Governance Institute of Australia

T +61 2 9223 5744 F +61 2 9232 7174
E info@governanceinstitute.com.au
Level 10, 5 Hunter Street, Sydney NSW 2000
GPO Box 1594, Sydney NSW 2001
W governanceinstitute.com.au

20 April 2015

Melissa Lui
Lawyer, Corporations
Australian Securities & Investments Commission
Level 5, 10 Market Street
Sydney NSW 2000

By email: policy.submissions@asic.gov.au

Dear Ms Lui

Consultation paper 228: Collective action by investors Update to RG 128

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on the practice of governance. We provide the best education and support for practising chartered secretaries, governance advisers and risk managers to drive responsible performance in their organisations.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies. They frequently are those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC), and in listed companies have primary responsibility to deal with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules. Our members have a thorough working knowledge of the operations of the markets and the needs of investors, as well as compliance with the *Corporations Act 2001* (the Act). We have drawn on their experience in our submission.

General comments

Governance Institute welcomes ASIC's efforts to facilitate investor engagement on corporate governance, including through collective action. A healthy relationship between ASX-listed entities and their long-term institutional investors (both asset managers and asset owners) is crucial to the efficient functioning of Australia's economic system. Effective engagement between them is central to maintaining the health of the relationship. When effective engagement takes place, benefits accrue to both parties, who both want the entity to prosper and perform well over the long term, operating under a sound governance framework. Consequently, engagement between those entities and institutional investors is a leading edge area of corporate governance in Australia. Governance Institute recognises the importance of constructive investor engagement in maintaining good corporate governance, and in 2014, in conjunction with Sandy Easterbrook, issued *Improving engagement between ASX-listed companies and their institutional investors: Principles and Guidelines* (available at http://www.governanceinstitute.com.au/media/678497/improving-engagement-asx-listed-companies-institutional-investors-guidelines-final.pdf).

However, we also recognise that the challenge in any regulatory response is to achieve a balance between facilitating investor engagement, including collectively, to promote good corporate governance, and the need to ensure that control over an entity does not occur

inappropriately. We commend ASIC on its efforts to achieve this balance — Governance Institute acknowledges that it is a very difficult balance to achieve in a Regulatory Guide.

While we appreciate the efforts made by ASIC in preparing the draft Regulatory Guide 128 (draft RG 128), our comments in this submission point to where we find that draft RG 128 has not achieved the intended balance and where we are of the view that it can benefit from greater clarity. We recognise that ASIC is seeking to clarify that it intends to more closely monitor investor action that involves replacement of directors or specific strategic decisions and we agree that the focus needs to be on collective action that can lead to inappropriate control. We also recognise that ASIC has sought to clarify that it will not examine collective action aimed at promoting good corporate governance only. Such action could include investors seeking better disclosure to the market; more comprehensive board evaluation processes; more sophisticated risk management systems; improved sustainability or corporate social responsibility reporting; and changes to executive remuneration frameworks.

However, we are of the view that draft RG 128 has a tendency in some aspects to over-regulation of legitimate forms of engagement intended to secure improvements in governance processes and outcomes. Such engagement may, for example, involve investors speaking with each other to promote better corporate governance in the entities in which they invest with no objectives in relation to change in control of the entity concerned. We provide detailed comment on this below.

Draft RG 128

Investors taking action on matters of corporate governance are not seeking control of the entity

Paragraph RG128.6, notes that:

> The challenge for investors in wishing to act together to promote good corporate governance in an entity is that the takeover or substantial holding provisions are broadly drafted and the actual situations to which these provisions apply are variable.

The problems that arise from this broad drafting go to the heart of why the balance in draft RG 128 has not always been achieved between facilitating collective, constructive investor engagement on corporate governance and the need to ensure that control over an entity is not achieved inappropriately.

Section 12(2)(b) of the Act provides that investors may become ‘associates’ if they enter or propose to enter into:

> a relevant agreement for the purpose of controlling or influencing the composition of the designated body’s board or the conduct of the designated body’s affairs.

Section 9 of the Act provides that:

> **relevant agreement** means an agreement, arrangement or understanding:
> (a) whether formal or informal or partly formal; and
> (b) whether written or oral or partly written or oral.

Investors seeking to control the composition of the board or to influence the conduct of the designated body’s affairs may be seeking control of the company. Good corporate governance, however, would see it as entirely proper for investors to seek to *influence and improve* the composition of a company’s board and management decision making and governance processes *when there is no objective of gaining control*.

It is central to investor engagement on good corporate governance that investors form a view as to the effectiveness of the board, including how it is managing board renewal and succession planning. Investors therefore have a legitimate interest in board composition and will vote on director elections and re-elections, that is, they will seek to influence board composition. The question of control is, in such a process, not an objective at all.

We note that some long-term institutional investors such as superannuation funds have notified the market that they intend to use their voting power to vote against director re-elections when they hold concerns about the corporate governance in any particular entity. Importantly, when such investors vote against director re-elections, they do not propose candidates themselves or seek to appoint replacement directors. They are not seeking to control the composition of the board. They are using their voting power as a 'wake-up call' to the board that they have concerns with the governance of the entity.

However, given the current drafting of the provisions in the Act, and regardless of ASIC's intention to support such collective action by investors, if two investors hold a discussion in which they each note that they intend to vote against a director who is standing for re-election, due to concerns, for example, with the length of the director's tenure and a poor history of governance during that tenure, the mere fact of the discussion may see them being classed as 'associates'. There is a risk that the discussion would constitute an 'understanding' in which the investors sought to 'influence' the composition of the board, regardless of whether each had independently arrived at the same decision.

While we accept that ASIC has sought to clarify that it would not see such discussions giving rise to an association, involve entering into a relevant agreement or constitute unacceptable circumstances, draft RG 128 confirms that concerns may arise for the regulator if there is an understanding that investors will vote in a particular way(see Table 1).

Our members are of the view that it is important to consider the historical circumstances in which the provisions of the Act were drafted and introduced. In the 1980s, a spate of hostile takeover activity saw a number of loosely allied companies seek to take over public listed companies. Two main goals had underscored the evolution of the takeover provisions: namely promoting the efficiency of the market for corporate control and providing shareholder protection. The Eggleston Report, which informs the takeover provisions, had been particularly concerned to ensure that shareholders knew which person(s) were in the position to determine the future of the company through their voting power, that there was equal opportunity for all shareholders and that all shareholders were abiding by the rules.

While we appreciate that ASIC has to have regard to the law as it stands, our view is that draft RG 128 tends to blur the line between investors acting collectively for the legitimate purpose of promoting good corporate governance and the inappropriate purpose of seeking to control the entity.

Table 2: Conduct more likely to constitute acting as associates or entering into a relevant agreement giving rise to a relevant interest

This blurring is very apparent in Table 2.

Sections 249D and 249N have more frequently been used to call for constitutional change or the removal of directors arising from investor concern over particular aspects of the governance of the entity than for the purpose of seeking control of the company. However, draft RG128 sets out the use of these provisions as evidence of conduct more likely to constitute acting as associates or entering into a relevant agreement.

Section 249D has recently been amended. We supported the repeal of the 100 member rule that provided for 100 members to requisition a meeting (for example, Woolworths was forced to hold a general meeting to consider a resolution on $1 limits on poker machines, and while the meeting reportedly cost $500,000 to run, the resolution only received support from 2.5 per cent of shareholders). However, we were also in support of the provision that allows for groups with five per cent of the votes that can be cast to requisition a general meeting, as it is good corporate governance for shareholders to be able to requisition a general meeting to discuss issues of governance if there is a reasonable level of shareholder support for such a discussion before other shareholders are put to the cost of a meeting.

We recognise that some shareholder activists have acquired just over five per cent of shares in a company to requisition a general meeting to be convened for a particular resolution to be put to shareholders. In doing so, they have aimed to effect a substantial change in the targeted company, such as the reconstitution of the board, without expending the necessary capital to acquire a controlling stake in the company. Table 2 is intended to clarify that ASIC will closely examine such collective action to assess if there is a breach of the provisions under Chapter 6.

However, by providing this as a worked example of conduct seeking to control the entity inappropriately, the use of this shareholder right to express joint concerns over corporate governance practices within an entity is stifled.

Section 249N provides for the right of 100 members to put issues on the agenda of the annual general meeting (AGM), and we see this as a central plank in a corporate governance framework. Directors are not obliged to include in a notice of meeting a proposed resolution whose object could not lawfully be effected. Shareholders cannot put ordinary resolutions to the general meeting concerning the day-to-day management of the company — they can only seek constitutional change. For example, at the 2014 AGM of Commonwealth Bank of Australia Ltd, a group of shareholders requested the inclusion of a resolution to amend the constitution so as to require that the board of the entity determine and report to shareholders each year on its assessment of the quantum of greenhouse gas emissions financed by the entity. Being a proposed change to the constitution, this was included in the notice of meeting as a special resolution. The group proposing the resolution comprised 0.0086% of the company's shares on issue. While the resolution sought to influence management decision making through a change to the constitution, it did not seek to control that decision making.

Table 2 shows the risk of over-reach evident in RG128. Our knowledge of the use of these provisions is that they have been utilised frequently by investors with the objective of promoting good corporate governance. Their use by investors on a collective basis should not be interpreted automatically as investors seeking to control the company inappropriately.

The two-strikes rule

We are concerned that draft RG128 makes no reference to the two-strikes rule, which is a mechanism that can be used to seek control of an entity inappropriately.

The Corporations Act provides that:

- if 25 per cent of the votes cast at an AGM oppose the adoption of the remuneration report, and shareholders make comments at the AGM on the report, then in the following year the board must report in the annual report, on any proposed responses to those comments, or explain why it does not propose any response.
- if 25 per cent of the votes cast at two consecutive AGMs oppose the adoption of the remuneration report, then at the second AGM the company must give shareholders the option (if 50 per cent or more of votes cast are in favour of a 'spill') to require that the entire board (except the managing director and any directors appointed since the remuneration report was approved by the board) stand for re-election at a further general meeting (the spill meeting). This meeting must take place within 90 days.

The vote on the remuneration-report resolution has been used in some instances as a proxy for other concerns about the corporation, including general performance concerns. If the vote is against the resolution in two consecutive years, the potential for the vote to be used as a means of replacing the board is very real. This is particularly the case in small companies, where the restrictions on voting, which exclude the key management personnel named in the remuneration report, can see a minority of investors control the vote. The use of the two-strikes rule where it leads to a spill motion can prove to be a destabilising tool in the hands of companies intent on a hostile takeover. Investors that acquire 20 per cent of a relevant interest in voting shares (subject to the exceptions that are available) — the trigger point for compulsory acquisition — could spearhead moves against the company's board on the pretext of its remuneration report. While voting on the spill motion and, if necessary, the subsequent re-election of directors does not exclude key management personnel (who often have significant shareholdings) and is based on the usual principle of majority, not the 25% threshold, the potential for seeking inappropriate control of the entity under this rule exists.

We strongly recommend that the RG contain worked examples of the use of the two-strikes rule to seek control of the entity and how ASIC would deal with such circumstances.

Replacement of class order

We note that Commissioner John Price stated in a letter to the editor published in the *Australian Financial Review* on 25 March 2015 that any regulatory action would consider whether the 'conduct undermines takeover and substantial shareholding disclosure laws, rather than simply for promoting good corporate governance'.

In order to facilitate this approach, which we can see draft RG 128 seeks to achieve, **we recommend** that a class order is required.

Draft RG 128 seeks to clarify that the existence of a voting agreement is likely to be price-sensitive information and may need to be disclosed before any person with knowledge of that voting agreement trades securities. We are also of the view that for RG 128 to function in the manner that ASIC intends, investors need to provide ASIC with the information it needs to ascertain if the collective action is conduct that is seeking to control the entity or to promote good corporate governance.

We do not recommend that the current class order be retained.

Rather, **Governance Institute recommends** a new class order be introduced to provide relief for those investors seeking collective action for the purposes of promoting good corporate governance from the definition of 'associate' and 'relevant agreement', given those definitions were drafted in a different era, one that did not contemplate the extent of shareholder engagement on matters of governance that we now see taking place.

We recommend that investors should not have to apply for relief — we recommend standing relief. For example, the ASIC class order on share purchase plans operates as standing relief, so that if companies meet all the conditions set out in the class order, they can rely on it and need not apply.

Our reasons for recommending standing relief are that investors may not see an issue of governance concern arise until they receive the notice of meeting. Institutional investors currently have to lodge their votes 18 to 20 days before the meeting to ensure they will make their way through the chain of custodians and end up with the nominee in time to meet the statutory deadline for the lodgement of proxies. They also need to consider the recommendations from proxy advisory firms. When notices of meeting are issued no later than

28 days prior to the AGM as required by the Corporations Act, this would leave a very narrow window of time for investors to communicate with each other, apply for relief and have the relief considered.

However, we are conscious that standing relief could be abused by investors seeking to control the entity inappropriately. **We recommend** that investors acting collectively must inform ASIC that they are relying on the relief and inform ASIC of *why* they are relying on the relief. This provides ASIC with the opportunity to consider whether the relief is being used appropriately and to extend scrutiny to the circumstances applying in the use of the relief if concerns arise. This would facilitate ASIC's intent to provide for collective action by investors seeking to promote good governance.

Conclusion

Governance Institute is of the view that the focus in draft RG 128 should be on collective action that is used to seek control of an entity inappropriately, rather than collective action by investors seeking to promote good corporate governance. While we appreciate that ASIC has sought to do this in the draft, we are of the view that the current draft does not always achieve this balance. We are also of the view that a replacement class order, set up quite differently from the current class order, would assist ASIC to achieve this balance.

Governance Institute also recommends that amendments may be required to the Corporations Act to facilitate collective action by investors seeking to promote good corporate governance in the entities in which they invest. We would be more than happy to discuss any such proposals with ASIC.

We would also be more than happy to review a revised draft RG 128.

Yours sincerely

Tim Sheehy
Chief Executive