IFSA Submission

February 2007

Review of the Principles of Good Corporate Governance and Best Practice Recommendations

OVERVIEW

IFSA continues to support the Council's original reason for coming into being, namely 'to develop and deliver an industry-wide, supportable and supported framework for corporate governance which could provide a practical guide for listed companies, their investors, the wider market and the Australian community.'

IFSA strongly believes that the Principles developed in 2003 represent such a framework and that they have served the Council, listed companies, their investors, the wider market and the Australian community well.

In providing comments below, IFSA seeks to ensure that the original aims of the Council continue to be pursued and that the Council continues to be highly regarded by Government as an effective and balanced body, significantly mitigating the Government's need to play a "front-line" role in regulating corporate governance practices.

IFSA would also like to emphasise its strong support for the fundamental "if not, why not" approach which underpins the operation of the Principles. It is through this unique approach that 21 diverse stakeholders have been able to come together and form the Council.

Given feedback from Council members to the ASX and vice-versa, IFSA believes that investor's expectations in relation to the use of the "if not, why not" approach need to be more effectively communicated to listed entities. In this regard, IFSA has suggested some additional wording that more clearly articulates what constitutes meaningful "if not, why not" reporting.

PART A: PRINCIPLES AND RECOMMENDATIONS – CONTENT

Specific comments regarding revised Principles

Principle 1

No substantive comments.

Principle 2

No substantive comments.

Principle 3

IFSA supports the addition of new material directed at hedging arrangements.

IFSA recently responded to Proposal 2.1 of the Corporations and Financial Services Regulation Review Proposals Paper which touches on this issue. Our response is copied below for Council's information.

> IFSA, along with the Australian Institute of Company Directors, Australian Employee Ownership Association and the Australian Shareholders Association, is in the process of finalising guidance to companies on this issue within our updated 'Executive Equity Plan Guidelines'. The wording proposed to be included in the Guidelines states:

Companies should have a written and published policy covering the period before and after the vesting of securities where executives might seek to acquire and/or trade in financial products issued over the company's securities by third parties which operate to limit the economic risk of the equity plan.

Pre-vesting hedging activities should be prohibited, particularly where the company has informed the market that a portion of executives' remuneration is 'at risk'.

The company's policy should also require executives to disclose any post-vesting hedging activities to the company. Any breaches of company policy should be treated seriously, and where appropriate, disclosed to the market.

IFSA supports an outcome consistent with the approach above, noting that it goes beyond that which appears to be proposed under this proposal.

IFSA also notes that the revised draft ASX Corporate Governance Council Principles have sought to address this issue with the following references contained in the revised text of the draft principles:

[In relation to establishing a company trading policy]

3. Require designated officers to provide notification to an appropriate senior member of the company, for example, in the case of Directors, to the Chair, of intended trading, including entering into transactions or arrangements which operate to limit the economic risk of their security holdings in the company. No prior notification is needed for dividend reinvestment plans and the like. (ASX Corporate Governance Council *Exposure Draft of changes 2 November 2006,* page 21)

[In relation to cautioning companies about not inadvertently misrepresenting the alignment of shareholders and executives' interests]:

Where a company makes any representations about the alignment of a Director's or Senior Executive's interests, the company should take into account the extent to which that Director or Senior Executive has an economic interest in the relevant securities. (As above, page 22)

[In relation to equity based remuneration]

Appropriately designed equity-based remuneration, including stock options, can be an effective form of remuneration when linked to performance objectives or hurdles.

Equity-based remuneration has limitations and can contribute to 'short-termism' on the part of senior executives. Accordingly, it is important to design appropriate schemes. The terms of such schemes should clearly prohibit entering into transactions or arrangements

which limit the economic risk of participating in unvested entitlements under these schemes.

The ASX Council has very effectively raised the bar on corporate governance practices in listed companies. IFSA therefore suggests that Treasury consult closely with the Council prior to releasing any draft provisions on this matter to ensure that regulatory overlap does not arise.

Principle 4

No substantive comments.

Principle 5

No substantive comments.

Principle 6

No substantive comments.

Principle 7

IFSA believes that all listed entities should have processes in place to identify, assess, monitor and manage all "material business risks". IFSA therefore supports the expanded wording in the revised Principle 7 that more clearly articulates the types of risks that companies need to identify, assess, monitor and manage.

Importantly, IFSA members do not distinguish between financial risks and other risks when assessing the value of a company. Instead, members are primarily focussed on arriving at the most accurate company valuation possible, taking into account all measurable indicators including the present and future risks and opportunities the company faces.

For this reason, IFSA supports the additional guidance provided to companies in this area.

However, IFSA is aware of strong views that have been expressed regarding the sensitivities associated with companies providing detailed disclosures of their risks and how they are managed.

IFSA does not wish to place companies in any competitive disadvantage or expose them to unnecessary potential liability, simply because of the nature of their disclosures under Principle 7. IFSA is confident, however, that what is required of companies under Principle 7 is not the disclosure of a prescriptive list of risks facing the company, or a ranking of material business risks facing the company at a point in time.

Instead, the revised Principle 7 encourages companies to disclose "a description of the company's risk management policy". The risk management policy is itself only required to include a description of:

- all elements of the risk management and internal control systems and any internal audit function; and

- the roles and accountabilities of the Board, Audit committee, or other appropriate Board Committee, management and any internal audit function.

Clearly then, it seems as though some listed entities may have misunderstood the application of the Principles in this area. The Principles do not require the disclosure of a company's risk profile, rather "a description of the company's risk management policy".

IFSA therefore suggests that when the final revised Principles are released, areas of common misunderstanding (such as this) should be identified and clarified in supporting material to remove any ongoing confusion.

Principle 9

IFSA's preferred approach

IFSA does not support the removal of Recommendation 9.4.

Instead, IFSA supports the principle of allowing shareholders to approve all equity-based remuneration plans for directors and executives, except those where the acquisition is pursuant to a *bona fide* salary sacrifice arrangement out of directors' or executives' fixed remuneration.

This approach provides neutrality between directors and executives (contrary to the current law) and ensures that shareholders are able to effectively assess the terms, impact and merit of any grant/issue of equity.

Concern with Listing Rule 10.14

While the present Listing Rule 10.14 safeguards against any dilutionary effects from the purchase of shares, it does not mitigate other shareholder concerns in relation to:

- the terms of the grants themselves – such as the amount in question; and
- the manner in which the shares were acquired – such as the source/terms of finance for the acquisitions that may have been provided by the company.

Hence, without prior approval of the plan, these risks remain unaddressed by the mere fact the shares are purchased on-market.

Remuneration Report

It has been suggested that voting on the company Remuneration Report provides a suitable alternative mechanism for investors to express their views with respect to equity plans or grants to executives or directors.

However, in assessing how to vote on a remuneration report, institutional investors take into account a range of factors, including non-executive director remuneration, bonus payments, long term incentives and overall remuneration levels. The non-binding remuneration report resolution is therefore, a blunt instrument for investors to express discontent over a particular grant of equity to executive directors, as institutions typically use their votes on such resolutions to express an overall view of a company's remuneration practices rather than a single aspect.

Practical effect of a change to Recommendation 9.4

IFSA understands that, subsequent to the amendment to Listing Rule 10.14, many companies continue to seek approval. This suggests that requiring shareholder approval of such grants is not considered an undue burden by most listed companies (with the vast majority of such grants being approved by substantial majorities of shareholders).

IFSA is interested to better understand listed company concerns, if any, in this area.

PART B: REPORTING OF MATERIAL BUSINESS RISKS AND CORPORATE RESPONSIBILITY/SUSTAINABILITY RISKS

The case for CR/sustainability reporting

As stated above, IFSA believes that all listed entities should have processes to identify, assess, monitor and manage all "material business risks". There is no reason for limiting these risks to those which are specifically accounted for on a company's balance sheet from year to year.

IFSA notes that in assessing Council's options in this area, a balanced view of the possible compliance costs against the benefits of increased reporting needs to be taken. Much of the debate surrounding increased disclosure in this area has focussed on the added compliance costs to companies, without sufficient regard for the gains that could flow from this type of reporting.

Reporting in this area provides companies with an opportunity to focus on sustainability related issues that are relevant to their business and which have the real capacity to affect their long term profitability. It also offers companies an avenue to meaningfully disclose to shareholders and investors what they are doing to protect that company's long-term economic interests.

Consequently, through such disclosure, investors will be better placed to analyse the full breadth of risks and opportunities facing the company, and therefore to more accurately assess the company's competitive advantage relative to its peers. This disclosure will also allow investors with a long-term focus to more effectively judge whether the company is operating in a way that seeks to maximise short-term gains over long-term profitability/sustainability or vice-versa.

The consultation paper queries whether requiring such reporting is beyond the scope of Council's mandate. Investors now seem more convinced than ever before that how a company goes about identifying, assessing and managing environmental and social issues is central to good corporate governance.

Indeed, 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.

IFSA, therefore, strongly believes that Council has an important role to play in this area.

IFSA's preferred approach

IFSA believes that a move towards increased disclosure in this area is largely inevitable given international developments and the increasing demand among institutional investors for this type of information.

Furthermore, IFSA believes that Council is best placed to decide on the appropriate mechanism for disclosure of CR/sustainability risks in the Australian market and therefore endorses Council taking the lead in this area. Consequently, IFSA supports the provision of additional guidance by Council, irrespective of which option is ultimately adopted.

On balance, IFSA is not at this stage proposing that a specific reporting trigger be inserted into the Principles. This is not because IFSA believes such a trigger is beyond the Council's mandate; rather it is because in IFSA's view, reporting against such a trigger would pose considerable challenges for companies without having given them an appropriate time to adjust to this new type of disclosure and what the market expects in this area.

Taking the initial step of providing guidance on what investors and shareholders expect in this area will also allow more time for investors to themselves become more proficient in their use of such disclosures where they are provided.

IFSA recognises, however, that Option B could also provide companies with flexibility in that it would be subject to the "if not, why not" approach. Thus, it would be open to a company to explain why they have not adopted the Recommendation.

IFSA is concerned, however, that the proposed Recommendation to be inserted into the Principles under Option B is framed in a manner which is inconsistent with other Recommendations in Principle 7. That is, it would require the specific disclosure of "other material business risks", whereas Principle 7 does not require the disclosure of "material business risks" per se. Therefore, the same arguments that are used to oppose the PJC's recommended approach (see paragraph 32 of the Part B Consultation Paper) would apply to this approach.

IFSA would be willing to consider an alternative Recommendation in this area if it was capable of avoiding the issues identified above. A possible alternative could include:

> **Recommendation 7.1:** The Board should establish policies on risk oversight and management *and ensure that they cover all reasonably foreseeable material business risks that the company may face.*

In summary, IFSA supports the provision of additional guidance by Council in this area and is prepared to consider alternative formulations to any specific recommendation in this area.

OTHER MATTERS

Additional "if not, why not" guidance

A search of existing guidance contained in the revised Principles reveals that there is relatively little guidance provided to listed entities about investor/shareholder expectations when they are making a "why not" statement in their annual report.

IFSA identified the following material relevant to the "if not, why not" approach:

- "The size, complexity and operations of companies differ, and so flexibility must be allowed in the structures adopted to optimise individual performance. That flexibility must, however, be tempered by accountability – the obligation to explain to investors why an alternative approach is adopted – the "if not, why not?" obligation."[1]

- "If a company considers that a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it - a flexibility tempered by the requirement to explain why."[2]

- "Where companies have not followed all the Recommendations, they must identify the Recommendations that have not been followed and give reasons for not following them."[3]

Based on IFSA members' experience in monitoring the corporate governance practices of listed entities, IFSA believes that additional guidance should be provided to better explain to listed entities the expectations of investors where a "why not" statement is provided.

Members have indicated that, on many occasions, the information disclosed in the Annual Report with respect to a "why not" statement is insufficient to explain why the approach is otherwise appropriate for that entity in meeting the Recommendation or Principle in question.

Members have also noted that on several occasions where they have sought further clarification from an entity regarding a "why not" disclosure in their Annual Report, the verbal explanation of the entity's deviation from the Recommendation has been much more informative than the written explanation in the Annual Report.

For this reason, IFSA believes that the Principles should provide additional guidance to companies to encourage them to clearly explain why their alternative approach meets the objective behind the principle, without necessarily following the specific recommendation.

IFSA therefore recommends that a heading 'Reporting under an "if not, why not" framework' be inserted into the guidance material that precludes the Principles, with existing text regarding the "if not, why not" approach being relocated to this new section.

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[1] Foreword, page 3.
[2] Disclosure of corporate governance practices (applying the "if not, why not?" approach), page 6.
[3] As above.

This more expanded section would also include the following:

- A clear statement that nothing in the Principles precludes a listed entity from meeting the objective of a Principle through alternative means to that recommended by Council.
- That Council supports listed entities seeking to meet the spirit of the Principles through whichever means they believe are most appropriate to their business.
- In all cases, listed entities should include a summary statement of whether they are adopting or exception reporting against the Council's Principles and Recommendations.[4]
- However, where a listed entity adopts the flexibility allowed under the Principles and deviates from a specific Recommendation, they should be required to outline their approach, explain how the approach they have taken is different from the Recommendation and why it still achieves the aim behind the Recommendation/Principle in question.

A more robust "if not, why not" approach will provide investors with more confidence that listed entities are "turning their minds" to the Principles and the corporate governance practices they promote.

Such an approach should also serve to provide listed entities with greater confidence in exception reporting – potentially alleviating company concerns around the level of prescription in the Principles and the view that this prescription may lead to a "tick-a-box" compliance approach.

Form of the Principles and Recommendations

IFSA does not support splitting the existing Principles into two separate documents.

Based on our experience, we do not agree that the present level of detail "impairs rather than enhances companies' disclosure." IFSA believes that any step to remove guidance from the Principles will likely result in greater confusion and uncertainty for listed entities.

While the Principles and Recommendations contain a degree of necessary prescription, the "if not, why not" approach ultimately allows companies to adopt an approach that is best suited to their specific situation. As outlined above, IFSA encourages exception reporting where appropriately explained and believes that investors will not adversely judge companies where such reporting has been provided.

Listed managed investment schemes

In feedback to IFSA, members have indicated that further work is still required to ensure that the Principles apply appropriately to listed schemes.

In particular, there needs to be greater recognition of the differing legal structure and regulatory requirements as between companies and listed schemes. Listed schemes have indicated that there is considerable duplication between material included in

[4] Note the User Survey of professional and private investors conducted by the Council in late 2005 found that such a statement would improve corporate governance disclosures. See page 9 of the *Exposure Draft, Principles and Recommendations.*

existing disclosure documents and the material to be included in their Annual Report in compliance with the Council's Principles.

IFSA believes that this can be minimised through a more effective incorporation of relevant material in the Annual Report by reference to other documentation that is also publicly available and frequently updated on websites – such as Product Disclosure Statements. This information is already targeted at investors in the scheme and hence is largely relevant to the types of disclosures required by Council.

IFSA also believes that providing additional guidance regarding reporting under the "if not, why not" approach (as suggested above) will also assist listed schemes to better comply with the Principles in a manner that takes account of their specific and distinct legal obligations under the Corporations Act.

IFSA has previously conducted separate working group discussions with listed managed investment scheme members and is interested in continuing this role and will look to present specific suggestions for Council to consider in this regard.

Redistribution of material in Principles 8 and 10

IFSA supports the redistribution of the material contained in these Principles. This should result in reduced overlap between Principles and therefore facilitate improved disclosure by listed entities.

Commencement date

IFSA supports the suggested commencement date of financial years starting 1 July 2007. However, depending on the extent of the changes made to the Principles, particularly in respect of Part B of the Consultation Paper, IFSA is mindful that a longer transition period may be required.

IFSA will finalise its position on this issue once the content of the Principles has been settled and once the position of issuers is clearer.