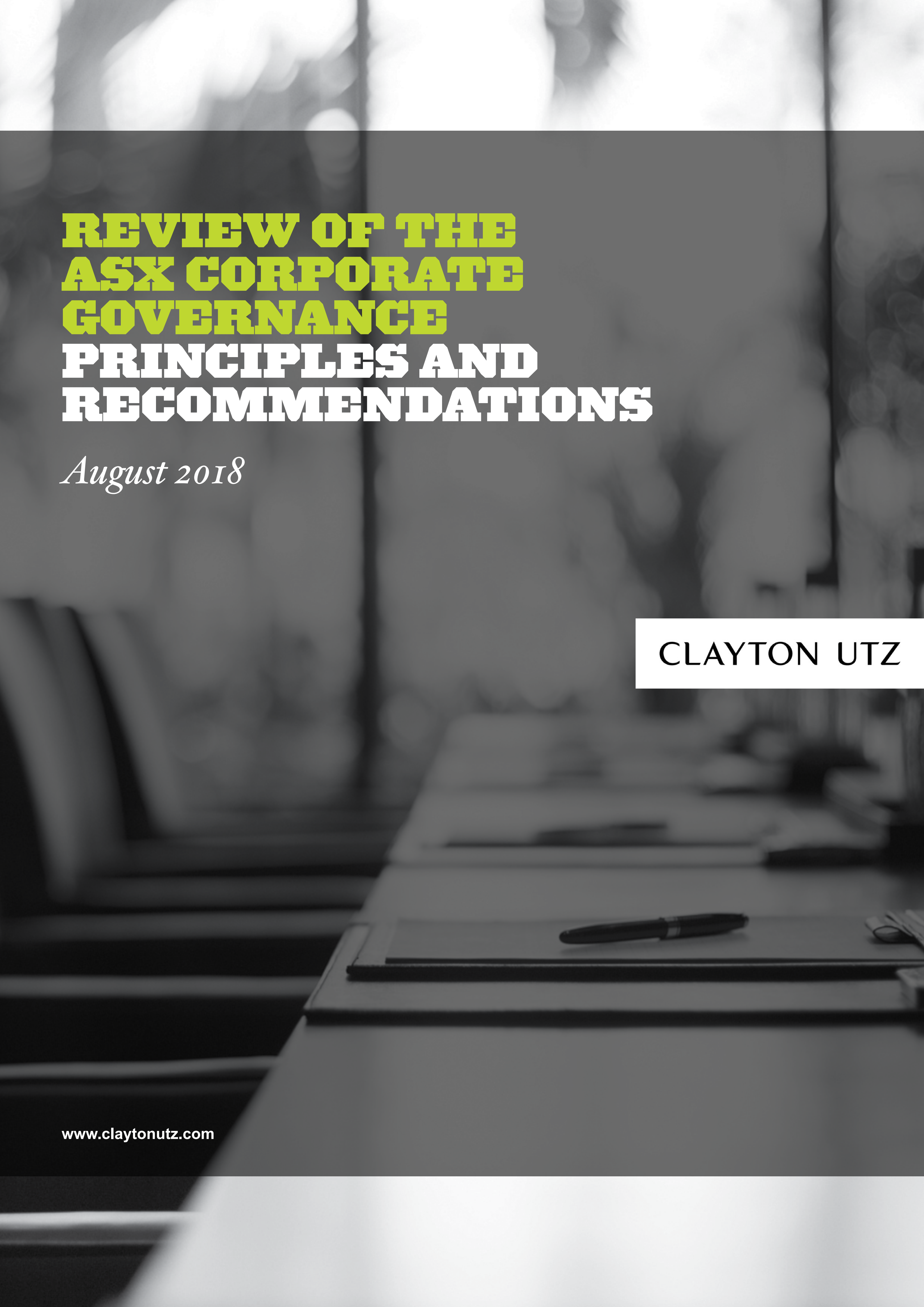

REVIEW OF THE ASX CORPORATE GOVERNANCE PRINCIPLES AND RECOMMENDATIONS

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On 2 May 2018, the ASX Corporate Governance Council issued:

- a communiqué;
- a consultation paper, ***Review of the ASX Corporate Governance Council's Principles and Recommendations;***
- a consultation draft of a proposed fourth edition of the Principles and Recommendations (***Principles and Recommendations***); and
- a mark-up of the consultation draft against the third edition of the *Principles and Recommendations.*

Although the submissions period has closed, the debate on these proposals will likely be ongoing throughout the year. It is currently envisaged that the Council will release the final version of the fourth edition of the Principles and Recommendations early in calendar 2019. On this timeline, the fourth edition of the Principles and Recommendations should come into effect for an entity's first full financial year commencing on or after 1 July 2019.

The proposed amendments to the Principles and Recommendations are extensive; in this paper we focus on the three key areas in which significant changes are proposed:

- changes which directly impact on the role and responsibilities of the Board with respect to the entity's purpose, its core values and desired culture, the risk management framework and risk appetite, including exposure to environmental or social risks and the entity's "social licence to operate" as a most valuable asset;
- revised Principles and Recommendations relating to the size and composition of the Board to ensure that it comprises individuals with the appropriate commitment, skills and knowledge of the entity and the industry in which it operates to enable the Board to discharge its duties effectively and to add value;
- continuing and increased focus on diversity, including the setting and disclosure of specific diversity targets and disclosure of achievement against those targets.

1. Changes which directly impact on the role and responsibilities of the Board with respect to the entity's purpose, its core values and desired culture, the risk management framework and risk appetite, including exposure to environmental or social risks and the entity's "social licence to operate" as a most valuable asset

These proposals, if implemented and applied by ASX listed entities to the full extent contemplated, have the potential to import the most fundamental change in the approach to corporate governance of listed entities in many years, circumventing changes which would typically be expected to occur through legislation and decisions of the courts.

This is because these changes transcend the conventional views with respect to the scope of the responsibilities which the entity and its directors have to its stakeholders and that which will be required to discharge these proposed responsibilities. The changes to the *Principles and Recommendations* encompass broad based concepts such as the purpose of the listed entity, its culture and core values, culminating in the need to preserve its social licence to operate as a valuable asset. These concepts invite the entity and its Board in discharging those responsibilities to have regard to the interests of a much broader group of stakeholders encompassing, it would seem, primary responsibilities to those stakeholders rather than responsibilities incidental to the interests of the conventional primary stakeholders – namely the entity and its shareholders.

In many respects this is not surprising given the breadth of the discussion in the broad company director community on the need to have regard to the interests of a broad range of stakeholders in the discharge of their responsibilities and the way in which the listed entity conducts its business, and the attention to this which has been drawn by business leaders both internationally and in Australia. The proposed ASX changes are timely; the Financial Reporting Council in the UK published its new Corporate Governance Code in 2018, underscoring the currency of these debates.

Some may argue that for that reason the changes which are proposed are simply reflecting the already recognised requirements. However, while there may be some truth in that, these changes when looked at as a complete package are fundamental. It must be remembered that Boards will be required to report against compliance with these *Principles and Recommendations* on an "if not why not" basis.

While some of these concepts have been familiar to some listed entities, for example in the resources sector, the proposals if implemented and applied to the full extent contemplated will require a substantially revised focus by listed entities and their Boards.

Let us then identify those changes which generate that outcome and analyse their consequences.

[Note: the key changes are underlined in the text throughout this paper]

1.1 RECOMMENDATION 1.1: BOARD CHARTER

<u>Changes to Recommendation 1.1</u>

Recommendation 1.1:

A listed entity should <u>have and</u> disclose <u>a board charter setting out</u>:

A. the respective roles and responsibilities of its board and management; and

B. those matters expressly reserved to the board and those delegated to management.

Commentary

Usually the board of a listed entity will be responsible under its charter for:

- demonstrating leadership;
- defining the entity's purpose and setting its strategic objectives;
- approving the entity's statement of core values and code of conduct to underpin the desired culture within the entity;
- overseeing management in its implementation of the entity's business model, achievement of the entity's strategic objectives, instilling of the entity's values and performance generally;
- approving operating budgets and major capital expenditure;
- overseeing the integrity of the entity's accounting and corporate reporting systems, including the external audit; and
- ensuring that the entity's remuneration framework is aligned with the entity's purpose, values, strategic objectives and risk appetite;

The senior executive team will usually be responsible for implementing the entity's business model, achieving its strategic objectives and instilling and reinforcing its values, all while operating within the values, code of conduct, budget and risk appetite set by the board.

The senior executive team will also usually be responsible for providing the board with accurate, timely and clear information on the entity's operations to enable the board to perform its responsibilities. This is not just limited to information about the financial performance of the entity, but also its compliance with material legal and regulatory requirements and any material misconduct that is inconsistent with the values or code of conduct of the entity.

The board charter should set out the role and responsibilities of the chair of the board. Usually, the chair will be responsible for leading the board, facilitating the effective contribution of all directors and promoting constructive and respectful relations between directors and between the board and management. The chair will also usually be responsible for approving board agendas and ensuring that adequate time is available for discussion of all agenda items, including strategic issues.

If the listed entity has a deputy chair or senior independent director, the board charter should also set out their roles and responsibilities.

The board charter should state the entity's policy on when and how directors may seek independent professional advice at the expense of the entity. This generally should be whenever directors, especially non-executive directors, judge such advice necessary for them to discharge their responsibilities as directors.

The nature of matters reserved to the board and those delegated to management will depend on the size, complexity and ownership structure of the entity, and will be influenced by its history and culture, and by the respective skills of its directors and management. These may vary over time as the entity evolves. The board should regularly review the division of functions between the board and management to ensure that it continues to be appropriate to the needs of the entity.

1.2 PRINCIPLE 3: INSTIL THE DESIRED CULTURE

Changes to Principle 3

Principle 3: Instil the desired culture

A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and in a socially responsible manner.

Commentary

A listed entity's "social licence to operate" is one of its most valuable assets. That licence can be lost or seriously damaged if the entity or its officers or employees are perceived to have acted unlawfully, unethically or in a socially irresponsible manner.

Preserving an entity's social licence to operate requires the board and management of a listed entity to have regard to the views and interests of a broader range of stakeholders than just its security holders, including employees, customers, suppliers, creditors, regulators, consumers, taxpayers and the local communities in which it operates. Long term and sustainable value creation is founded on the trust a listed entity has earned from these different stakeholders. Security holders understand this and expect boards and management to engage with these stakeholders and to be, and be seen to be, "good corporate citizens". This may include, for example:

- respecting the human rights of its employees, including by paying a "living wage" to employees and not employing bonded, forced or compulsory labour or young children, even in jurisdictions where that may be lawful;
- maintaining a safe and non-discriminatory workplace;
- offering employment to people with disability or from socially disadvantaged groups in society;
- dealing honestly and fairly with customers and suppliers;
- not engaging in aggressive tax minimisation strategies;
- not dealing with those involved in or who finance crime, corruption, human conflict or terrorism;
- acting responsibly towards the environment; and
- only dealing with business partners who demonstrate similar lawful, ethical and socially responsible business practices.

1.3 RECOMMENDATION 3.1: CORE VALUES

Changes to Recommendation 3.1

Recommendation 3.1:

A listed entity should articulate and disclose its core values.

Commentary

A listed entity's core values are the guiding principles and norms that define what type of organisation it aspires to be and what it requires from its directors, senior executives and employees to achieve that aspiration. They create a link between the entity's purpose (why it exists) and its strategic goals (what it hopes to do) by expressing the standards and behaviours it expects from its directors, senior executives and employees to fulfil its purpose and meet its goals (how it will do it).

An entity's statement of core values is often closely allied to, but is different from, a code of conduct, which tends to be more detailed and prescriptive statement of dos and don'ts for directors, senior executives and employees.

An entity's statement of core values will often encompass ideals such as innovation, courage, passion, curiosity, honesty, integrity, accountability, teamwork, and so on. Given the importance of an entity's social licence to operate, it will also usually include a commitment by the entity to complying fully with its legal obligations and to acting ethically and in a socially responsible manner.

Management should draft, and the board should approve, an entity's statement of core values. Once approved, management should be charged with inculcating those values across the organisation. This includes ensuring that all employees receive appropriate training on the values and management continually referencing and reinforcing those values in their interactions with staff (ie setting the "tone at the top").

Properly implemented, a statement of core values can help shape the entity's culture and drive good decision making. It can also be an important recruitment and retention aid.

To achieve this, however, a statement of core values must be more than a poster on a wall. The listed entity must be seen to live and breathe those values. To this end, the board and senior executives must consistently demonstrate leadership when it comes to the entity's stated values. This includes ensuring that their own actions and decisions are consistent with the entity's stated values and that any conduct by others within the organisation that is inconsistent with those values is dealt with appropriately and proportionately.

1.4 RECOMMENDATION 7.2: RISK MANAGEMENT FRAMEWORK

Changes to Recommendation 7.2

Recommendation 7.2:

The board or a committee of the board should:

(a) review the entity's risk management framework at least annually to satisfy itself that it continues to be sound and that the entity is operating with due regard to the risk appetite set by the board; and

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

Commentary

One of the key roles of the board of a listed entity is to monitor the adequacy of the entity's risk management framework and validate that the entity is operating with due regard to the risk appetite set by the board.

The board may charge an appropriate board committee (such as the risk committee or the audit committee) with this task. If it does, this should be reflected in the charter of the committee in question.

The Council acknowledges that from time to time circumstances may dictate that an entity needs to operate outside of the current risk appetite set by the board. Where that occurs, the matter should be brought to the attention of the board.

To improve transparency and promote investor confidence, the Council would encourage the board of a listed entity not only to disclose that it has reviewed the entity's risk management framework but also any insights it has gained from the review and any changes it has made to that framework as a result.

1.5 RECOMMENDATION 7.4: ENVIRONMENTAL AND SOCIAL RISKS

Changes to Recommendation 7.4

Recommendation 7.4:

A listed entity should disclose whether it has any material exposure to environmental or social risks and, if it does, how it manages or intends to manage those risks.

Commentary

As mentioned above in the commentary to principle 3, a listed entity's "social licence to operate" is one of its most valuable assets. That licence can be lost or seriously damaged if the entity conducts its business in a way that is not environmentally or socially responsible.

Investors recognise this and increasingly are calling for greater transparency on the environmental and social risks faced by listed entities, so that they in turn can properly assess the risk of investing in those entities.

To make the disclosures called for under this recommendation does not require a listed entity to publish an "integrated report" or "sustainability report". However an entity that does publish an integrated report in accordance with the International Integrated Reporting Council's *International <IR> Framework*, or a sustainability report in accordance with a recognised international standard, may meet this recommendation simply by cross-referring to that report.

Entities that believe they do not have any material exposure to environmental or social risks should consider carefully their basis for that belief and benchmark their disclosures in this regard against those made by their peers.

One particular source of environmental risk relates to climate change. This is also referred to generically as "carbon risk" and includes:

- physical risks, such as the risk of assets being destroyed or rendered unproductive, or business operations being disrupted, by extreme weather events or long term shifts in climate patterns;
- transition risks, such as the risks arising from changes in legislation or government policy, or the need to adopt new technologies, seeking to mitigate the effects of climate change or facilitating the shift to a lower carbon economy; and
- liability risks, where people who suffer damage caused by climate change, or a failure to respond to climate change, seek redress from those they believe are responsible.

Many listed entities will be exposed to these types of risks, even where they are not directly involved in mining or consuming fossil fuels.

The Council would encourage entities that have a material exposure to climate change risk to consider implementing the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD).

OUR ANALYSIS

The proposed changes to the *Principles and Recommendations* outlined above have the effect of emphasising the role that listed entities play in the society and environment in which they operate. In a broadening of the scope of corporate governance and ensuring that an organisation is run in a responsible manner with accountability, transparency and compliance, entities can no longer focus only on their short term commercial outcomes. The *Principles and Recommendations* will now be expecting entities (led by the Board) to have a positive impact on its stakeholders and society at large – a "social licence to operate". This shift is consistent with current public sentiment and expectations, and heightened awareness of corporate governance shortcomings.

There is now a societal expectation for our companies and businesses to be good corporate citizens, and to focus on long-term sustainability, rather than just short-term financial results, the premise being that good companies will survive, and bad companies will ultimately fail.

The concepts of corporate social responsibility and a social licence to operate are not new for mining companies, and already form part of governance regimes in other jurisdictions (such as the UK), but they are new for the ASX corporate governance regime. ASX has introduced a conviction that a listed entity should have regard to the views and interests of a broad range of stakeholders in order to preserve this social licence to operate and to maximise the value to shareholders over the longer term.

Boards of directors are now expected to clearly define the entity's purpose (Recommendation 1.1), and its core values (Recommendation 3.1) and that purpose and those core values must include providing positive outcomes for a variety of stakeholders (employees, customers, local communities, regulators), not just an entity's shareholders. A listed entity must establish and reinforce a culture of acting lawfully, ethically and in a socially responsible manner, consistent with long-term and sustainable value creation (Principle 3).

An entity's social licence to operate comes from the trust it earns from a variety of stakeholders. With community trust in business eroding, the Council is seeking to address this by requiring entities and their directors to turn their mind to not only the purpose for operating, but also the landscape and community in which they operate it. The two things do not exist exclusively of each other.

The changes to the recommendations are placing this responsibility with the Boards of listed entities. Boards are expected to set the tone from the top. The Board's oversight function now extends to ensuring that the entity acts in a manner which is consistent with its core values and code of conduct, and ensuring that an entity's "social licence to operate" remains intact.

This is a departure from the traditional and more narrow responsibilities and duties of directors, to act in good faith in the best interest of the entity and its shareholders. A more holistic approach to what that means is now expected – the Board is expected to maintain and defend the entity's social licence to operate, and the obligation to act in an entity's best interest extends to the interests of a broad range of stakeholders, and the entity's role in society more generally.

This will have the effect of further expanding the scope of a director's role as all aspects of their oversight (senior management, strategy, risk etc) will now also need to be measured against the company's purpose, core values and culture which the Board has adopted. We would expect a Board to require its senior management to now report its performance against the same. Boards will need to be provided with the information they need to monitor this performance. The revised recommendations provide some guidance on this information through requiring the reporting of material breaches of the entity's code of conduct and by defining thorough whistleblowing and anti-bribery and corruption policies, but the information provided will need to go further than this to ensure that a Board can satisfy itself that its purpose, culture and core values are being properly protected.

The revised principles call on Boards to review the listed entity's risk management framework and now specifically require that framework to focus on environmental and social risks with a particular focus on environmental risks relating to climate change. This reinforces an emerging view that Boards have a duty to consider climate change issues in the exercise of their duties.

From a practical perspective, Boards will now need to ensure that, if they have not already, they spend time defining the entity's purpose, its core values and the culture which the Board wishes to entrench, and then continually test themselves and the organisation against that purpose and culture and those values. Much like an entity would do monitoring its business strategy and financial performance.

An entity's purpose and core values, its culture and risk appetite must be communicated to the organisation and wider community as a whole, which then should provide an entity with further checks and balances and a commitment to ensure that it is properly addressing these matters.

While there will be a chorus to the effect that the time required to attend to these matters distracts a Board from the time which could be spent monitoring the company's operating and financial performance, the overwhelming evidence is that the matters which are reflected in these proposed *Principles and Recommendations* have broad support in the director, and business and wider community.

2. Revised Principles and Recommendations relating to the composition of the Board to ensure that it comprises individuals with the appropriate commitment, skills and knowledge of the entity and the industry in which it operates to enable the Board to discharge its duties effectively and to add value

The proposed changes are designed to ensure that Boards are comprised of directors with the appropriate commitment, skills and knowledge of the entity of which they are a director, and the industry in which the entity operates. Directors of listed entities are sometimes appointed because of the particular skillset they might bring eg. lawyers can comment on companies' regulatory issues and other legal matters, while corporate governance gurus can advise the Board on the proper performance of director duties. In reality, however, these skills and expertise can be brought in.

Recent corporate scandals around the world, particularly in the banking sector, have precipitated a growing concern that Boards are not properly executing their oversight function over senior management, in large part from a lack of subject matter knowledge or professional expertise amongst the directors. While a diversity of expertise is important, studies have shown that it is the presence of specific expertise relating to the nature of the company that is statistically significant in improving shareholder value.[1]

The increased expertise of directors can positively improve firm value and performance. Recent studies have confirmed that, all else being equal, increasing the number of independent directors on the Board with significant expertise in the company's main object of operations, or with recent experience in related industries, is positively correlated with increasing firm value.[2] Directors with related industry experience have a significant positive impact on firm value and performance because of their ability to handle industry shocks and support firms that face severe information problems.[3] The evidence indicates that having directors with discrete industry expertise on the Board is not only good corporate practice, but also improves profitability for shareholders.

While directors may be elected with all the important skills and knowledge needed to give effective oversight of senior management, the fast-changing nature of the global economy requires directors to be dynamic in upskilling in order to remain current with market practice. Directors who have served on a Board for an extended period of time, but without continual professional development, may find themselves out of date with current technological, legal and financial challenges and practices, hindering their ability to provide effective oversight of management.

The *Principles and Recommendations* contains a number of changes designed to increase the expertise, skills and commitment of the directors that sit on Boards:

2.1 PRINCIPLE 2: STRUCTURE THE BOARD TO ADD VALUE

<u>Changes to Principle 2</u>

Principle 2: Structure the board to <u>be effective and</u> add value

A listed entity should have a board of an appropriate size, composition, skills, commitment <u>and knowledge of the entity and the industry in which it operates</u>, to enable it to discharge its duties effectively <u>and to add value</u>.

[1] Balogh, 'Professional Expertise on Boards, Corporate Lifecycle, and Firm Performance', University of Sydney Business School, 11 September 2016. Available at: http://www.business.uwa.edu.au/__data/assets/pdf_file/0010/2938006/2016-09-11-ABalogh_Expertise-WP.pdf

[2] Charitou, Georgiou and Soteriou, 'Corporate Governance, Board Composition, Director Expertise, and Value: The Case of Quality Excellence' (2016) 20(3) Multinational Finance Journal 181, 229-230.

[3] Dass, Kini, Nanda, Onal and Wang, 'Board Expertise: Do Directors from Related Industries Help Bridge the Information Gap?' (2014) 27(5) The Review of Financial Studies 1533, 1585.

Commentary

A high performing, effective board is essential for the proper governance of a listed entity. The board needs to have an appropriate number of independent non-executive directors who can challenge management and hold them to account, and also act in the best interests of the listed entity as a whole rather than in the interests of an individual security holder or other party.

The board should be of sufficient size so that the requirements of the business can be met and changes to the composition of the board and its committees can be managed without undue disruption. However, it should not be so large as to be unwieldy.

2.2 RECOMMENDATION 2.2: BOARD SKILLS MATRIX

Changes to Recommendation 2.2

Recommendation 2.2:

A listed entity should have and disclose a board skills matrix setting out the mix of skills that the board currently has or is looking to achieve in its membership.

Commentary

A board "skills matrix" is a useful tool that can help the board identify any gaps in its collective skills that should be addressed by providing professional development to existing directors or taking on new directors. It can also assist the board in its succession planning.

Disclosing the board skills matrix gives useful information to investors and helps to increase the accountability of the board in ensuring it has the skills to discharge its obligations effectively and to add value.

A board skills matrix should address the full range of skills that the board considers desirable in its membership. In this regard, boards are increasingly being called upon to address new or emerging issues including around culture, conduct risk, digital disruption, cyber-security, sustainability and climate change. The board should regularly review its skills matrix to make sure it covers the skills needed to address existing and emerging business and governance issues.

There is no prescribed format for a board skills matrix. It can set out either the mix of skills that the board currently has or the mix of skills that the board is looking to achieve in its membership.

In the former case, the board skills matrix will usually take the form of a table listing all of the skills the board thinks it should have and indicating the presence or absence of those skills among existing board members. This need only be done collectively across the board as a whole, without identifying the presence or absence of particular skills by a particular director. Commercially sensitive information, such as the fact that the board may be looking to acquire a particular skill as part of an as-yet unannounced and incomplete plan to move into a different field of activity, can be excluded.

In the latter case, the board skills matrix is likely to be in the form of a statement rather than a table. The statement should make it clear that it is a description of the mix of skills the board is looking to achieve in its membership and not a representation of the existing skills the board has. It should also summarise the steps the board is taking to acquire those skills.

Whichever format it follows, the entity should explain what it means when it refers to a particular skill in its board skills matrix and the criteria a director must meet to be considered to have that skill.

2.3 RECOMMENDATION 1.6: PERFORMANCE EVALUATION OF THE BOARD

Changes to Recommendation 1.6

Recommendation 1.6:

A listed entity should:

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

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

Commentary

The board performs a pivotal role in the governance framework of a listed entity. It is essential that the board has in place a formal and rigorous process for regularly reviewing the performance of the board, its committees and individual directors. Particular attention should be paid to addressing issues that may emerge from that review, such as the currency of a director's knowledge and skills or if a director's performance has been impacted by other commitments.

The board should consider periodically using external facilitators to conduct its performance reviews.

A suitable non-executive director (such as the deputy chair or the senior independent director, if the entity has one), should be responsible for the performance evaluation of the chair, after having canvassed the views of the other directors.

To improve transparency and promote investor confidence, the Council would encourage the board of a listed entity not only to disclose whether a board performance evaluation has been undertaken but also any insights it has gained from the evaluation and any governance changes it has made as a result.

2.4 RECOMMENDATION 2.6: PROFESSIONAL DEVELOPMENT FOR DIRECTORS

Changes to Recommendation 2.6

Recommendation 2.6:

A listed entity should have a program for inducting new directors and for periodically reviewing whether there is a need for existing directors to undertake professional development to maintain the skills and knowledge needed to perform their role as directors effectively.

Commentary

All new directors should be offered induction training, tailored to their existing skills, knowledge and experience, to position them to discharge their responsibilities effectively and to add value. This could include, for example, having interviews with key senior executives to gain an understanding of the entity's structure, business operations, history and culture and conducting site visits of key operations.

If a director is not familiar with the legal framework that governs the entity, the entity's induction program should include training on their legal duties and responsibilities as a director under the key legislation governing the entity and the Listing Rules (including ASX's continuous and periodic reporting requirements).

If a director does not have accounting skills or knowledge, the entity's induction program should also include training on key accounting matters and on the responsibilities of directors in relation to the entity's financial statements.

As mentioned previously, boards are increasingly being called upon to address new or emerging issues including around culture, conduct risk, digital disruption, cyber-security, sustainability and climate change.

The board or the nomination committee of a listed entity should regularly assess whether the directors as a group have the skills, knowledge and experience to deal with new and emerging business and governance issues. Professional development for directors should be considered where gaps are identified and they are not expected to be addressed in the short term by new appointments.

The board or the nomination committee should also ensure that directors receive briefings on material developments in laws, regulations and accounting standards relevant to the entity.

OUR ANALYSIS

The addition of "knowledge of the entity and the industry in which it operates" (Principle 2) as part of the skillset of the Board serves to increase the overall expertise of the Board, which in turn should result in better and more informed oversight of senior management. As discussed above, the empirical evidence suggests that appointing directors with deep knowledge of the entity and the industry in which it operates not only benefits stakeholders writ large, but can provide more effective oversight of senior management, leading to better profitability and increase value for shareholders. The movement for more industry specialists to serve as directors of entities that operate in their field of expertise has been growing stronger over the last 2-3 years.

There are a number of new skills that are intended to be included in the Board "skills matrix" (Recommendation 2.2), including "digital disruption", "cyber-security", "sustainability" and "climate change", that reflect the new skills and knowledge an effective Board must be across in order to oversee listed entities and their management effectively.

Knowledge and expertise in these areas are emphasised to tackle 'existing and emerging business and governance issues' that have been exposed in various corporate scandals, both domestic and abroad. For example, the recent Australian Cyber Security Centre's 2017 threat report showed a 15% increase in cyber incidents on Australian business from the year before, including a listed company with links to national security projects. Maintaining intimate knowledge of the cyber-security threats to a particular listed company at the Board level is critical to protecting these corporations.

While a Board "skills matrix" is not a new phenomenon for large listed companies, the detailed commentary indicates a renewed focus on disclosing the actual Board skills matrix, rather than a broad statement about the skills matrix that the Board has determined it requires and asserts it has. From a practical perspective, listed companies will need to delicately balance meaningful disclosure for investors on the one hand, and ensure commercially sensitive information is not divulged on the other. For example, divulging in a skills matrix a need for a particular skill or knowledge outside the scope of the listed entity's existing operations or business would not be required.

The commentary provides a road map for constructing a Board skills matrix for companies who either have not constructed one before, or have not complied with the spirit of the Recommendation. For example, it is possible for entities to draw up a list of the entity's existing directors and their respective skillsets, and reverse engineer the skills matrix to disclose the directors' skills and knowledge as the skills and knowledge required by the entity. In contrast, a genuine and thorough skills matrix construction would first look at what skills and knowledge the entity needs, and then cross-reference with the skills and knowledge of the existing directors. The commentary to Recommendation 2.2 makes clear that this is the approach expected of listed entities.

The increased emphasis on the “currency of a director’s knowledge or skill” or “if a director’s performance has been impacted by other commitments” (Recommendation 1.6) reflects a growing concern that directors are not elected or nominated for their skill or expertise, but rather because of their business connections or acceptability to senior management. This commentary reflects this increased emphasis on directors properly performing their oversight and monitoring responsibilities. From a practical perspective, the process of evaluating the performance of directors is unchanged.

If directors elected to the Board are deficient in some aspect of the core professional skills required to properly serve as a director, this may weaken their ability to monitor senior management. To counter this, Recommendation 2.6 lists a number of professional development areas where all directors must be brought up to speed, including knowledge of the “entity’s structure, business operations, history and culture”, “legal duties and responsibilities as a director” and a “base level of understanding of accounting matters”.

It is expected that any gaps identified amongst the skills of the directors should not be “addressed in the short term by new appointments”, but rather by professional development. This implies that having a broad range of skills amongst the Board of directors is not a tick-the-box exercise, but is an integral part of having a competent Board providing adequate monitoring and oversight of the entity. There is also an implied recognition here that each director brings a unique skillset upon appointment, and while new appointments may bring new skills to the Board, certain skills brought by outgoing directors may not be easily replaced.

While the tenor of the changes to the *Principles and Recommendations* relating to the skills and composition of the Board indicates an additional level of compliance and reporting, the substance of the changes reflects trends emerging in discussions in the corporate community around the requisite level of skills and knowledge required to serve effectively as a director on Boards.

3. Continuing and increased focus on diversity, including the setting and disclosure of specific diversity targets and achievement against those targets

Calls for increased diversity in the workplace have been growing across social and corporate communities around the world as evidence emerges of the benefits that diversity brings both to cultivating a positive corporate culture and the outcomes for a wide variety of stakeholders. As the *Principles and Recommendations* makes clear, diversity is seen “as an asset to listed entities and a contributor to better overall performance”. The increased emphasis on diversity comes in light of new evidence that Australia’s performance is relatively average compared to other OECD nations when it comes to key diversity indicators across senior leadership and management positions in the private sector, as evidenced by Australia’s mid-range performance in the OECD’s recent “Pursuit of Gender Equality”.[1]

Recent studies have indicated the positive outcomes for shareholders when increasing diversity at the Board and management level. A study of ASX500 listed companies finds that there is a positive association between Board diversity and firm financial performance.[2] This is especially true when female directors are appointed to key decision-making committees. [3] The percentage of female presentation on ASX200 Boards is also positively correlated with a firm’s market capitalisation.[4] One study showed gender diverse Boards increased the quantity and quality of public disclosure by firms to investors and the stock market.[5] An interesting development is the strength of research on the correlation between ethnic diversity and financial performance.[6] This also coincides with some greater activism around cultural diversity in the last two years through a consortium of leading Australian organisations, Sydney University and the Australian Human Rights Commission (amongst others).[7]

The *Principles and Recommendations* places significant emphasis on diversity, with Recommendation 1.5 and its concomitant commentary representing the most significant change from the 3rd edition.

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[1] OECD. *The Pursuit of Gender Equality: An Uphill Battle* (2017).

[2] Vafaei, Ahmed and Mather, ‘Board Diversity and Financial Performance in the Top 500 Australian Firms’ (2015) 25(4) *Australian Accounting Review* 413, 424.

[3] Green and Homroy, ‘Female Directors, Key Committees and Firm Performance’, *Economics Working Paper Series*, Lancaster University, October 19 2015, 21.

[4] Australian Institute of Company Directors, *30% by 2018: Gender Diversity Progress Report* (2018) Vol 11, Dec 2017-Feb 2018, 11.

[5] Abad, Lucas-Perez, Minguez-Vera and Yague, ‘Does gender diversity on corporate boards reduce information asymmetry in equity markets?’ (2017) 20 *Business Research Quarterly* 192, 201.

[6] McKinsey report, Delivering through Diversity (January 2018).

[7] Leading for Change: A blueprint for current diversity and inclusive leadership (2016) and Leading for Change: A Blueprint for Cultural Diversity and Inclusive Leadership Revisited (2018).

3.1 RECOMMENDATION 1.5: DIVERSITY POLICY

Changes to Recommendation 1.5

Recommendation 1.5:

A listed entity should:

(a) have and disclose a diversity policy;

(b) through its board or a committee of the board:

i. set measurable objectives for achieving gender diversity in the composition of its board, senior executives and workforce generally;

ii. charge management with designing, implementing and maintaining programs and initiatives to help achieve those measurable objectives; and

iii. review with management at least annually the entity's progress towards achieving those measurable objectives and the adequacy of the entity's programs and initiatives in that regard; and

(c) disclose in relation to each reporting period:

i. the measurable objectives for achieving gender diversity set by the board or a committee of the board;

ii. (the entity's progress towards achieving the measurable objectives;

iii. whether the review referred to in (b)(iii) above has taken place; and

iv. either:

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

B. if the entity is a "relevant employer" under the Workplace Gender Equality Act, the entity's most recent "Gender Equality Indicators", as defined in and published under that Act.

If the entity was in the S&P / ASX 300 index at the commencement of the reporting period, the measurable objective for achieving gender diversity in the composition of its board should be to have not less than 30% of its directors of each gender within a specified period.

Commentary

Diversity is increasingly seen as an asset to listed entities and a contributor to better overall performance, particularly in a competitive labour market.

A listed entity should have a diversity policy that expresses its commitment to embrace diversity at all levels and in all its facets, including gender, marital or family status, sexual orientation, gender identity, age, physical abilities, ethnicity, religious beliefs, cultural background, socio-economic background, perspective and experience.

Research has shown, in particular, that better gender balance on boards and in senior management is associated with better financial performance. The promotion of gender diversity can broaden the pool for recruitment of employees, enhance employee retention, foster a closer connection with and better understanding of customers, and improve corporate image and reputation. For these reasons, this recommendation has a number of provisions focussed specifically on gender diversity, including that the board of a listed entity or a committee of the board should set measurable objectives for achieving gender diversity in the composition of its board, senior management and workforce generally and charge management with designing, implementing and maintaining programs and initiatives to help achieve those measurable objectives.

If the board decides to delegate to a committee of the board (such as the nomination or remuneration committee) the task of setting the entity's gender diversity objectives, this should be reflected in the charter of the committee in question.

The diversity objectives the board or a committee of the board sets should include appropriate and meaningful benchmarks that are able to be, and are, monitored and measured. These could involve, for example:

- achieving specific numerical targets for the proportion of women on its board, in senior executive roles and in its workforce generally within a specified timeframe;
- achieving specific numerical targets for female representation in key operational roles within a specified timeframe with the view to developing a diverse pipeline of talent that can be considered for future succession to senior executive roles; or
- achieving specific targets for the "Gender Equality Indicators" in the Workplace Gender Equality Act.

Recent reviews suggests that diversity policies are most effective when a listed entity sets numerical targets to be achieved within a specified timeframe, outlines the initiatives it is introducing to help meet those targets and then reports regularly on its progress in meeting those targets.30 Non-numerical objectives such as "introducing a diversity policy" or "establishing a diversity council", and aspirational objectives such as "achieving a culture of inclusion", while individually worthwhile, are unlikely to be effective in improving gender diversity unless they are backed up with appropriate numerical targets.

To focus management's attention on achieving the diversity objectives the board or a committee of the board has set, the board or committee may wish to consider setting key performance indicators for senior executives on gender participation within their areas of responsibility and linking part of their remuneration (either directly or as part of a "balanced scorecard") to the achievement of those KPIs.

To improve transparency and promote investor confidence, the Council suggests that a listed entity consider disclosing any insights from the annual review conducted by the board or a committee with management and any changes the entity has made to its gender diversity objectives and programs as a result.

A listed entity should tailor its gender diversity reporting to reflect its own circumstances and to give an accurate and not misleading impression of the relative participation of women and men in the workplace and the roles in which they are employed. In particular, when reporting the proportion of women in senior executive positions under recommendation 1.5(c)(iv)(A), listed entities should clearly define how they are using the term "senior executive". This could be done, for example, by reference to their relativity in terms of reporting hierarchy to the CEO (eg, CEO - 1, CEO - 2 etc) or by describing the roles that term covers (eg, leadership, management or professional speciality).

The board of a listed entity should also include gender diversity as a relevant consideration in its succession planning.

The Council would encourage larger listed entities with significant numbers of employees to show leadership on gender diversity issues and to provide more granular disclosures of the relative participation of women and men in senior executive roles than the base levels set out in this recommendation. This includes:

- where they define "senior executive" for the purposes of recommendation 1.5(c)(iv)(A) to include more than one level within the organisation (eg, CEO – 1 and CEO - 2), reporting the numbers of women at each level rather than, or as well as, cumulatively across all levels; and

- reporting the relative participation of women and men in management roles immediately below senior executive (eg, down to CEO - 3 and CEO - 4).

Each of these measures will allow readers to gain a better understanding of the progress of women in the organisation through the different levels of management and of the "pipeline" of candidates potentially available for higher management roles.

The Council would also encourage listed entities to benchmark their position on gender diversity against their peers, to undertake gender pay equity audits, and to disclose the outcomes and actions taken as a result so that security holders and other stakeholders gain an insight into the effectiveness of the entity's gender diversity programs and initiatives.

The Council would suggest that boards of listed entities have regard to other facets of diversity in addition to gender when considering the composition of the board. In particular, having directors of different ages and ethnicities and from different cultural or socio-economic backgrounds can help bring different perspectives and experiences to bear and avoid "groupthink" in decision making.

A listed entity may find the suggestions in Box 1.5 helpful when formulating its diversity policy.

BOX 1.5: SUGGESTIONS FOR THE CONTENT OF A DIVERSITY POLICY

1. Articulate the corporate benefits of diversity in a competitive labour market and the importance of being able to attract, retain and motivate employees from the widest possible pool of available talent.

2. Express the organisation's commitment to diversity at all levels and in all its facets, including gender, marital or family status, sexual orientation, gender identity, age, physical abilities, ethnicity, religious beliefs, cultural background, socio-economic background, perspective and experience.

3. Emphasise that in order to have a well-functioning diverse workplace, discrimination, harassment, vilification and victimisation cannot and will not be tolerated.

4. Commit to ensuring that recruitment and selection practices at all levels (from the board downwards) are appropriately structured so that a diverse range of candidates are considered and guarding against any conscious or unconscious biases that might discriminate against certain candidates.

5. Commit to designing and implementing programs that will assist in the development of a broader and more diverse pool of skilled and experienced employees and that, over time, will prepare them for senior management and board positions.

6. Recognise that employees (female and male) at all levels may have domestic responsibilities and adopt flexible work practices that will assist them to meet those responsibilities.

7. Provide opportunities for employees on extended parental leave to maintain their connection with the entity, for example, by offering them the option (without any obligation) to receive all-staff communications and to attend work functions and training programs.

OUR ANALYSIS

Recommendation 1.5 (**R1.5**) bolsters the requirement for "numerical, measurable objectives" for diversity at all levels of the entity; namely "the composition of its Board, senior executives and workforce generally". These objectives are to be reviewed at least annually by the Board of directors. The commentary explains the basis for this change: "aspirational objectives such as 'achieving a culture of inclusion', while individually worthwhile, are unlikely to be effective in improving gender diversity unless they are backed up with appropriate numerical targets."

R1.5 also provides for an explicit gender diversity objective for listed entities, which is that "the composition of its Board should be to have not less than 30% of its directors of each gender within a specified period." This comes off the back of new data from KPMG and McKinsey that gives evidence that better gender balance on Boards and in senior management "is associated with better financial performance", helping to justify this normative change in diversity's place in corporate governance. The 30% target is achievable for many companies (the ASX200 is currently sitting at 27.7% female directors as at 31 May 2018)[1] and aligns with other local and global targets for women on Boards. The increased focus on gender diversity by institutional investors means that the target is likely to be achieve by ASX200 companies before the end of the term of the new edition, however the challenge remains for small to mid-cap companies to achieve the 30% target.

Another key change in R1.5 is that companies disclose their diversity policies in full. This may require some consolidation of existing policies and expose some gaps vis-à-vis Box 1.5. The greater transparency and detail across the market could assist in benchmarking against peers and industry leaders, leading to better gender diversity outcomes overall.

The new commentary suggests that in terms of Board composition, companies should have regard to other facets of diversity in addition to gender and suggests such diversity can help avoid groupthink in decision-making. This could be a nod to new research around the benefits of other diversity forms.[2] Geographical and cultural diversity immediately come to mind in this context. For example, while much has been said about the importance of Asia to Australia and thus its listed entities, representation on Boards of listed entities by persons with true Asian experience and capability is very low. The reference to avoidance of groupthink reflects contemporary discussion on the importance of managing biases.

A few other elements reflecting some market movement include:

- elevating the consideration of gender diversity KPIs for senior executives (an effective but difficult initiative) to the commentary; and
- the addition in Box 1.5 of the idea of keeping in touch with parental leavers – quite a granular suggestion but instrumental in keeping women (in particular) in the workforce and minimising the career interruption and flow-on effects.

The significant changes to the diversity policy Recommendation tracks a similar discussion being held in the corporate community, and society writ large, about the positive benefits that robust diversity mechanisms bring for various stakeholders. The wholesale nature of the changes reflect a growing perception that Australia must perform better in key diversity indicators in corporate leadership

[1] AICD, 30% by 2018: Gender diversity progress report March-May 2018, Quarterly Report, Volume 12.

[2] including McKinsey's research mentioned above.

CONTACTS

Sydney

Rory Moriarty
Partner
+61 2 9353 4764
rmoriarty@claytonutz.com

Rod Halstead
Director
+61 2 9353 4126
rhalstead@claytonutz.com

Lara Solomons
Senior Associate
+61 2 9353 5671
lsolomons@claytonutz.com

Perth

Mark Paganin
Partner
+61 8 9426 8284
mpaganin@claytonutz.com

Liz Humphry
Special Counsel
+61 8 9426 8471
lhumphry@claytonutz.com

Brisbane

Andrew Hay
Partner
+61 7 3292 7299
ahay@claytonutz.com

Melbourne

Andrew Walker
Partner
+61 3 9286 6943
awalker@claytonutz.com

Kate Allison
Senior Associate
+61 3 9286 6425
kallison@claytonutz.com

Sydney
Level 15
1 Bligh Street
Sydney NSW 2000
+61 2 9353 4000

Melbourne
Level 18
333 Collins Street
Melbourne VIC 3000
+61 3 9286 6000

Brisbane
Level 28
Riparian Plaza
71 Eagle Street
Brisbane QLD 4000
+61 7 3292 7000

Perth
Level 27
QV.1 Building
250 St Georges Terrace
Perth WA 6000
+61 8 9426 8000

Canberra
Level 10
NewActon Nishi
2 Phillip Law Street
Canberra ACT 2601
+61 2 6279 4000

Darwin
17–19 Lindsay Street
Darwin NT 0800
+61 8 8943 2555

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