



29 March 2006

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Submission to the Discussion Paper on Corporate Social Responsibility

Dear Mr Kluver

AMP Capital Investors (AMPCI) is pleased to provide a submission in response to the Corporate Social Responsibility Discussion Paper from the Australian Government Corporate and Markets Advisory Committee (CAMAC). Recognising that CAMAC will access submissions to the Parliamentary Joint Committee on Corporations and Financial Services (PJC), and the closely related nature of this inquiry, we draw the attention of CAMAC to the AMPCI submission to PJC (7 September 2005).

This submission complements the submission from our Sustainable Funds Team to the PJC, addressing many of the issues raised by CAMAC in the Discussion Paper. This submission outlines issues from the perspective of AMPCI, and its investees, and as such, it may not represent the views of AMP Limited, or its related entities.

By way of background, AMP Capital Investors is one of Australia and New Zealand's leading specialist investment managers. We manage over A\$88 billion for investors; it is our only focus. AMP CI has been contributing to improving the Corporate Governance of Australian companies for many years. We vote on all resolutions put at meetings of all companies in which we hold shares and engage with companies in which we wish to see an improved level of governance. As a result of this relationship with companies, we continually consider the role and performance of Australian company directors. More details on the work undertaken by AMP CI in the area of corporate governance can be found at www.ampcapital.com.au.

In addition, the AMPCI Sustainable Funds invests over 1 billion in Australian listed assets. The Funds actively consider 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.

Our response to the Discussion Paper, given in Annexure A, includes our commentary on the four questions posed to CAMAC. AMPCIs views can be summarised as follows:

1. Directors should have regard to the interest of specific classes of stakeholders or the broader community when making corporate decisions because having regard to these stakeholders is necessary to:
 - a. manage the crucial intangible assets of the organisation; and
 - b. minimise the risk of additional regulatory and compliance costs.

Given the disparate views expressed in the submissions to the PJC, the current expectations of directors requires clarity with respect to the extent to which they take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions. Clarity can be achieved through the following, or similar, revision to the Corporations Act:

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.*

2. In addition, to meet the implied social contract obligations to the community implicit from allowing companies limited liability and being a legitimate party in civil society, companies need to act in a manner acceptable to society's expectations.

A suggested revision to the Corporations Act should be:

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

3. Australian companies should be encouraged to adopt socially and environmentally responsible business practices to ensure enlightened shareholder value. A variety of industry initiatives and best practice social and environmental reporting are available to assist the transition to these business practices and should be encouraged by government and industry groups.
4. 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. This could replace the requirements currently provided under s299(1)(f)
5. To facilitate effective disclosure of material non-financial issues, further guidelines are required to assist companies meet the intent of s299A Corporations Law. The disclosure should be of issues that directors are already 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.

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: Response to the Discussion Paper

The CAMAC Discussion paper raises the broad question of “*What are the incentives or disincentives for a company to conduct its business in a socially responsible manner?*” We believe that from an investor perspective, the incentives are clear - the sources of business value and structures of corporate governance are changing. Intangible assets such as brands, intellectual property, knowledge and reputation are increasingly central to corporate success. In addition companies are also vulnerable to social, ethical and environmental risks.

Companies that take a proactive approach to managing their social and environmental responsibilities are likely to exhibit higher quality management, stronger innovation, better relations with regulators and communities, increased ability to attract and retain key staff, greater resilience to shocks and enhanced market reputation. We believe that this will result in a lower risk relative to peers and consequently a higher valuation and outperformance over the long-term.

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 companies¹. 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.

Our response to the Discussion Paper includes our commentary on the four questions posed to CAMAC.

1. Should the Corporations Act be revised to clarify the extent to which directors may take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions?

This question implies a degree of uncertainty on the part of directors and others about the issue of accounting for the interests of stakeholders. Submissions to the PJC inquiry² support the assertion about uncertainty, producing a range of interpretations about role of relationships with other stakeholders and what the broader concept of “corporate social responsibility” means for company directors. Some respondents (or stakeholders) focussed on the complete suite of sustainability issues that could be interpreted as corporate responsibility actions, while others narrowly interpreted obligations, basing discussion upon common company actions currently carried out, such as the role of directors in allowing company donations. Given this disparate understanding about the space which directors should be operating within, there is little surprise that submissions indicated stakeholders were experiencing a varying extent of consideration to their interests or the interests of the community, by companies.

It is our understanding that the current 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.

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 safety³, 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.

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,

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

2 http://www.aph.gov.au/Senate/committee/corporations_ctte/corporate_responsibility/index.htm

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

financiers, employees, contractors and the community. These relationships with stakeholders are important for developing and implementing a company's strategy and in the management of risk. Therefore, there is an obligation on directors 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 to 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.

Given the disparate views on the role of stakeholder issues and timeframes under which directors should be operating, it is not surprising that Directors may feel uncertain about their duties. Faced with this uncertainty, it is also not surprising that some Directors may take a risk averse or a narrow legal interpretation of their duties, to the detriment of shareholders and stakeholders.

Therefore, it appears that it is appropriate to clarify the duties of directors. Clarification can be achieved through the following, or similar, revision:

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.

2. Should the Corporations Act be revised to require directors to take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions?

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 existing and potentially 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 & Company⁴ and others⁵ 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.

⁴ Court, D., & Loch, M., (1999), Capturing the Value, Advertising Age, 70 (46), pp. 12-15.

⁵ Gu, F., & Lev, B., (2001), Intangible Assets: Measurement, Drivers, Usefulness

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.

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.

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.

The changes to Section 180(2)(d) of the Corporations Act suggested in the previous discussion clarifies the existing duty of directors to consider stakeholders, when there is alignment between stakeholder and company interest.

In addition, companies expect to be legitimate stakeholders in civil society, making demands of governments and society 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 for which companies, shareholders and society also benefits. 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.

However, the Corporations Law appears not to encourage a company to meet its social contract. This becomes particularly important at times when the company's interest, especially in the short term, may be in conflict with the community's expectation of appropriate corporate behaviour.

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. Consequently, an appropriate requirement for directors can be achieved with the following revision:

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

3. Should Australian companies be encouraged to adopt socially and environmentally responsible business practices and if so, how?

From the investor perspective, greatest shareholder value is generated when corporations follow the maxims of enlightened shareholder value, suggesting that Australian companies should be encouraged to adopt socially and environmentally responsible business practices. These maxims include:

- socially and environmentally responsible business practices ensure that directors will focus on both short and long term consequences of business decisions;
- business practices aimed at promoting shareholder interests must consider other stakeholders such as employees, customers, suppliers, the environment and society, particularly when the business relies on these stakeholders for their success. In other words, “shareholders are not likely to do well out of a company whose workforce is constantly on strike, whose customers don’t like its products and whose suppliers would rather deal with its competitors.”⁶

To encourage the adoption of responsible business practices, there are a number of industry initiatives which promote and assist the transition to social and environmental responsibility. For example, The Minerals Council of Australia’s Enduring Value Code 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 including the environment 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.

The voluntary nature of the initiatives also raises other issues. If the initiatives are used as a way of demonstrating that self-regulation is more appropriate than new laws, some companies will take advantage of their voluntary nature and avoid or not meet their corporate responsibilities.

Notwithstanding these reservations, Australian companies should be encouraged to adopt the socially and environmental practices that these initiatives should be encouraged.

One particular area that should be encouraged in the area of voluntary reporting on a company’s environmental and social performance. Reporting encourages accountability for a company’s environmental and social performance, which can be important to both employees and external stakeholders. 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.

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.

⁶ Professor Paul L Davies Enlightened Shareholder Value and the New Responsibilities of Directors. Inaugural WE Hearn Lecture, 4 October 2005

A recent study⁷ found that only 116 companies among the 509 covered by the study produced reports that discussed 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.

4. Should the Corporations Act require certain types of companies to report on the social and environmental impact of their activities?

Despite guidelines for reporting environmental and social issues and risks (such as the ASX Corporate Governance Council *Principles of Good Corporate Governance and Best Practice Recommendations*), many companies do not provide adequate information to enable shareholders to determine the material changes to a company's risk profile. The focus of reporting remains the short term disclosure of financial information, with a lack or absence of short term corporate responsibility performance and long term environmental and social risk.

Apart from the requirements under s299(1)(f) and s299A 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. The absence of regulation is in an environment where many of the issues that could be reported are information that the directors of a company should reasonably be expected to know or would have easy access to, e.g. compliance breaches; Loss Time Injury Frequency Rate (LTIFR); presence of a certified EMS; and donations to political parties.

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 suggests that the directors may not have inquired or have appropriate non-compliance reporting mechanisms.

Given that meeting legal requirements is the minimum standard set by the community for a company's corporate responsibility and therefore a measure to assess whether directors are meeting their duties, it is proposed that the Director's Report provides details on all non-compliances within the financial year. This should provide an ideal corporate responsibility KPI of the director to shareholders. 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.”

S299a requires the disclosure of non-financial information that shareholders would reasonably require to make an informed assessment of:

- the operations of the company reported on;

⁷ More information on the scope of current reporting is available at www.deh.gov.au/settlements/industry/corporate/reporting/links.html

- its financial position, and
- the company's business strategies and its prospects for future financial years.

Of particular interest to shareholders should be the business strategies and prospects for future financial years, with regard for non-financial issues. For example, if extreme or unusual weather patterns affect the quantity or quality of a natural resource input, how will this effect production levels and costs, and what is the company's understanding of climate change in this scenario. What is the company's strategy to mitigate further harm from weather or climate change impacts. Perhaps more importantly for investors, what is the contribution of that company to climate change and what are its strategies to mitigate its contribution.

The Explanatory Memorandum states that this section provides the flexibility to allow disclosure to evolve over time as reporting expectations of the mainstream market change. Unfortunately some companies have tended to take a minimalist approach to reporting in general and as such are unlikely to meet the important intent of the section of appropriately informing shareholders of key non-financial information.

Other jurisdictions have taken a slightly more prescriptive view on what should be reported.

The UK's shelved Operating and Financial Review (OFR) regulations provide some valuable direction for changes to be made here in Australia. The OFR required 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 were covered by the OFR were 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 for Australian companies 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.

The recent retraction of the OFR in the UK was in part due to reporting requirements that many British companies and those throughout the EU will need to meet under the EU Accounts Modernisation Directive (AMD). The AMD requires companies to report relevant environmental and workplace matters using key performance indicators (KPIs) *"to the extent necessary for an understanding of the development, performance or position of the business of the company."*

In principle, the AMD provides directors with the requirement to report non-financial information about material risks and strategies of the company, which may affect its performance:

"...for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters."

Again, a similar disclosure requirement for Australian companies 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.