

# financial services newsletter

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# IFSA update

## The long and winding road to corporate social responsibility

**Richard Gilbert**

INVESTMENT AND FINANCIAL SERVICES ASSOCIATION

### A trip down memory lane

The debate around corporate governance has come a long way since the first Investment and Financial Services Association (IFSA) *Blue Book* was printed in 1995. At the time, the *Blue Book* was practically the lone voice providing guidance on corporate governance issues.

The *Blue Book* is now into its fifth edition and no longer stands alone in the corporate governance arena. Indeed, almost every year since then has seen amendments to the *Corporations Act 2001* (Cth) and to accounting standards that have raised the governance bar — particularly for listed public companies.

Comprehensive legal obligations now extend to a very wide range of corporate governance matters, including a continuous disclosure regime, obligations around managing and disclosing conflicts of interests at board level, executive and director remuneration disclosure, and auditor independence requirements to name but a few.

However, many other aspects of good corporate governance remain regulated in a less formal fashion. For example, since 2003 Australian Stock Exchange (ASX)-listed companies have operated under a set of corporate governance principles that promote corporate governance practices above and beyond the legal standards.

Importantly, the principles are neither mandatory nor prescriptive and therefore allow companies to deviate from specific recommendations by justifying, in respect of their unique circumstances, why any such deviation is appropriate.

### The case for environmental and social governance

However, the treatment of environmental and social issues within the existing corporate governance framework concerns the investment community. The question now is, what do environmental and social issues have to do with corporate governance? The answer, I believe, is that how a company identifies, assesses and manages the risks and opportunities it faces is central to good corporate governance.

Put more simply, investors increasingly expect that the board and senior management will turn their minds to effectively managing environmental and social factors that have the clear capacity to affect company performance.

Many companies would not dispute this and have suggested that it is about reaching a state of 'enlightened self-interest' — where environmental and social factors are managed in a way that either protects capital or results in positive returns to shareholders.

### Food chain effect

In my time as CEO of IFSA, I have seen these issues move increasingly into the mainstream. I have witnessed the significant growth in 'ethical' or 'socially responsible' funds under management, such that many big brands now offer funds or investment options in that area. I have also noticed that the so-called passive investment managers, such as index funds, are taking a more active interest in good governance.

More recently, I have observed numerous IFSA members broaden their investment processes to incorporate environmental, social and governance (ESG) related considerations into their analysis of what constitutes a sound investment.

These developments have not come about in a vacuum. Whether we like it or not, in the investment world just as it is in the natural world, there is a 'food chain'. At the top of the food chain are shareholders/institutional investors who have the ultimate say through being able to elect and remove the board of directors or, indeed, through disposing of their shares in the company.

A significant number of our superannuation funds are beginning to focus on ESG issues. Recently, a number of superannuation funds have signed up to the UN Principles for Responsible Investment (along with at least five IFSA members).

It is logical that patient investors with a long-term horizon will focus on long-term risks and opportunities. Sustainability risks that may appear insignificant to a day trader can become critical to a superannuation fund investing on behalf of members who may not be retiring for another 40 or so years.

As more superannuation funds take an interest in this area, it will inevitably motivate their service providers to turn their minds to these issues.

Once this happens, it will not be long before researchers, analysts and fund managers are knocking on company doors asking for more information

about how these issues are being managed so as to better inform their buy/sell/hold decisions or recommendations. This is what I refer to as the 'food chain effect'.

Interestingly, IFSA members find themselves on both sides of the fence, with up to 15 recently being surveyed by the Carbon Disclosure Project (a single global request for disclosure of information on greenhouse gas emissions — formerly sent to Fortune 500 companies and, for the first time this year, also to the Australian Stock Exchange (ASX) 100).

### The endgame

In the same way that companies have responded to the high levels of corporate governance activism in relation to 'main-stream' corporate governance issues, they are now beginning to respond to increased scrutiny of their management of environmental and social issues.

Initially, the market will focus on those environmental and social issues facing companies that are quantifiable. Things such as energy consumption, employee turnover, breaches of environmental laws, and waste management will be in the spotlight. These are matters that have a clear link to the company balance sheet and through it to shareholder value.

Further on, once more comprehensive and consistent reporting frameworks are adopted and as more complex valuation models are developed, I anticipate that a broader range of environmental and social issues will begin to be considered more systematically.

While the full adoption of measures, such as the Global Reporting Initiative, may be some way off, studies have shown that more than 20 per cent of the companies in the top 500 are now reporting on sustainability — having grown from less than 1 per cent in 1995.

In a further indication of what is likely to come, a recent Mercer survey of mainstream professional investors found that within five years, 44 per cent of Australian investment managers expect that the integration of social and/or environmental corporate performance indices will be commonplace. Even starker, the Mercer research suggests this figure will rise to more than 90 per cent within 10 years.

If these high levels of adoption materialise, I am confident that market forces will drive Australian companies towards more comprehensively assessing and managing the environmental, social and governance issues that have the potential to affect their performance.

As with all things, any sudden and unexpected imposition of a plethora of new rules on listed companies and institutional investors needs to proceed with caution. The investment markets are in many ways fickle creatures. If the cost of compliance affects investor returns, new opportunities are sure to arise in the unofficial and less well regulated non-listed market. Some commentators are now saying that the rush of red tape on the listed securities market in the US has decreased the appetite for initial public offerings and been the catalyst for private equity's rise to prominence, which in many cases entails delisting the company.

In Australia, via the CLERP 9 amendments and the ASX Council's Corporate Governance Principles, we have managed to preserve the balance between sound regulation and entrepreneurship. May that continue to be the case as we move into this new ESG era. ●



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