

## **Chapter Two – Background on corporate governance**

2.1 This chapter outlines Australia's corporate governance framework and its relevance to shareholder engagement, based on the delegated authority model in which company directors make decisions in the company's interest, subject to shareholder oversight. As background for the following two chapters, the committee describes the importance of effective channels of communication between companies and their shareholders, as well as efficient and transparent voting mechanisms to enable shareholders to enforce board accountability. Finally, the committee notes inquiry participants' preference for a non-regulatory approach to improving shareholder engagement in Australia.

### **Corporate governance model**

2.2 The participation and engagement of shareholders in the companies in which they invest occurs within the parameters of the delegated authority model of corporate governance. This operates on the basis that company directors are responsible for overseeing the direction and management of the company, which they have a fiduciary duty to undertake in the best interests of the company in accordance with section 181 of the Corporations Act 2001 (Corporations Act). Although the Corporations Act provides for shareholders to engage in direct decision-making in limited circumstances, such as amending the company constitution (section 136) or reducing share capital (section 256C), this control over setting the direction and overseeing management of the company rests with the Chairman and the board and implemented by company management under the guidance of the Chief Executive.

2.3 In discharging their duties, directors are held accountable for their decisions by shareholders with the legal entitlement to remove and appoint directors under section 203D of the Corporations Act. This governance model recognises that management by shareholders would be impractical, but ensures that those responsible for the company's performance and direction are accountable to the owners of the company for the decisions they make on their behalf.

2.4 The Institute of Chartered Accountants described the accountability of the board as the mechanism for offsetting the concentration of decision-making control they possess.<sup>1</sup> Similarly, the Australian Institute of Company Directors (AICD) told the committee that this corporate governance model struck an appropriate balance between control and accountability:

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1 Institute of Chartered Accountants, *Submission 7*, p. 2.

...shareholder participation in business decisions would dilute board accountability and make it impossible for companies with large numbers of shareholders to operate effectively in a modern economy.<sup>2</sup>

2.5 They also advised that it best manages the conflicts associated with a diverse mix of shareholders with both long- and short-term imperatives.<sup>3</sup>

2.6 ASX Limited commented that this framework provides good value to companies and shareholders via improved corporate governance:

Shareholder involvement in corporate governance primarily consists of monitoring the performance of the board of directors and the company as a whole. The agency costs associated with this model, such as continuous disclosure compliance and other forms of shareholder monitoring and company communication, are outweighed by the efficiencies which flow from this model.<sup>4</sup>

### **Shareholder engagement and effective governance**

2.7 The critical nexus between these decision-making and accountability functions is engagement between shareholders and the company board that is informed, meaningful and effective. Evidence received by the committee suggested that participation and engagement with company boards is an important means by which shareholders are able to improve the value of their share ownership and minimise risk.<sup>5</sup> Treasury submitted that ineffectual shareholder engagement brought increased investment risk:

Shareholders must retain effective mechanisms to examine the affairs of the company and voice concerns to the company and its managers. Shareholder participation is vital in ensuring accountability of the company's board and management. Without effective monitoring of directors and management by shareholders, there is an increased risk of directors and managers underperforming.<sup>6</sup>

2.8 To provide an example of its benefits, Australasian Investor Relations Association cited a recent US survey of fund managers claiming that a potential ten per cent share price premium could be attached to companies with 'superb' investor relations.<sup>7</sup>

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2 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 56.

3 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 56.

4 ASX Limited, *Submission 14*, p. 2.

5 ASFA, *Submission 2*, p. 2; Regnan Governance Research, *Submission 22*, p. 2; Chartered Secretaries Australia, *Submission 8*, p. 3.

6 Treasury, *Submission 17*, p. 4.

7 Australasian Investor Relations Association, *Submission 12*, p. 1.

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2.9 Shareholder engagement and participation that contributes to good corporate governance has two main features:

1. Shareholders being well informed about the companies in which they invest through effective communication; that is, transparent reporting of company information and meaningful dialogue between shareholders and company boards; and
2. Shareholders being able to perform their accountability role by exercising their voting entitlements effectively.

2.10 These elements of shareholder engagement are summarised below and the issues raised during the inquiry that relate to them are examined in further detail in chapters three and four respectively.

### **Communication between shareholders and company boards**

2.11 Access to relevant information and the opportunity to engage directly with the board on matters of corporate governance are critical to enabling shareholders to exercise their accountability in a way that benefits the company. The various methods, both mandatory and voluntary, that companies use for communicating information to shareholders include:

- Mandatory company reporting as stipulated by the provisions contained in Chapter 2M of the Corporations Act;
- Regular disclosure of information that might have a material effect on the share price as mandated by ASX Listing Rule 3.1;
- Reporting performance at company meetings, which must be conducted in accordance with the provisions contained in Chapter 2G of the Corporations Act;
- Informal briefings to investors, usually major institutional shareholders.

2.12 In its submission, Treasury outlined the importance of shareholders being able to make an informed assessment of the companies they invest in:

A key objective of Australia's financial reporting framework is to provide existing and potential shareholders, as well as a range of other stakeholders, with full and reliable information about a company. These disclosures enable users to make informed investment decisions, actively participate at AGMs, influence management and hold it accountable for the company's operations. The financial reporting framework therefore provides an important platform to enable shareholders to participate and engage with a company.<sup>8</sup>

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8 Treasury, *Submission 17*, p. 8.

2.13 An important consideration during the inquiry was the need for companies to tailor, and shareholders demand, methods of communication that best suited the requirements of diverse classes of investors. In particular, there is a clear distinction between the type of communication with company boards that is suitable to large, well resourced institutional investors, and the most appropriate way for companies to engage with individual retail investors. The next chapter, Chapter Three, addresses the problems associated with communication between companies and shareholders in the context of these two separate investor classes.

2.14 What ought to be noted here, though, is the increasing significance of institutional investors that has occurred in recent times. According to the ASX, institutional shareholders comprise a growing segment of the equities market, largely due to the increasing value of superannuation funds under management. Their submission stated that, from June 1988 to March 2007, institutional investment rose from 23.1 per cent to 40.4 per cent of total investments. They added that 'a significant proportion' of the 32.5 per cent of securities held by investors outside Australia (in March 2007) would be institutional investment. During the same period household (retail) investment declined from 36.1 per cent to 23.7 per cent as a proportion of total investment in the Australian stock market.<sup>9</sup>

2.15 Treasury also commented on the 'de-retailisation' trend, emphasising the need for the corporate governance framework to be flexible enough to adapt to the 'differing requirements of different types of shareholders and their relative prominence in the market at any one time'.<sup>10</sup>

### **Accountability through shareholder voting**

2.16 The voting rights attached to share ownership provide investors with an important mechanism by which to maintain the accountability of a company board. The principal regulatory provisions that apply to voting on company resolutions, including the election of directors, are contained in Part 2G.2 and part 2D.3 of the Corporations Act. The ASX Listing Rules, which are enforceable under sections 793C and 1101B of the Corporations Act, also regulate company voting procedures. ASX Listing Rule 14.2 sets out the requirement for companies to provide for proxy voting. The Listing Rules also establish the process for electing company directors. The relevant provisions are as follows:

- Listing Rule 14.3 stipulates the time frames within which director nominations must be accepted (35 business days, subject to the company constitution);
- Listing Rule 14.4 limits tenure of directors to three years (after which time they must be re-elected); and

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9 ASX Limited, *Submission 14*, p. 4.

10 Mr Matthew Brine, Treasury, *Committee Hansard*, Canberra, 15 April 2008, pp. 70-71.

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- Listing Rule 14.5 requires director elections to be held annually.<sup>11</sup>

2.17 Chapter Four reviews evidence to the committee on problems associated with the mechanisms used to lodge and record votes and the capacity of shareholders to exercise their vote effectively.

### **Preferred approach to reform**

2.18 As described by the committee intermittently in the following chapters, the basis for any deficiencies in the participation and engagement of shareholders on corporate governance matters is frequently company or shareholder inertia or apathy, or companies' cultural resistance to acknowledging the views of investors. In other words, investors and companies are not always choosing best practice currently permitted by the current regulatory framework, rather than being hampered by it, or being permitted to abuse an overly relaxed system to the detriment of shareholders. Consequently, the majority of contributors suggested that additional regulation may not be effective or warranted in facilitating engagement.

2.19 Although the committee received a number of recommendations on regulatory means to improve shareholder engagement, contributors did not mostly express the opinion that the current regulatory framework for corporate governance was fundamentally responsible for obstructing engagement between shareholders and companies. For example, AICD said: 'there is always the opportunity for incremental improvement, but we do not by any means believe that the system is inherently wrong or that there is any systemic problem with it'.<sup>12</sup> They added that, from their experience, shareholders are not expressing concern that they are insufficiently engaged.<sup>13</sup> The Law Council of Australia submitted that the current system allowed sufficient shareholder participation and did not require legislative or regulatory change.<sup>14</sup>

2.20 Chartered Secretaries Australia (CSA) noted the importance of maintaining a balance between engagement with shareholders and the efficient management of companies. They asserted that there are:

...areas where further discussion and communication by relevant parties could engender improvements, but we stress that any additional regulation at this point is more likely to create regulatory and administrative burdens on companies than facilitate the effective engagement of shareholders.<sup>15</sup>

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11 ASX Limited, *Submission 14*, p. 5.

12 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 58.

13 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, pp. 58-59.

14 Law Council of Australia, *Submission 21*, p. 1.

15 Chartered Secretaries Australia, *Submission 8*, p. 3.

2.21 The Institute of Chartered Accountants concurred, stating that shortcomings in company governance 'are best overcome by proactive voluntary corporate governance action rather than prescriptive regulation'.<sup>16</sup> CSA contended that black-letter-law approaches tended to produce 'the wrong outcomes'.<sup>17</sup> The Business Council of Australia maintained that 'flexibility' within the regulatory framework best facilitated engagement.<sup>18</sup> Regnan commented that regulatory change must be preceded by investor demand:

...the driver for change now has to be very strong investor demand and institutional demand. That will probably lead to requests from companies and investors for a regulatory regime to give force to what they agree in the market on engagement.<sup>19</sup>

2.22 ASX Limited stated that any further regulatory diversion from the delegated authority model would be unwarranted:

Starting ... from the basis that the current governance framework works well, and contributes to market efficiency, any exception to the default position that shareholders appoint directors as their agents to act on their behalf needs to be supported by an identifiable and justifiable principle. An example of such a principle is regulation providing for a direct shareholder vote in circumstances where a conflict of interest between shareholders and directors cannot be managed by any other means. In our view, current regulations give adequate effect to this principle.<sup>20</sup>

### **Committee view**

2.23 Shareholders own their companies, so engagement with company boards is their right, but there is a benefit beyond the exercising of that right. Shareholder engagement through dialogue, disclosure and voting ensures the accountability of company boards and management, providing an important check on their power that serves to improve corporate governance standards. This works in much the same way as the central tenets of democracy improve the standards of political governance via the accountability of elected representatives. In the political sphere this occurs through best practice elections, checks and balances on institutional power, selection on merit and transparency. Maintaining political accountability includes equally vital institutional and participatory elements; the right structures need to be in place to enable democratic participation to be as effective as possible. Similarly, the willingness and capacity of shareholders to engage, question, form opinions and vote

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16 Institute of Chartered Accountants, *Submission 7*, p. 5.

17 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 4.

18 Business Council of Australia, *Submission 29*, p. 2.

19 Mr Nathan Fabian, Regnan Governance Research, *Committee Hansard*, Sydney, 16 April 2008, p. 51.

20 ASX Limited, *Submission 14*, p. 2.

on company matters is essential to bringing these democratic principles to bear in the corporate realm.

2.24 However, the notion that those granted responsibility for running publicly listed companies should be accountable in this way is sometimes met with resistance from elements within the corporate sector. Some company boards prefer instead to use the delegated authority model of corporate governance as an opportunity to operate autonomously, with minimal shareholder-based accountability. This attitude is clearly detrimental to the objective of best practice corporate governance.

2.25 The committee recognises that Australia's standards of corporate governance are relatively high. But there is certainly room for improvement; Australia's companies and boards are not perfect. Companies that have failed to adequately facilitate shareholder engagement and participation need to be pressed harder to do so. Regulators such as the Australian Securities and Investments Commission and the ASX, as well as industry bodies such as the Investment and Financial Services Association, have developed very effective best practice methodology and principles. These organisations should be encouraged to continually adapt their corporate governance guidance to account for shareholder engagement objectives and to explore ways of ensuring they are adopted by companies not giving them sufficient credence. Rather than imposing minimum standards of engagement on companies, legislative reform is best suited to removing impediments currently preventing companies from engaging with shareholders in line with best practice guidance.

2.26 It is in this context that the committee discusses the more contentious shareholder participation and engagement issues and makes its recommendations.

