the entity can simply state in its corporate governance statement under Listing Rule 4.10.3 that the recommendation is "not applicable", without including any further "if not, why not" explanation.

100. The Council proposes that externally managed listed entities apply the following recommendation in lieu of recommendations 1.1 and 2.6:

Alternative to recommendations 1.1 and 2.6 for externally managed listed entities: The responsible entity of an externally managed listed entity should disclose:

(a) the arrangements between the responsible entity and the listed entity for managing the affairs of the listed entity;

(b) the role and responsibility of the board of the responsible entity for overseeing those arrangements; and

(c) its program for inducting new directors and providing appropriate professional development opportunities for continuing directors to develop and maintain the skills and knowledge needed to perform their role as a director effectively.

101. The reasons for this alternative recommendation are explained in the related commentary in the draft third edition.

102. The Council also proposes that externally managed listed entities apply the following recommendation in lieu of recommendations 8.1, 8.2 and 8.3:

Alternative to recommendations 8.1, 8.2 and 8.3 for externally managed listed entities: An externally managed listed entity should clearly disclose the terms governing the remuneration of the manager.

103. Again, the reasons for this alternative recommendation are explained in the related commentary in the draft third edition.


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