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Submission to Parliamentary Joint Committee on Corporations and Financial Services in relation to the engagement and participation of shareholders in the corporate governance of the companies in which they are part-owners.

1. Introduction

1.1 Regnan is pleased to submit to the Parliamentary Joint Committee on Corporations and Financial Services in relation to the engagement and participation of shareholders in the corporate governance of the companies in which they are part-owners.

1.2 Regnan is a specialist governance research and engagement entity operating in Australia. Regnan is owned by eight leading institutional investors who are responsible for around A$350 billion of invested funds. At the time of this submission, Regnan was retained by ten institutional investors with a mandate to proactively identify potential governance risks and to engage investee companies in relation to these risks.

1.3 Regnan clients invest around A$52 billion across S&P/ASX200 index companies or around one in eight dollars invested by institutions in companies that comprise that market index.

1.4 Regnan was incorporated in May 2007. Prior to this time, the underlying governance engagement process adopted by Regnan was exercised by the BT Governance Advisory Service, a specialist business unit of BT Financial Group. BT GAS commenced in December 2001 with a mandate from the then PSS and CSS schemes, now ARIA.

1.5 In transitioning from BT GAS to the independently owned Regnan in May 207, institutional investment in proactive engagement grew more than five-fold from $9 billion to $52 billion.

1.6 This submission reflects the views of Regnan and its observations relate only to institutional investment.

1.7 Regnan submits that constructive engagement by institutional investors with listed companies is increasing in frequency and depth, but that a lack of clear regulatory guidance and a number of practical barriers are constraining desirable progress.

2. Understanding governance

2.1 Regnan regards governance as being concerned with the stewardship of enterprise. Governance concerns itself with managing risks arising from the separation between principals (owners) and agents (directors and their management). Corporate governance, as traditionally understood, is but one pillar of effective principal-agent risk management.

2.2 Regnan has been mandated to report to its institutional investor clients in relation to governance of investee companies since December 2001. Environmental, social as well as corporate governance risk has always comprised this mandate. This view of ESG has recently become more generally accepted, but is not yet market practice.

2.3 A "three-pillars" approach to governance risk management is more economically rational than a single "corporate governance" focus. Company boards that might be 'independent' and 'align executive remuneration with shareowner interests' (the "80%" of corporate governance concern), can just as readily destroy value through poor environmental or social governance practice. It is Regnan's view that the more significant governance failures for Australian companies have in fact arisen due to poor governance over stakeholder interests; for example see commissions of inquiry into both James Hardie(Jackson) and AWB (Cole).

2.4 The United Nations Principles for Responsible Investment (UN PRI) provides a flexible mechanism whereby institutional investors can exercise governance over all three pillars of governance. A feature of the UN PRI was its development by institutional investors, for institutional investors and has been effective in bridging between US, UK/European as well as Australian investors. Three Australian institutions were founding signatories to the UN PRI. Around 200 investors globally have adopted these principles, of which more than 10% are Australian institutions. The UNPRI provides an effective set of guiding principles for institutional shareholders wanting to enhance their engagement activities.

2.5 The UN PRI specifically uses the acronym "ESG" when making reference to governance. Principle 2 of the UN PRI specifically deals with "responsible ownership", including governance engagement.

2.6 Regnan encourages the Committee to adopt an ESG perspective when considering the subject of investment governance.

3. Duty to engage

3.1 Constructive engagement between shareowners and investee companies is integral to effective investment practice and it is Regnan's view that investors have a fiduciary duty to engage with investee companies. Constructive engagement is not an "optional practice" but is a practical investment tool for the purpose of minimising risk at a low transaction cost relative to more public and confrontational alternatives.

3.2 The fiduciary duty to engage was clearly endorsed by Justice Neville Owen in Chapter 6.3 of the HIH royal Commission – the Role of Shareholders:

> Shareholder apathy can play a part in undesirable corporate governance. If shareholders as owners are unwilling or unable to exercise their powers or make themselves heard, directors and management will lack guidance or constraint from those whose interests they are supposed to serve. Shareholders have an interest in

seeing that a board is properly constituted and in holding it to account for the company's performance.[1]

3.3 Regnan's view is that while Justice Owen provided a broad and rational interpretation of fiduciary duties there are still perceived limitations to the legitimacy of this interpretation among some institutional shareholders and financial intermediaries such as fund managers.

3.4 While Justice Owen went on to specifically refer to corporate governance as traditionally defined, Regnan believes these comments apply equally to a 'three-pillared' approach to governance.

3.5 In the absence of clear regulation or guidance from Regulators on the importance of engagement, Principle 2 of the UN PRI provides the means by which Justice Owen's statement can be translated into practical action:

We will be active owners and incorporate ESG issues into our ownership policies and practices. Possible actions:

- Develop and disclose an active ownership policy consistent with the Principles
- Exercise voting rights or monitor compliance with voting policy (if outsourced)
- Develop an engagement capability (either directly or through outsourcing)
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights)
- File shareholder resolutions consistent with long-term ESG considerations
- Engage with companies on ESG issues
- Participate in collaborative engagement initiatives
- Ask investment managers to undertake and report on ESG-related engagement.[2]

4. Governance engagement toolkit

4.1 In Regnan's view, there are three primary tools available to investors in the pursuit of engagement with investee companies. These are, in order of risk mitigation intervention:

- proactive engagement,
- voting shareholdings, and
- class actions.

[1] HIH Royal Commissioner Justice Neville Owen, The Failure of HIH: A corporate collapse and its lessons, Vol. 1, Part Three, Section 6.3

[2] See: http://www.unpri.org/principles/

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Australian shareowners have adopted one or more of these tools. The degree of adoption varies by each investor, depending on their individual needs including the circumstances of any one particular investment.

4.2 Regnan is a specialist engagement service and does not provide voting or class action services however it is our view that effective governance requires that investors access the tool(s) that are appropriate for specific needs.

4.3 Shared service models such as Regnan are economically practical approaches to meeting the engagement needs of institutional investors. This is no different to the business models adopted by proxy voting agencies and litigation specialists.

4.4 Investment in skills and resources is no less important in governance than other elements of investment management. Regnan employs a total of ten ESG specialists in order to research and engage all companies comprising the S&P/ASX200 index. Like many financial services, governance is dominated by fixed costs and shared service models maximise the ability of investors to engage their investee companies while ensuring an appropriate depth of research skills. As Justice Owen also observed in his HIH Royal Commission:

> But just as corporations must avoid a 'tick the box' approach to corporate governance, so too should investors avoid analysing corporations by rote.[3]

5. Impediments to engagement

5.1 Impediments to further engagement by institutional investors include the following:

- Limited understanding of engagement mechanisms and when or why to use each method.
- Lingering uncertainty about the breadth of fiduciary responsibilities of trustees and institutional investors, and lack of regulatory guidance to provide clarity.
- A weak or inconclusive demonstration of engagement or participation practices by government as investor.
- An inadequate understanding of Environmental and Social governance issues among funds managers.
- The relatively 'new' cost burden to institutional investors of performing research, oversight and engagement activities.

There are a number of factors influencing this state progress.

[3] HIH Royal Commissioner Justice Neville Owen, The Failure of HIH: A corporate collapse and its lessons, Vol. 1, Part Three, Section 6.3

5.2 Despite principles of good governance being integral to the legitimacy of the limited liability company, the modern notion of governance was significantly and only recently boosted by Sir Adrian Cadbury's Report in December 1992.[4]

5.3 In Australia, the Australian Securities Exchange only introduced governance principles in 2003 and the transition from Corporate Governance to an ESG framework remains a work that is in the very early stages of progress following a detailed review by the Parliamentary Joint Committee on Corporations and Financial Services in 2006.[5]

5.4 The UN PRI is only a recent addition to the set of principles to guide institutional investors.

5.5 Investment in effective engagement practices requires a long-term investment perspective. Governance engagement benefits are, by their very nature, difficult to measure. The manifestation of risk, through depressed share prices, makes for easy measurement. Governance engagement however is aimed at mitigating or avoiding risk. Thus successful engagement should mean that measurable risk is not achievable.

5.6 This paradox of engagement has some similarity with insurance. A property owner who maintains, say, 20 years of insurance cover for fire is taking reasonable steps in risk minimisation. After 20 years the insured may never have claimed on their policy. What has been the actual benefit of the policy that has been in force for the 20 years and considerable premium paid over that period?

5.7 Just as the property owner who fails to maintain appropriate insurance makes for a poor asset manager, the investor who fails to engage fails to optimise their investment management. Where the investor is managing other people's money, this sub-optimal management is even more apparent.[6]

5.8 Despite the impediments and factors influencing these, there are a number of positive trends that are encouraging greater engagement by institutional investors.

5.9 Increasing adoption of the UN PRI by institutional investors provides a significant and positive signal that institutional investors are now recognising the importance of a substantial approach (as opposed to a form-based approach) to all three pillars of governance. The Australian Council of Superannuation Investors (ACSI) played a significant role in their review of the UN PRI and subsequent recommendation of adoption to their 41 members around August 2006. The non-proscriptive structure of the UN PRI means that adoption of the Principles will see further improvements to engagement practices by investors.

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[4] See : The Report of the Committee on the Financial aspects of Corporate Governance at www.ecgi.org/codes/documents/cadbury.pdf

[5] See Corporate responsibility: Managing risk and creating value at www.aph.gov.au/senate/committee/corporations_ctte/corporate_responsibility/report/index.htm

[6] Again see Justice Neville Owen referred to at 3.2.

5.10 As more investors review and adopt the UN PRI, this can be expected to increase demand for engagement resources within institutional investors as well as in engagement services such as Regnan.

5.11 The challenge of calculating a numeric value to any one or more engagement activities in and of itself should not be a defence to a failure to engage. Poor governance is known to drive specific stock risk (ie. Loss to shareowners) whether it be derived from the governance of environmental factors, social factors or corporate factors.

5.12 It is reasonably foreseeable and better understood that poor governance can trigger community risks (consumer or labour boycott), regulatory risks (increasing the cost of operating enterprise to all investee entities) as well as litigation risk (possible pecuniary loss as well as reputation).[7]

5.13 In addition to viewing these risks on an individual investment basis, modern institutions are universal investors and this has fundamentally changed their approach to governance and risk assessment.

6. Institutional investors: Universal and permanent portfolios

6.1 The significant growth of institutional investment, particularly following the introduction of occupational superannuation in 1992, has led to two concepts that did not exist as little as 10 years ago. These are permanent share ownership and universal share ownership.

6.2 Diversification is a fundamental risk management tool used by institutional investors.[8]

6.3 For many institutional investment portfolio's (in particular larger superannuation funds) diversification means the risk of not holding a particular security is as great as the risk of holding too much. Institutions are therefore exposed to every environmental, every social and every corporate governance risk residing in the relevant benchmark index that typically defines the "investible universe".

6.4 Historically most institutional investors have been concerned with only the risk of an individual investment relative to its benchmark. This has driven the focus on selection of active funds managers with the aim of adding value against the benchmark.

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[7] S 52 (2) The covenants:
The covenants referred to in subsection (1) are the following covenants by each trustee of the entity: ... f) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following: ...(i) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;

[8] The duty to ensure adequate diversification is codified in SIS Act S 52 (2) (f) (ii) to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following: ... (ii) the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification.

6.5 At the aggregated portfolio level, that is the aggregation of diverse investment styles,[9] the institutional investor will typically own most if not all of the benchmark. Thus permanent share ownership is consistent with effective diversification however it needs to be recognised for its implications for effective governance.

6.6 In addition to permanent ownership, the new paradigm for institutional investors is a reality of universal share ownership.

6.7 The diversification of institution investment strategies has meant these portfolios typically own all elements of economic means of production. That is, institutional investors own the exploration and extraction of minerals. They also own the transport system for goods and services (planes, trains and tollways), the real estate upon which commerce is located. They own the manufacturer of goods and provider of services, the banking and insurance system that underpins such commercial activity, as well as the tourism assets used by the labour force (and others) for recreation.

6.8 This universal ownership means institutional portfolios include exposure to an investee company's performance that is derived from stakes- or 'referred risk' from that company's suppliers, competitors and neighbours. Universal owners are exposed to the performance of the entire benchmark and therefore to broad factors such as consumer confidence, market integrity and a stable economy. For universal investors, a company's externalities are costs borne elsewhere in the portfolio.

6.9 Another description of universal ownership is below:

> A universal owner is a large financial institution, such as a pension or mutual fund, which owns securities across a broad cross-section of the economy. Because of the diversified portfolio of stocks, bonds and other asset classes, investment returns (especially long-term ones) will be affected by the positive and negative externalities generated by the entities in which the universal owner invests. Being external means they are not controlled by the entity and therefore can be viewed in terms of potential risk (for negative externalities) or opportunity (for positive ones).
>
> On the one hand an investor may benefit from the investment returns generated directly by a company or sector that itself is responsible for creating the negative externalities (costs borne by other firms or by society at large). On the other hand, this benefit comes at the expense of a negative impact on the investment returns to other investments that to some degree absorb the negative externality. Because universal owners own cross-sections of the economy, they inevitably find that some of their holdings are forced to bear the cost of other sectors' or firms' externalities. This creates an incentive for universal owners to minimize negative externalities and maximize positive ones across portfolio holdings.

[9] Generally accepted investment styles for equity investments include Value, Growth, Quantitative, Thematic, Core (no deliberate style bias), Index and Enhanced Index. As each style adopts a different range of criteria in stock selection the aggregation of these styles within an investment strategy ensures diversification of stocks – being a much greater number of stocks held than had just one style been adopted.

Typically, the cost of negative externalities significantly exceeds the cost of their mitigation, resulting in a "dead weight loss" to universal owners if corrective action is not taken.[10]

6.10 The most important economic outcome of universal ownership is the absence of externalities is the fact that what were traditionally regarded as "independent" (that is, separate) investments are in fact inter-dependent.

6.11 The universal investor who "buys" poor corporate governance in the pursuit of super-normal investment return must also take into account any impact from the fact they will also own the provider of banking services and the insurance sector that finance and / or underwrite some or all of that governance risk. This is the same for the "buyer" of poor environmental governance who is fact threatening the long-term license to operate of the individual investee entity, together with the risk of regulatory imposts across all companies within a particular sector of commerce, or even the entire universe of investee companies (eg. Corporations Act, ASX listing rules or "voluntary" codes of conduct).

6.12 Modern investment brings together the traditional challenge of selecting outperforming assets, while cognisant of permanent and universal share ownership. Under this new paradigm, the efficient portfolio is like solving the Rubik's Cube. The Cube that is the efficient portfolio cannot be solved (achieved) without the intelligent application of governance practices, including engagement of investee entities.

7. Opportunities for regulatory reform

7.1 Just as there is no legislating for ethical business practice, there is no 'silver bullet' for effective governance practices, including engagement.

7.2 A key means to support growth in engagement by investors is greater communication and education regarding the role of engagement within the sphere of economically rational investment decision-making. The sole purpose for encouraging engagement lies in its effectiveness in ensuring the exercise of a fiduciary duty [11] and as a component of cost-effective risk management.

7.3 Section 1013DA of the Corporations Act indirectly deals with investor engagement and the related ASIC guidance indicates that engagement is necessary to obtain information about the legitimacy of environmental, social or ethical claims made by investee's.[12] It may be appropriate to review the effect of this and other legislation relating to governance and risk (for example the Superannuation Industry Supervision Act S 52.) to examine whether the current legislation and regulations:

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[10] Universal ownership: exploring opportunities and challenges. Conference report, April 10-11 2006. Saint Mary's College of California and Mercer Investment Consulting.

[11] See 3.2, above.

[12] See REGULATORY GUIDE 65: Section 1013DA disclosure guidelines, © Australian Securities and Investments Commission December 2003, page 17, specifically 2.16 (a) and (b)

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a) provide a legitimate platform to enable governance engagement practices to develop, and

b) whether specific guidance would remove any uncertainty as to the legitimate role of engagement in the exercise of institutional investment.

7.4 It is Regnan's view that while the legislative and regulatory regime is not inconsistent with the adoption of engagement practices, their adoption would be assisted if engagement was specifically addressed in ASIC Guidance.

7.5 A research effort along the lines of the Commonwealth's leading publication, The Mays Report; Corporate sustainability – an investor's perspective, would be a useful and timely contribution.[13] The key ingredients in the Mays Report were the use of a steering committee selected from leading practitioners with expertise within the investment industry, and detailed case studies that provided insight into the issue being communicated.

7.6 The Commonwealth should be encouraged to formally adopt a pro-engagement policy, while leaving its respective investment agencies to determine the degree to which engagement can be an effective tool in their exercise of efficient investment practice.

7.7 APRA should be encouraged to give appropriate consideration to the use of governance tools, including engagement, when reviewing the practices of those institutional investors that fall within their jurisdiction.

[end of submission]

[13] See www.environment.gov.au/settlements/industry/finance/publications/mays-report/index.html