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Précis Paper

Three Pillars of Good Corporate Governance

A discussion of the development and state of corporate governance in Australia in relation to international jurisdictions.

Discussion Includes

- The history of Corporate Governance
- Three pillars of Corporate Governance
- Corporate Governance: CSR, ESG
- Due diligence
- Compliance
- ASX principles
- Diversity among directors

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Three Pillars of Good Corporate Governance

1. In this edition of BenchTV, Professor Michael Adams (Special Counsel, Coleman Grieg, Sydney) and Ms Grace Borsellino (Academic, Western Sydney University, Sydney) discuss the three pillars of corporate governance and how they apply to companies in Australia. They outline the ethical and professional responsibilities of directors and the ways in which companies can improve their risk management and profitability. This includes eliminating complacency and increasing board diversity.

<u>Introduction</u>

2. It is important to note that the meaning of corporate governance varies in different contexts, i.e. in finance, accountancy and management strategy. The presenters are looking at corporate governance from a legal perspective, though the concept is broad. Corporate governance applies to government departments, not-for-profits and to the corporate sector. Although examples may be drawn from the corporate side, the principles are relevant for all three.

<u>The history of Corporate Governance</u>

3. Corporate governance has a long history. The 13^{th} century cantons in Switzerland were the first documented examples of corporate governance.

4. At the end of the 1980's, there was a feeling that the boards of directors of companies weren't taking the governance role seriously enough. There had been a series of big financial disasters around the world. Under the instruction of the UK Government, Sir Adrian Cadbury, (Chairman of Cadbury and Cadbury Schweppes for 24 years) led an investigation into a number of corporate collapses and what had gone wrong with the boards. This led to the Cadbury Report in 1992. This report was a landmark development in corporate governance for common law jurisdictions. It inspired the King Report on Corporate Governance in South Africa and the original Bosch Report in Australia.

5. It took further corporate disasters for countries to revisit the issue of corporate governance. In the US, the *Sarbanes–Oxley Act 2002* was passed in light of major corporate and accounting scandals, such as WorldCom and Enron. In Australia, the HIH Royal Commission took place in 2003. Justice Neville Owen in his final report arising from the HIH Royal Commission stated that corporate governance is not a term of art. 'Corporate governance'

is not designed to have one meaning. It is a framework, relating to a series of factors such as:

a. The stakeholders
b. The board
c. The decision-making processes

6. Some companies had drifted into a tick-the-box approach. They were only interested in compliance, not the overall strategy of the company. They weren't interested in corporate social responsibility or other factors. The ASX threatened that the government, through the *Corporations Act 2001* (Cth), would impose stringent liability provisions unless action was taken. Stakeholders thus developed a principles-based approach, focusing on better disclosure. This led to the initial ASX Corporate Governance Principles (first edition released March 2003). If you are a listed, public company on a stock exchange you are required to explain in your report the 8 principles and how you follow them.

7. Australia was one of the few countries to adopt a soft law, 'if not why not' approach. This means, that if you do not follow one of those principles you are allowed to explain via your website, and documentation, why you do not. If you explain the reasons why and how, and all investors are aware, it is deemed acceptable. In contrast, in the US, it is very common that the CEO and chair is the same person. Australia follows more of a British model.

The Three pillars of Corporate Governance

8. Many new lawyers have little understanding of the connection between corporate governance, due diligence and compliance. These are the three pillars of corporate governance.

Corporate Governance

9. Corporate governance dictates that the overall board responsibility is to take into account the long-term strategy of the company, the risk profile of the company and also an understanding of its stakeholders. Nowadays, this is split into two sub-concepts: CSR (Corporate Social Responsibility) and ESG (Environment Social Governance).

CSR

10. CSR is the company's understanding of its position as a good corporate citizen in the context of:

a. The local community
b. Its relationship with its employees
c. Its relationship with supply chain management

11. Particularly, supply chain management can include:
    a. Reference to the Global Slavery Index
    b. Ensuring factories are safe factories
    c. Ensuring compliance with anti-corruption under the Transparency International Index (The Corruption Perceptions Index (CPI))
    d. Ensuring the health and safety of foreign workers

12. Technology and social media are making it easier for consumers to hold companies accountable.

13. Under the Australian High Court decisions, the company's primary responsibility remains its shareholders. However, in the UK under s172 of *the Company's Act 2006* (UK), directors may also take into account other stakeholders such as:
    a. Creditors
    b. Employees
    c. The community.

14. Australia, as of yet, does not have this provision.

ESG

15. ESG is from the investor perspective. An example is a superannuation fund with a mandate to invest ethically. A mandate could preclude investment in companies dealing in alcohol, gambling, or fossil fuels. ESG is where the investors will only invest in companies that comply with certain standards. In these circumstances, the board will be looking at its investors and its stakeholders.

Due Diligence

16. Due diligence is split into two parts.

17. The traditional due diligence (transactional or external due diligence) is a defence. For example, if a company buys a major asset they would want to ensure that each element of the transaction has been checked and verified by an external expert (lawyer, merchant banker, auditor, accountant etc.). This builds up a series of files which can be used to say

that at the relevant date, the information was honestly believed to be correct. This is a valuable defence in any class action or any legal action following the transaction.

18. A different type of due diligence is a systematic approach whereby the board will request management to do an audit of risk:
    a. The legal risk will be identified within the business and examined
    b. A report will be produced
    c. A risk management strategy will be put together
    d. A compliance system will check that the risk is being management appropriately
    e. The information will be regularly fed to the board

19. The senior management team would be responsible for identifying the risk and commissioning the report through their employees, sometimes they will include an external consultant in the review.

20. It is an industry by industry, specific, detailed plan.

21. For example, a company who buys land would want to ensure:
    a. The value is correct
    b. The land is not contaminated
    c. There are no restrictions on the use of that land (development etc.)

22. Every 1-2 years the plans should be checked with a review and an audit.

<u>Compliance</u>

23. Compliance can either come from the Australian Standards (AS/NZS) or the ISO's, (the International Standards). The ISO provides very detailed, quality assurance programs.

24. However, these systems can lend to a tick-the-box approach. This can lead to complacency. Compliance systems need to be regularly updated, checked and also, often linked to training to avoid this.

25. Even though a company can only take reasonable precautions in their management of risks, they need to show:
    a. There is a systematic approach
    b. There is understanding
    c. That the employees react to and report on accidents and issues appropriately

26. The compliance programs thus play an important role in informing due diligence systems and the board's understanding of the company's overall management of risks.

ASX principles

27. In 2003 nearly 20 organisations including the ASX, regulators and professional bodies all came together to draft guiding principles.

28. In Australia, there are:
    a. 2.2 million companies
    b. 20 000 public companies
    c. 2000 companies quoted on the stock exchange

29. The ASX developed, out of the UK and some other jurisdictions, some really clear principles which you can benchmark, and through the annual reports state, how the company is travelling in terms of its systems and approach.

30. The ASX defines corporate governance as:
    a. A framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within the corporation
    b. It encompasses the mechanisms by which companies, and those in control, are held to account

31. In ordinary words, it is about the frameworks and the approach the board takes to corporate governance.

32. This is a living document and thus far there have been three additions. The latest addition was released in 2014, ASX Corporate Governance Council's Principles and Recommendations (ASX Principles) (3rd Edition). Although the principles are only binding on listed companies, many other organisations will use them as a benchmarking document for their own corporate governance.

33. There are:
    a. 8 core principles
    b. 29 specific recommendations

34. They can be found on the ASX website (http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf). Both the commentary and the principles themselves are available.

35. The principles are as follows:
    1. Lay solid foundations for management and oversight
    2. Structure the board to add value
    3. Act ethically and responsibly
    4. Safeguard integrity in corporate reporting
    5. Make timely and balanced disclosure
    6. Respect the rights of security holders (i.e. shareholders and other creditors)
    7. Recognise and manage risk
    8. Remunerate fairly and responsibly

36. Principle 8 refers to compliance with the *Corporations Act 2001* (Cth) in terms of disclosures of salaries of directors and senior executives and having a very clear remuneration committee that is responsible for setting fair bonuses as well as basic salaries.

37. Those 8 guiding principles should be followed and explained by every company on the stock exchange. Australia adopted an 'if not why not' principle. If the company has a good reason not to follow the principle, they are allowed to explain on their website or in their annual report why the principle has not been followed. Therefore, shareholders and investors can make an informed decision whether to accept any non-compliance.

38. Few companies do not follow the principles. The few exceptions, explain clearly why they have not done so and most investors have accepted their reasons.

<u>Diversity among directors</u>

39. Australia has a long history of boards being composed of mostly middle age males. Research has shown that having a gender mix is really valuable for the profitability of companies and in general, for good corporate governance.

40. The ASX guiding principles in its commentary does not mandate quotas or targets but does deal with the idea of broader diversity and reporting it. In a company's annual report, there is a clear note on the company's policy dealing with diversity and the data surrounding it.

41. In Norway, it is mandatory that 40% of directors are female whilst the EU has been moving to at least a 1/3 if not more for female representation.

42. Australia has been slow to move towards any sort of target or quota. It is an important first step that the 3rd edition of the ASX principles has explicitly articulated the issues surrounding diversity and at least now we will have better data to make more informed decisions.

BIOGRAPHY

Professor Michael Adams

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Professor Michael Adams is an internationally recognised specialist in corporate law, governance, securities markets regulation, and legal education (especially e-learning). Michael has been writing, teaching and regularly presenting on all these topics for over 20 years. He is a Fellow of the Australian College of Educators (FACE), as well as the Australian Academy of Law (FAAL), and is also a Fellow of the Governance Institute of Australia (FGIA & UK FCIS). Professor Adams has been the former President of the Australasian Law Teachers Association, the Corporate Law Teachers Association and Chartered Secretaries Australia (now Governance Institute of Australia). He is the co-author of ten books and 30 chapters, 50 articles and over 250 conference/seminar presentations. In 2000, he was the recipient of the Australian University Teacher of the Year, for Law and Legal Studies, as well as 2005 CSA President's Award

Grace Borsellino

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Grace Borsellino teaches and researches in Corporate Law. Prior to joining Western Sydney University, Grace taught in the area of corporate and commercial law for 5 years at other tertiary and educational institutions. Grace graduated law at Western Sydney University and was admitted to practice law in 2005. Grace is currently undertaking post graduate studies at Western Sydney University in the School of Law. Her research interests are corporate law and corporate governance. Grace has co-authored, researched and edited in a number of publications in relation to corporate governance. Grace is an active participant in community engagement and appears on behalf of the school of law as an Academic and Professional Speaker in Schools. Grace is the Course Administrator for the Master of Laws (International Governance)

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