7 September 2005

Dr Anthony Marinac
Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Suite SG.64
Parliament House
CANBERRA ACT 2600

Submission to the Inquiry into Corporate Responsibility

Dear Dr Marinac

AMP Capital Investors Sustainable Funds Team (AMPCI Sustainable Funds) is pleased to provide a submission to the Inquiry into Corporate Responsibility (the "Inquiry"). This submission focuses only on the for profit incorporated entities under the Corporations Act.

The submission outlines a number of issues from the perspective of AMPCI Sustainable Funds, and its investees, and as such, it may not represent the views of AMP Limited, or its related entities.

By way of background, the AMPCI Sustainable Funds (the "Funds") invests over 800 million in Australian listed assets. The Fund actively considers a company's Corporate Responsibility in its investment decision making process. The Fund's Research and Engagement Handbook (available at www.sustainablefuturefunds.com) provides more information on how the Fund assesses Corporate Responsibility.

I have attached for the Committee's consideration a paper outlining AMPCI's Sustainable Funds approach against some of the Committee's terms of reference, and I would be pleased to provide further information should you wish.

AMPCI's Sustainable Fund's views may be summarised as follows:

1) Considering the interests of stakeholders is in the best interest of a company, including shareholders, and is required as part of the social contract companies have with society. The social contract results from the privilege of limited liability granted to companies and is a prerequisite for companies being considered legitimate stakeholders in civil society.

2) Director's duties with in the Corporation's Law should be changed to reflect these obligations. Suggested changes to the law are:

   S180(2)(d) ***rationally believe that the judgement is in the best long-term interest of the corporation, taking into consideration the interest of legitimate stakeholders and the environment.***

   S180(2)(e) ***have considered community, and legitimate stakeholder expectations, on appropriate corporate behaviour.***

3) Voluntary industry and international initiatives and reporting play an important part in clarifying and encouraging accountability of a company's corporate responsibility. These initiatives should be more actively encouraged by governments and industry associations.

4) There are four corporate responsibility areas where there should be a mandatory requirement for Director's to report to shareholders and other stakeholders:

   a) Non-compliance with law;

b) Occupational health and safety performance

c) Greenhouse gas emissions; and

d) Political donations.

5) In addition, a requirements for Director's to report to shareholders

" the main trends and factors which are likely to affect their future development, performance and position, prepared so as to enable the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for those strategies to succeed."

The review should, to the extent necessary, provide information about:

a) the employees of the company and its subsidiary undertakings, (what does undertakings mean?)

b) environmental matters, and

c) social and community issues."

This is similar to that required under the UK OFR regulation,

Further discussion on the Terms of Reference and other issues identified is given in the Annexure attached.

Again, thank you for the opportunity to make a submission to the inquiry and if you would like clarification on the issues raised, please do not hesitate to contact me on the number given below.

Yours sincerely

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Annexure A: AMPCI Sustainable Funds: Response to the Committee's terms of Reference

1. The extent to which organisational decision makers should have regard for the interest of stakeholders, other than shareholders, and the broader community.

There are three prime reasons why organisational decision-makers should have regard to the interest of stakeholders, other than shareholders and the broader community. It is necessary to:

- manage the crucial intangible assets of the organisation;
- minimise the risk of additional regulatory and compliance costs; and
- meet the implied social contract obligations to the community, implicit from allowing companies limited liability and being a legitimate party in civil society.

The prominence of intangible assets, or intangible capital, as value and growth creators, at the corporate and national level, is today widely acknowledged: McKinsey & Company[1] and others[2] have found that intangible capital constitutes between one-half and two thirds of the market value of Fortune 250 companies. An intangible asset can be a patent, copyright, brand name or trademark. It also encompasses the know-how embodied in employees and working practices; the value of relationships with suppliers and customers; and the trust of the community. The intangible capital is driven by diverse factors: innovation, human capital, organisational processes, customer, supplier and community relations. These drivers involve some of the key stakeholders for an organisation's operation.

Therefore, ensuring good financial returns to shareholders requires the effective management and utilisation of intangible capital. That is, it requires an organisation's decision makers have regard for the interests of stakeholders critical to those intangible assets, notably employees, suppliers, customers and the community. From the perspective of most investors, it is critical that a company has a regard for key stakeholders.

Not all companies have taken the same view on how they should manage their intangible assets. Some have relied on focussing on those that have direct nexus or short-term focus to financial returns, eg focussing on brand management through public relations. Others have taken a more holistic, broader and long-term approach to managing intangible assets and hence have considered a broader range of stakeholders, for example by being a good and active corporate citizen.

AMP Capital's Sustainable Future Fund has looked at the relationship between a company's corporate social responsibility (CSR) performance and total shareholder return of Australia's top 300 listed companies[3]. In the study those companies that take a broader view of stakeholders and stakeholder interests were considered better at addressing their corporate responsibility. The study found that the pool of higher performing CSR companies provided an investment return statistically better, over 4 and 10-year periods, than the pool of lower performing CSR companies. The results support the proposition that there is a relationship between a company's level of corporate responsibility and shareholder return.

While in many cases, there is alignment of interests between the long-term financial interests of shareholders and the appropriate management of key stakeholders, it is not the case all the time. Misalignment of interests or the externalisation of costs can and do exist. Examples include situations where there is a failure in the market, law or incentives, or where different values or timeframes exist between the organisational management and stakeholders. In many of these cases, a particular stakeholder, including the natural environment, can be significantly adversely impacted.

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[1] Court, D., & Loch, M., (1999), *Capturing the Value, Advertising Age,* 70 (46), pp. 12-15.

[2] Gu, F., & Lev, B., (2001), *Intangible Assets: Measurement, Drivers, Usefulness*

[3] Rey, M & Nguyen, T. (2005), *Financial Payback from Environmental and Social Factors in Australia*, AMP Capital Investors, available at www.sustainablefuturefunds.com

Clearly governments have a role in setting minimal standards, through law, to minimise the majority of the adverse impacts of companies. However, given the complex nature of society and the relationships between stakeholders, and recognising that society's standards change with time and particular circumstances, prescriptive legal standards will not capture all of society's minimum standards for corporate behaviour. A reliance on legal standards to capture all of society's expectations will lead to an explosion of company law and place an extraordinary compliance burden on companies, with no guarantee that the outcomes will be acceptable. Therefore, if companies do not meet society's expectations and consider the interests of stakeholders, they run the risk of additional regulation and the associated compliance costs, which are likely to be higher than if the company or industry met society's expectations to begin with.

Finally, companies expect to be legitimate stakeholders in civil society, making demands of governments and contributing to policy development. To be a legitimate part of civil society, companies need to demonstrate that they act responsibly. This means that there is a level of corporate responsibility demanded of companies, over and above what might be set out in law, which is demanded as part of the social contract between companies, stakeholders and the community. This social contract is also implicit in society granting companies the privilege of limited liability.

"Limited liability" came about from a weighing up of the cost and benefits to broader society of allowing the owners of companies the financial benefit of minimising the downside risks of entrepreneurial endeavours. It was, and still is, a privilege granted to companies by society, through company law. Implicit in being granted the privilege is the responsibility to ensure that the company meets the minimum expectations of acceptable corporate behaviour and provides a benefit to society, which requires having regard to, and understanding of the impact of its operations on legitimate stakeholders.

Therefore, through having regard for legitimate stakeholders, companies can both meet their implied responsibility as part of limited liability and being a legitimate player in civil society and minimise the risk of burdensome legal requirements. Considering the interests of many of a company's key stakeholders is also required as part of good business practice.

2. The extent to which the current legal framework governing Directors duties encourages or discourages them from having regard for the interests of stakeholders, other than shareholders and the broader community

The Corporations Law sets out Director's duties, which include:

- A degree of care and diligence; and
- Making judgements in the best interests of the company.

The company is owned by shareholders and clearly has an obligation to consider shareholders, but a company's business is also a series of relationships with stakeholders, namely with suppliers, customers, financiers, employees, contractors and the community. Therefore, there is an obligation to consider other stakeholders, within the context of a company's business and objective of making a profit. However, one of the challenges and responsibilities for directors is to balance the different timeframes that different stakeholders may be operating under and the tangibility of any outcome of a decision.

For example, a short-term decision to return capital to current shareholders of a company may result in poorer services to customers, ultimately leading to under-investment and poorer longer-term returns for shareholders. Alternatively directors may choose to invest in the business improve services at the expense of returning capital to shareholders but building a long-term customer base and company profitability. In other company circumstances and after considering both and long-term issues, the directors' decision to return capital to current shareholders may be totally appropriate action.

Another example is accepting that corporate philanthropy plays an important part in maintaining a company's reputation and meeting its social contract. The specific action may not have a measurable impact on a company's reputation or a material impact on company profitability but it certainly could be in

the best interest of the company. However, there appears to be some anecdotal evidence that some directors struggle with determining whether such actions would be consistent with their duties.

Therefore, the Corporations Law appears to neither encourage nor discourage having regard for other stakeholders, with the test being the best interest of the company. However, the Corporations Law appears not to encourage a company being responsible or meeting community expectations to go beyond what might be required by law, ie to consider the interests of other stakeholders when at times it may be in conflict with the company's interest, especially in the short-term.

In addition, there are a number of other requirements on directors under a number of other laws on conditions of labour, including occupational health and safety[4], consumer protection and the environment. However, while these laws generally make Directors potentially liable for some non-compliances with the law, the obligation is to comply with the law rather than consider the interests of stakeholders.

An additional area which would encourage Corporations and directors to consider broader stakeholders is to make them accountable for reporting on a company's performance in the Directors Report in satisfying the minimum corporate responsibility requirements set out by law.

Currently, there is a requirement under section 299(1)(f), namely to report:

> *"if the entity's operations are subject to any particular and significant environmental regulation under a law of the Commonwealth or of a State or Territory—give details of the entity's performance in relation to environmental regulation."*

There are three problems with this reporting requirement as it stands. The first is that it only requires discussion about environmental regulation. The second problem is that the test of "particular and significant" has resulted in a materiality test being used by many organisations about what, if anything, is reported. This does not necessarily provide shareholders, stakeholders or the general community an assessment of the company's general environmental performance. The third problem is the reliance on Director's "being aware" of non-compliances, which suggest that the Directors may not have inquired or have appropriate non-compliance reporting mechanisms.

In summary the current legal framework provides some scope for consideration of stakeholder interests, however it is limited to:

a) being part of considering the company's interest; or
b) being part of meeting legal requirements; or
c) reporting on significant environmental non-compliances.

It does not require the directors to ensure the company acts responsibly or meet the community's expectations or make Director's accountable for reporting on the legal compliance of an organisation, even though compliance with the laws of the land might be considered the minimal requirement of corporate responsibility or within the context of the company's interest.

3. Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or Directors to have regard for the interests of stakeholders, other than shareholders, and the broader community. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act

The discussion above suggests there is room to clarify the role of Directors in considering corporate responsibility. The first is to clarify the ability to consider broader stakeholders as part of considering company interests. Such a change could be incorporated into section 180 (2)(d) so the section becomes:

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4 For example see s26 NSW Occupational Health and Safety Act 2000

S180(2)(d) ***rationally believe that the judgement is in the best long-term interest of the corporation, taking into consideration the interest of legitimate stakeholders and the environment.***

A definition of legitimate stakeholder could be defined as someone, or something upon which, the operations of the company have had, are having or may have in the future, a significant impact.

However, this change again does not necessarily require a director to consider a company's responsibility under its social contract with society. Therefore, an additional sub-section should be added, namely:

S180(2)(e) ***have considered community, and legitimate stakeholder expectations, on appropriate corporate behaviour.***

A question arises about who, or what organisations, may represent the interests of the community or persons or objects, eg the environment, animals, that cannot represent themselves even though they may be impacted upon by a company's operations.

In this case. a test of whether a person or organisation represents a legitimate stakeholder could involve:

- A prime objective test to represent a particular issue; and
- Whether they have communicated with the corporation about the issue.

This is an area that would require further consideration, so as to minimise the potential for excessive litigation.

As noted above, the Corporations Law only requires the Director's Report to discuss environmental performance in relation to environmental regulation. Given that meeting legal requirements is the minimum standard set by the community for a company's corporate responsibility, it is proposed that the Director's Report provides details on all non-compliances within the financial year. Therefore, section 229 (1)(f) could be changed to:

> **"*give details on any prosecutions, fines, notices, or directions by regulators, or voluntary agreements with regulators, as a result of actual, or potential, non-compliance with occupational health and safety, environmental, employment or trade practices law, or other regulation, applicable to the entity's activities.***
>
> ***For the purposes of this section, information should be reported for all operations, sites or activities for which the entity has a controlling interest or operates on behalf of other entities, whether or not there is ownership component.***

4 Any alternative mechanisms, including voluntary measures that may embrace consideration of stakeholder interests by incorporated entities and/or their Directors

There are a number of industry initiatives, such as, The Minerals Council of Australia's Enduring Value Code, that has facilitated organisations to consider stakeholder interests.

There are also a number of voluntary international initiatives or standards, such as the Extractive Industry Transparency Initiative, the UN Global Compact, ILO Standards, Human Right Norms and OECD Guidelines for Multinationals which also encourage broader consideration of stakeholders and which should be encouraged.

While the intent of these initiatives is generally positive, they vary in the degree to which both stakeholders accept the initiatives, and organisations that signed or agreed to them are held accountable for fulfilling their commitments. The first is in part due to stakeholders not being involved in the development of the initiative or the sometimes low (as perceived by the stakeholders) standard of corporate responsibility set. It is also a result of perceived poor compliance/enforcement mechanisms within such initiatives and the lack of requirement to publicly report on progress.

An additional issue is that they are voluntary and therefore if they are used as a way of avoiding new laws, some companies will take advantage of their voluntary nature and avoid or not meet their corporate responsibilities.

Therefore, except for the mandatory reporting of non-compliances and performance in a number of key issues discussed later in this submission, organisations should be encouraged to voluntarily report on their key impacts and issues and steps to manage and improve key impacts and issues relevant to stakeholders.

There are a number of guidelines, most notable the Global Reporting Initiative (GRI), which provide direction on the scope and depth of the reporting to stakeholders. However, to effectively embrace consideration of stakeholder interests an organisation needs to also clearly articulate why the issues being reported are of importance to the organisation or the stakeholder.

5. The appropriateness of reporting requirements associated with these issues

Apart from the requirements under s299(1)(f) of the Corporations Law and the National Pollutant Inventory, there are limited legal requirements to report on the impact of an organisation's operations on stakeholders to either shareholders or other stakeholders.

However, a recent study[5]. found that only 116 companies among the 509 covered by the project produced reports that covered to some extent the corporate responsibility. The percentage of Australian companies reporting is significantly lower than in many other OECD countries. As stakeholder reporting is relatively new, and there are no set requirements for reporting stakeholder issues, the quality and scope of the reports varies widely. The better reports generally tend to follow the Global Reporting Initiative Guidelines.

The AMP Capital Sustainable Future Funds believe that voluntary reporting is still appropriate. For some companies stakeholder reporting is part of their competitive advantage in a bid to differentiate themselves in the market place. For stakeholders voluntary reporting is a way of determining which companies believe it is important to communicate to them and what issues the company believes are important.

In addition, unfortunately there is no guarantee that will lead to companies being more responsible as some will focus on complying with the reporting requirement and or public relations rather than actually having regard to stakeholder interests.

However, there are three areas where there is a case for mandatory reporting:

- Reporting on an entity's occupational health and safety (OH&S) performance, as providing a safe workplace is a key expectation of companies. Both severity and frequency data should be provided along with the number of and average claims for workers compensation. Geographical and divisional OH&S performance information, as is currently provided for financial results, should also be provided. This will require an agreed standard for reporting, as currently there is no consistency in OH&S data reporting;
- Reporting on an entity's greenhouse gas emissions, as climate change is a significant emerging risk issue for investors and the community at large. The WSBCD Greenhouse Gas Protocol provides a suitable framework for reporting greenhouse gas emissions.
- Political Donations, made in Australia and overseas, as part of enhancing transparency and minimising the potential for corruption. While there is a requirement for notifying political donations to the Australian Electoral Commission, there is currently no requirement to report donations to shareholders directly or to the community. In addition, there is currently no requirement to report donations made to governments outside Australia.

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5 More information on the scope of current reporting is available at www.deh.gov.au/settlements/industry/corporate/reporting/links.html

6. Whether regulatory, legislative or other policy approaches in other countries could be adopted

The UK's Operating and Financial Review (OFR) regulations requires a balanced and comprehensive analysis of, amongst other things,

> *" the main trends and factors which are likely to affect their future development, performance and position, prepared so as to enable the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for those strategies to succeed."*
>
> *"The review should, to the extent necessary, provide information about:*
>
> *a) the employees of the company and its subsidiary undertakings,*
>
> *b) environmental matters, and*
>
> *c) social and community issues."*

It should be noted that the issues that are covered by the OFR are issues that Directors should already be aware of and considering within their current responsibility "*of discharging their duties with the degree of care and diligence that a reasonable person would exercise."* The requirement for Directors to be considering these issues is not placing an additional responsibility on Directors. It is requiring directors to report back to shareholders how they are addressing this responsibility.

A similar disclosure requirement under the Annual Directors' Report would be of meaningful relevance to shareholders and other stakeholders. In addition, the disclosure of such would be a measure of the extent that Directors understand and are meeting their responsibility.

Currently there is a requirement for the Directors' Report to refer to *"likely developments in the entity's operations in future financial years "*, under s299(1)(e) of the Corporations Law. However, prejudicial information can be omitted. As a result few companies provide any meaningful disclosure under this section.

The Fund believes that ability to omit discussion because of prejudicial information omission should not apply to the OFR type disclosure proposed. The onus should be on directors to provide information required to meet the objective, ie *to enable the members of the company to assess the strategies adopted by the company.*