



Ethical Investment Association

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John Kluver  
Executive Director  
Corporations and Markets Advisory Committee  
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Dear Mr Kluver,

### **INQUIRY INTO CORPORATE SOCIAL RESPONSIBILITY**

The Ethical Investment Association (EIA) is pleased to make this submission in response to the Corporate Social Responsibility: Discussion Paper, released in November 2005, by the Corporations and Markets Advisory Committee (CAMAC).

The EIA is Australia's peak industry body for professionals working in the area of Sustainable Responsible Investment (SRI) and Ethical Investment and also helps individuals and organisations to learn more about how they can become sustainable and responsible investors. At present, almost every fund manager, superannuation fund and financial adviser working in the area of SRI is a member of the EIA, as are other professionals working toward similar goals.

The EIA was formed in 1999 to promote the concept and practice of SRI to an increasingly interested general public, to the mainstream investment community, to analysts, superannuation fund trustees, financial advisers, regulators, religious, charitable and other values-based organisations, government and non-government organisations and to the corporate sector.

The EIA Charter is as follows:

1. Business needs to be judged on environmental, social and governance performance, as well as their financial performance.
2. Business needs to continuously strive for improvement in all these areas of performance.
3. We support the growth of the SRI industry and believe it can assist business to improve performance.
4. We believe that SRI portfolios can provide competitive returns for investors within defined risk parameters.
5. We encourage transparency within the investment industry in order to empower investors.

The EIA also supports measures that seek to improve and promote corporate responsibility.

**Question One: 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 corporation decisions?**

Yes. The EIA believes that directors should have regard for the interests of stakeholders other than shareholders; that these interests should be formally incorporated into strategic and tactical decision making and, on occasion, should act as a constraint on pure profit-seeking behaviour.

This position is not inconsistent with the practices adopted by many companies. The EIA notes that some leading companies already have in place a framework and processes for taking into account various stakeholder interests when making strategic and financial decisions.

The EIA also notes that numerous company directors and peak business bodies are confident that the Corporations Act already permits such consideration to take place, and claim that it does indeed take place in many corporate boardrooms through both formal and informal processes.

However, as the Corporations Act is unclear regarding the extent to which directors may take into account the interests of other stakeholders, at the very minimum it should be revised to explicitly recognise directors' ability to consider the interests of non-shareholder stakeholders, particularly in relation to decisions that are likely to have negative environmental or social consequences.

Given that there appears to be little corporate opposition to the notion that such consideration routinely takes place, the business community should have no objection to legislated recognition of this flexibility - indeed, a legislated solution would do much to enhance the reputation of corporations, especially if accompanied by a community education programme promoting the important role that corporations play in promoting positive social and environmental outcomes in Australia.

The EIA's rationale for a legislated solution is simple; while the current Corporations Act requirements are flexible enough to permit directors to have regard to the interests of specific classes of stakeholders and the broader community, there clearly remains an attitude among some corporate officers in Australia that the interests of the broader stakeholder community can and should be sacrificed in the interests of short-term shareholder returns. Indeed, corporate law and practice in Australia has contributed to a perception among some executives that they have a *responsibility* to maximise returns to shareholders through the externalisation of environmental and social costs created as a result of the firm's economic activity (for example, unsustainable environmental practices, or inequitable labour practices).

The externalisation of environmental and social costs by the corporate sector raises two important commercial concerns for investors, as well as concerns about social equity.

Firstly, a company's profitability is impacted by its management of natural and human resources and this will affect shareholder returns. Secondly, the EIA believes that traditional company analysis is inadequate for long-term investment decision making if it fails to take into account the sustainability of sources of natural and human capital. Lack of disclosure of these issues creates a market that is inadequately informed about a company's prospects. Point two is particularly relevant in Australia where approximately 45% of listed Australian shares are owned by long-term superannuation investors.

Legislative clarification that directors have the flexibility to take into account the interests of non-shareholder stakeholders should be welcomed by the business community. It will give comfort and possible legal protection to those directors who may, from time to time, wish to act in the long-term interests of the company at the expense of short-term profits. It may lessen opposition to corporate philanthropy, community business partnerships and other charitable works. It will help promote innovation in the creation and delivery of more sustainable services, products and manufacturing. It will help reduce allegations of 'greenwashing' as well as general community cynicism regarding the primacy of the profit motive. And finally it may reduce the risk of further government regulation due to a softening of community attitudes.

**Question Two: 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 corporation decisions?**

The EIA interprets this question in two parts. The first being an examination of whether directors should be required to take stakeholder issues into account. The answer to this aspect of the question is "yes". For all of the commercial and ethical reasons outlined in Question One, the EIA believes that a general positive requirement for directors to take account of specific stakeholders in corporate decision-making is both commercially prudent and socially responsible.

In particular, there are unique issues at stake in this regard for the superannuation investment community. Long-term investors now dominate Australia's financial marketplace with superannuation set to grow significantly in the coming decades. A growing number of superannuation investors recognise that profitability is dependant upon a company's capacity and skills in building long-term co-operative relationships with

specific classes of stakeholders - in particular staff, customers, suppliers, the environment, shareholders and the host communities in which the company operates. These superannuation investors require assurance and disclosure that a company is aware of the risks and opportunities related to these issues and that decision-making is conducted in that framework.

In light of these considerations, the EIA also acknowledges that such a requirement may open avenues for a company to act in ways detrimental to shareholder value, and therefore adequate measures would need to be enforced to safeguard against self-interested or subjective decision-making.

The second part of the question is interpreted to ask whether a specific set or class of stakeholders should be identified within the Corporations Law. The answer to this aspect of the question would be “no”. The EIA believes that directors should have the opportunity to identify their own stakeholders and the priority which will be assigned to them. This plurality of approach is also reflected in the varying SRI investment styles. These differing SRI investment styles include:

- traditional ‘negative screening’ companies will rule out investment in certain activities or sectors;
- ‘positive screening’ companies will seek to prioritise investment in certain activities or sectors;
- ‘best of sector’ investors may invest in all types of activities and sectors, but seek to promote corporate change by prioritising investment in the companies in each sector that score most highly on certain criteria; and
- Investors using an ‘engagement overlay’ approach might invest in all activities or sectors, but seek to promote change by using their influence as shareholders to engage directly with company boards or management.

In summary, the EIA supports changes to the Corporations Law that encourage companies to act in the interests of society and the environment, however our experience is that there is no ‘correct’ approach to corporate social responsibility.

### **Question Three: Should Australian companies be encouraged to adopt socially and environmentally responsible business practices and, if so, how?**

Yes. The EIA strongly supports initiatives designed to encourage the adoption of socially and environmentally responsible business practices. We believe this will be best accomplished, in a manner beneficial to shareholders, companies and the community, through better disclosure to investors of the social and environmental consequences of business practices.

The EIA supports the strengthening and expansion of the existing ASX Principles of Good Corporate Governance and Best Practice Recommendations. It is noted that this has been recommended to the ASX Corporate Governance Council recently by the Federal government and the Federal Environment Minister, Ian Campbell. We further understand that the ASX Corporate Governance Council is undertaking work exploring how such a reporting regime might operate. Though the EIA is not a member of the ASX

Corporate Governance Council, we support its efforts as a robust forum through which the interests and concerns of both investors and companies can be addressed.

In the context of the ASX Corporate Governance disclosure regime, there is an opportunity to introduce stronger reporting and disclosure requirements of ASX listed companies through Principle 3 (“Promote ethical and responsible decision-making”), Principle 7 (“Recognise and manage risk”), and Principle 10 (“Recognise the legitimate interests of stakeholders”) of the ASX Principles of Good Corporate Governance.

In this respect, there are two pre-existing frameworks which are well placed to be adapted in order to augment the current ASX Guidelines:

1. The Global Reporting Initiative (GRI) which is the global standard for triple bottom-line reporting;
2. The Operating and Financial Review (OFR), a new mandatory disclosure regime proposed last year in the UK.

**Question Four: Should the Corporations Act require certain types of companies to report on the social and environmental impact of their activities?**

Yes, but the requirements of this reporting should not be legislatively prescribed.

The EIA supports the notion that individuals and institutions should make investment decisions fully informed of the environmental, social, and governance activities of investee companies. The ability to do so presupposes a certain level of disclosure regarding these matters.

There is no reason for listed companies to be exempt from the same sort of disclosure required of certain financial product issuers under Chapter 7 of the *Corporations Act 2001* (s1013D). This clause stipulates that financial product issuers must disclose the extent to which they take labour standards and environmental, social and ethical considerations into account in their investment decisions.

As noted above, in respect of ASX-listed companies, ASX Principles of Good Corporate Governance and Best Practice Recommendations already expect listed companies to “Recognise the legitimate interests of stakeholders” (Principle 10). Through the ASX Corporate Governance Council process, Australia has been able to develop a process through which the wider business and investor community can address concerns of corporate governance reporting, without imposing new or costly regulation. As well, Australia has been in the forefront of fostering sustainability reporting at home and internationally through involvement in the Global Reporting Initiative (GRI).

The EIA also notes that the Commonwealth Government has been promoting sustainability reporting through the Department of Environment and Heritage and more recently has been in dialogue with the ASX Corporate Governance Council on the matter of sustainability reporting for listed companies. The EIA also applauds the intent of the Energy Efficiency Opportunities Bill 2005, in that it will place new disclosure requirements on energy usage by the largest Australian companies.

### *Global Reporting Initiative (GRI)*

While the EIA would support further advancement of these initiatives, care must be taken to ensure that disclosure is not enhanced in a piecemeal and uncoordinated fashion. The intended outcome should be the widespread availability of meaningful and consistent sustainability reporting by listed companies, such as is provided for in the world-leading Global Reporting Initiative.

The EIA is concerned that there has been debate within bureaucratic and business circles that there may be value in developing an 'Australian version' of sustainability reporting guidelines. The EIA strongly believes that Australian corporations need to develop sustainability practices that are consistent with the Global Reporting Initiative, in order to:

- promote comparability between sectors and companies;
- promote comparability between Australian and multi-national companies;
- promote greater understanding of reporting 'best practice' in an international context;
- assist investors both in Australia and overseas to properly account for long-term sustainability risks when making investment decisions; and
- assist corporations to communicate with key stakeholder groups about their sustainability performance in the clearest manner possible. The presence of a range of different reporting guidelines will only serve to confuse corporations seeking to communicate their progress in this area.

The EIA would emphasise that the GRI already has a strong and robust presence within Australia, with large Australian companies who undertake sustainability reporting doing so in the context of GRI. We would also note that the Global Reporting Initiative is a multi-stakeholder process and an independent institution whose mission is to develop and disseminate *globally applicable* Sustainability Reporting Guidelines. Representatives from Australian industry have played a key role developing 'Sector Supplements' to the Guidelines, in particular for the Financial Services sector.

### *Operating and Financial Review (OFR)*

The EIA would suggest that the Committee consider the experience in the United Kingdom of the Operating and Financial Review (OFR) governed by the UK Accounting Standards Board (ASB). The legislation became mandatory in May 2005, but was unilaterally abolished by the Chancellor of the Exchequer in November 2005, an action now subject to legal challenge. The OFR is now under review with a view to possible reinstatement. It is described by the ASB as follows:

"It is a principles-based standard, which in particular makes clear that the OFR shall reflect the directors' view of the business. The objective is to assist shareholders to assess the strategies adopted and the potential for those strategies to succeed. The information in the OFR will also be useful to a wide range of other users."

Introduction of the OFR followed seven years of white papers prepared by the Company Law Review Steering Committee under the title “Modernising Company Law”. This series of papers included recommendations around director fiduciary duty regarding corporate social responsibility, long-term reporting and disclosure time horizons, and stakeholder considerations.

Importantly, the resulting OFR provided investors with a long-term view of a company’s strategic risks, opportunities and uncertainties, “The ASB believes it important that the OFR shall have a forward-looking orientation, identifying those trends and factors relevant to the investors’ assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives.”

Particular issues addressed include:

- non-financial information about the business and its performance relevant to the judgement of past results and future performance;
- resources, principal risks and uncertainties which may affect the entity’s long-term value;
- environmental matters, including the impact of the business on the environment, on the entity’s employees and on social and community issues;
- significant relationships with stakeholders which are likely to directly or indirectly influence the performance of the business and its value; and
- the impact of society and communities affected by the entity’s activities.

The broad nature of the information supplied in the OFR is of direct relevance to mainstream financial analysts in gaining a wider and deeper view of the company’s true value, in the present and in the future. In particular, the lengthening of the time horizon and the broadening of issues which may affect the performance and value of a company complements the long-term investment time horizon of superannuation investors, an increasingly dominant source of global capital.

The UK OFR addresses two issues of significant importance in the quest to improve corporate environmental, social and governance performance – the ability for analysts to price non-financial or qualitative issues in this area, and the ability of the financial markets to assess corporate performance over the long-term in order to better match long term superannuation liabilities with long-term market returns.

The EIA supports moves which will strengthen these two objectives as addressed in the OFR reporting structure and believes that these objectives can be incorporated into the current ASX Corporate Governance Guidelines, thereby avoiding changes to the Corporations Act.

In respect to Question 3 above, the EIA’s recommendation to CAMAC would be to either:

1. Incorporate GRI reporting requirements into the ASX Corporate Governance Guidelines; or
2. Use the UK OFR as a basis from which to draw out elements which pertain to long-term reporting time horizons, the consideration of environmental, social,

ethical and governance issues, and the consideration of stakeholders and to incorporate these elements into Principles, 3, 7 and 10 of the ASX Corporate Governance Guidelines.

*Section 299(1)(f) of the Corporations Act:*

The EIA represents the interests of numerous investors who are interested in taking the environmental implications of their investments into account.

Section 299(1)(f) remains the only piece of Federal Legislation requiring companies to disclose some aspect of their environmental impacts to investors and the community.

Given the Government's recent focus on stressing the importance of good corporate behaviour in maximising positive outcomes for the environment (ref. Environment Australia's Public Environmental Reporting Guidelines), it seems at odds with community and regulatory sentiment both in Australia and overseas to repeal this piece of legislation.

*Response to criticism that references to environmental issues are not relevant in the Corporations Act:*

- such criticism is rooted in antiquated notions of the purpose of corporate law. Most corporate law was conceived in order to limit personal liability for collective corporate action, and was created at a time when sustainability of resources and the natural environment were simply not matters requiring consideration. This is no longer the case;
- environmental issues are integral to the existence, operation and profitability of every corporation, in any industry, anywhere in the world. Corporations use natural resources as productive inputs, consume energy generated from natural resources, produce physical products and packaging that inhabit the environment and emit waste substances into the environment;
- the importance of environmental risks and impacts to a company's bottom line has been demonstrated through numerous academic studies in recent times;
- this research has supported work by other elements of Government to encourage the recognition of the important role corporate sustainability plays in improving Australia's environmental performance;
- examples of recent public policy recognising this role include:
  - \* the inclusion of requirements for Australian fund managers to disclose their position on the environmental activities of their investments in the Financial Services Reform Act;
  - \* recent draft disclosure guidelines released by ASIC in support of the FSRA; extensive work done by Environment Australia over the last five years in developing guidelines for and publicising the importance of public environmental reporting by corporations; and
  - \* numerous examples of international governments mandating public environmental reporting by corporations; and

- the mandating of the disclosure of guidelines on investment managers relating to environmental issues contained in the Financial Services Reform Act necessitates the existence of reliable information sources against which managers can disclose. It seems illogical for the government to require fund managers to disclose on these issues, and then remove a requirement for corporations to provide such information.

*Response to criticism that the section as it appears is 'vague':*

The EIA would support this conclusion, and point to evidence that few corporations are interpreting the legislation in a consistent way, or reporting under this section in a manner that facilitates comparison between corporations' environmental performance.

However, a conclusion that legislation is vague presents an argument for its clarification, not its abolition.

To resolve this situation, the EIA would strongly recommend that the section be amended to include a requirement that corporations make disclosures under this heading in some sort of consistent way, perhaps in accordance with a sub-set of guidelines prepared by the UN-supported Global Reporting Initiative (GRI).

This would match with the approach that has been taken in this matter following the passing of the Financial Services Reform Act, where ASIC prepared a set of draft disclosure guidelines that have been presented to the finance industry for comment.

The EIA would be eager to participate in such a process, and given that the EIA's membership includes professional SRI research bodies, we would be in a strong position to do so.

In the absence of such a set of guidelines, disclosure benchmarks may be set by State governments, resulting in a confusion of regulations and extra stress upon corporations, as is the case at the moment with environmental regulations.

If you have any further questions or comments on this submission, please feel free to contact me on 02 8224 0314 or 0412 924 014.

Yours sincerely,



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