

supported by

AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

KING & WOOD
MALLESONS
金杜律师事务所

The Power of Together

DIRECTIONS 2016

Current issues and challenges facing Australian directors and Boards

The AICD are pleased to partner with King & Wood Mallesons on the 2016 Directions Report. As the leader in corporate governance and the voice of directors, the AICD has a clear interest in the insights this report offers on the issues and challenges facing the director community. We look forward to discussing the governance issues emerging from the 2016 Directions Report and to our continuing collaboration with King & Wood Mallesons.

John Brogden, AM FAICD
Managing Director and Chief Executive Officer
Australian Institute of Company Directors

“Low growth does not just create the need for new innovation... it provokes a suite of conversations and initiatives about the core of the business too... and who within the organisation should be doing what in response...”

Survey respondent

It is not easy being a director in 2016 and Australian directors and Boards are regularly reminded of the challenge of how to best add value to an organisation in a low growth, volatile, digitally disrupted environment.

Across Australia, organisations are faced with the challenges of operating in a transitioning economy. This is in addition to rapid changes in technology which are offering new ways to do business (and raising the prospect that current business models and practices may soon become obsolete). At the same time organisations are acutely aware of the need to adapt to changing consumer demographics and preferences, and are presented with opportunities to access new markets. Clearly, the pace of change can be daunting.

All of these factors are coupled with continuing low growth across domestic and global markets, rising costs, ‘short-termism’ and vocal stakeholders with disparate views and a propensity to provide constant “feedback”.

It is therefore little wonder that Australian directors and Boards are facing a challenging time discharging their responsibilities and balancing the need to provide strategic oversight and invest for the future, with the need to supervise management, ensure compliance and deliver returns to shareholders.

In today’s fast paced business environment, it is clear that Australian organisations - and therefore Australian directors and Boards - need to swiftly evolve and adapt in order to remain relevant and effective.

This year’s Directions Report looks at some of the key issues and challenges facing Australian directors and Boards - and Australian organisations more broadly - along with some of the building blocks for growth, including:

- the key attributes needed around the Boardroom and the challenge of managing leadership change and succession;
- the need to embrace the new digital environment and foster innovation; and
- the importance of building a good corporate culture.

We also consider the challenges of engaging with stakeholders and the opportunities presented by cross-border investment.

We trust that our Report makes a useful contribution to the ongoing debate regarding the issues, challenges and opportunities facing Australian directors and boards.



Meredith Paynter

Partner, King & Wood Mallesons
Sector Leader for the Industrials, Consumer, Agribusiness and Health sector practice.



Nicola Charlston

Partner, King & Wood Mallesons
Transactional lawyer specialising in corporate and commercial law with an emphasis on public and private company mergers and acquisitions.



| | | |
|--------------|---|-----------|
| ONE | Searching for growth in a low growth, volatile and disrupted environment | 6 |
| | What's on the agenda for Australian Boards? | 7 |
| | Addressing the challenges | 8 |
| | Striving for growth | 9 |
| | Overcoming short-termism | 9 |
| TWO | Managing talent from the Boardroom | 12 |
| | The high cost of C-suite churn | 12 |
| | Planning for the future | 13 |
| | The search for the "right" directors | 14 |
| THREE | Directing disruption | 16 |
| | Digital disruption – a concern for Boards? | 16 |
| | The danger of doing nothing | 18 |
| | Dedicating dollars to disruption and innovation | 18 |
| FOUR | Corporate culture, it's the vibe | 22 |
| | What is corporate culture? | 22 |
| | Who is responsible for setting and maintaining corporate culture? | 23 |
| | What happens when corporate culture fails? | 24 |
| FIVE | Rising stakeholder influence, a challenge or an opportunity? | 26 |
| | Feeling the pressure | 26 |
| | Challenge or opportunity? | 26 |
| | Stakeholder engagement in the digital age | 27 |
| SIX | Beyond borders | 30 |
| | Inbound investment on the rise | 30 |
| | Navigating regulations at home and abroad | 30 |
| | Appendix | 34 |
| | The Report | 34 |
| | The Survey | 34 |
| | About KWM | 34 |
| | Our Corporate Head Office Advisory Practice | 35 |
| | About AICD | 35 |
| | Key Contacts | 35 |

4 out of 10

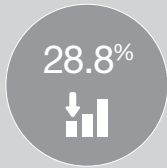


survey respondents say lack of capital/funding to invest is the greatest inhibitor to

achieving growth



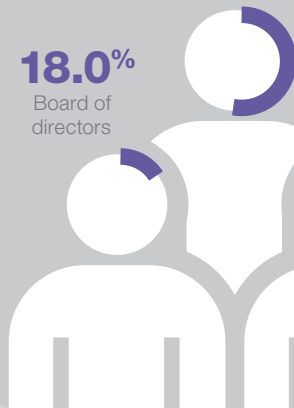
lack incentives to promote innovation



management too focused on the **short term**



aversion to risk taking

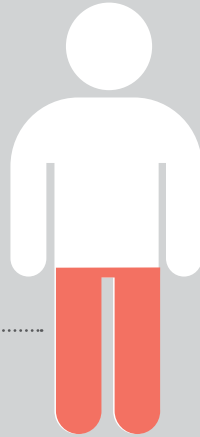


18.0%
Board of directors

55.7% say the **CEO** was most **influential** in setting the organisation/s corporate culture

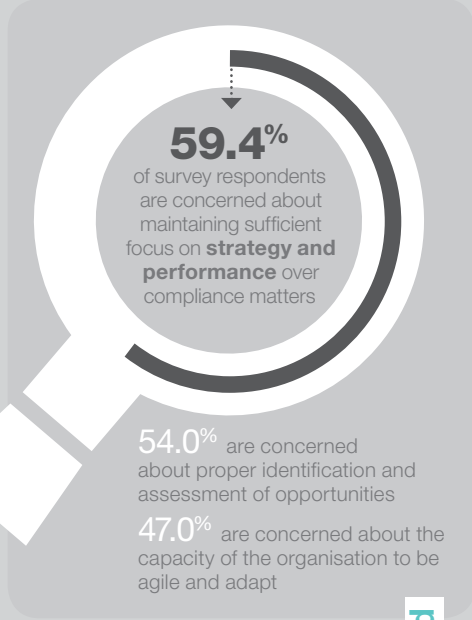
13.3%
Chairman

44.0% of survey respondents said that they did not have a current succession plan for their Chairman and CEO



of survey respondents expressed at least moderate concern about the impact of **digital disruption**

+4% of survey respondents are **not** currently **taking any steps** to respond to threat of digital disruption



53.7% of survey respondents said that their organisation/s had changed/improved their strategy/policies as a result of stakeholder pressure

25.9% identified

stakeholder pressure or intervention

as the great inhibitor to achieving growth in their organisation/s

Half of survey respondents stated that they **do not intend** to **invest overseas** in the coming year.

ONE

Searching for growth in a low growth, volatile and disrupted environment

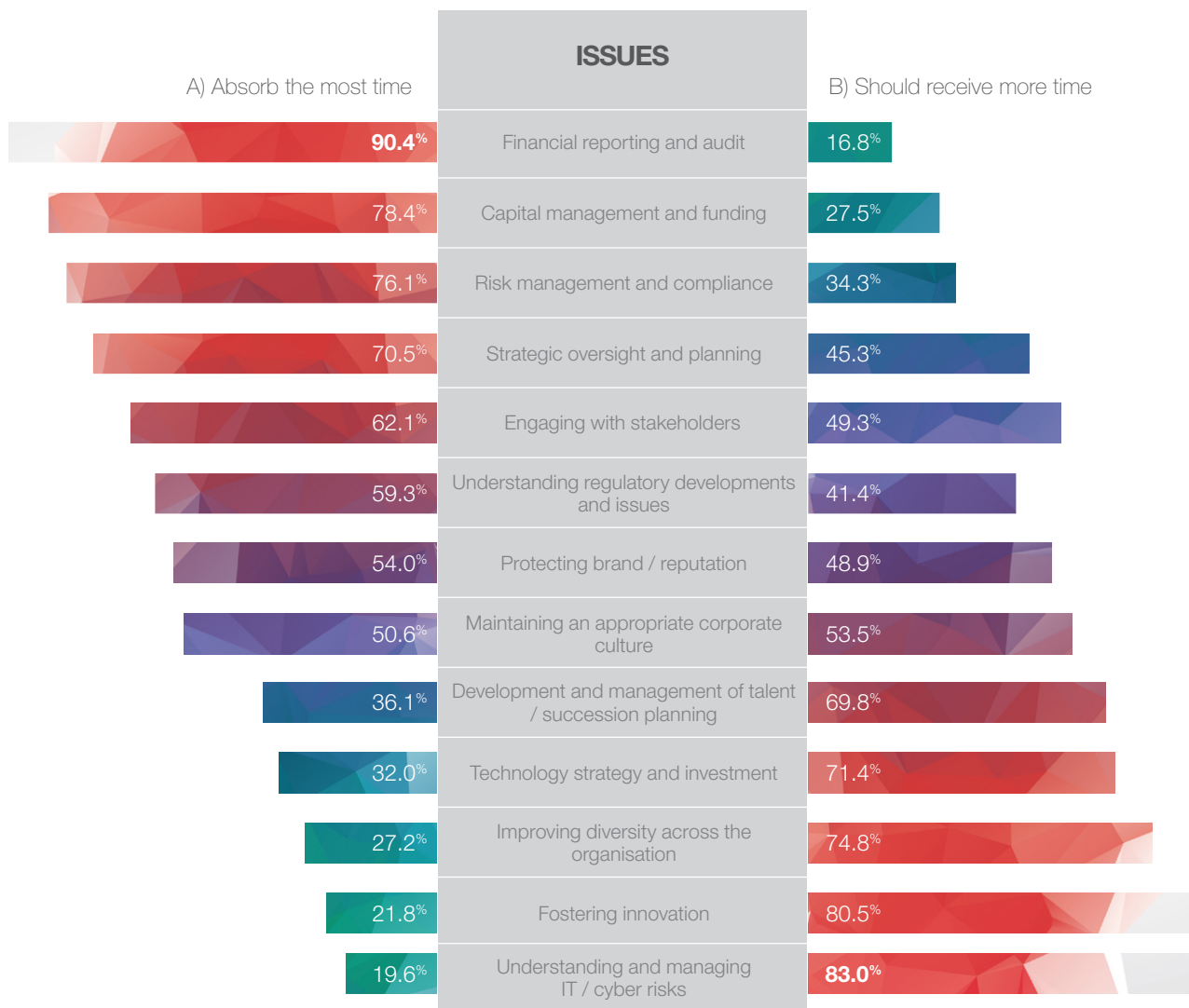
This year's survey results clearly demonstrate the real challenges that Australian organisations, and their directors and Boards, are facing in the current low growth business environment. It is a delicate balancing act of maintaining a steady hand on "business as usual" performance and operational matters, keeping employees and other stakeholders happy and ensuring that their organisations are "good" corporate citizens, while planning for the future in a volatile and disrupted environment.

Consistent with our survey results from prior years, it is clear that Australian directors continue to feel that too much of their time is taken up by oversight matters, such that they are unable to devote sufficient focus on strategic matters.

Of the issues listed:

A) which currently absorb the most time and attention of your Board(s)?

B) which do you consider should receive more time and attention by your Board(s)?



What's on the agenda for Australian Boards?

Survey respondents identified the issues which absorbed the most time and attention of their Board(s), and the issues which they considered should receive more time and attention from their Board(s).

While the issues absorbing the most time and attention from Boards – being financial reporting and audit (90.4%), capital management and funding (78.4%), risk management and compliance (76.1%), and strategic oversight and planning (70.5%) – are hardly surprising, it is interesting that strategic planning and oversight only ranked 4th (rather than 1st).

It is also noteworthy that financial and compliance matters strongly outranked “softer” issues such as engaging with stakeholders (62.1%), protecting brand/reputation (54.0%), and various other issues that have clear relevance for the future prospects and performance of the organisation.

Indeed, many of these issues, such as fostering innovation, technology strategy and investment, and development and management of talent / succession planning ranked among the top issues that survey respondents considered should receive more time and attention from Boards (but currently don't).

What do you consider represent the greatest area(s) of concern for your Board(s)?



Addressing the challenges

This disjuncture was further illustrated by our survey results relating to the areas of greatest concern for Boards, and the biggest challenges for individuals in performing their role as a director.

The results highlight that, at a Board level, maintaining sufficient focus on strategy and performance over compliance matters (59.4%), the proper identification and assessment of opportunities (54.0%), and the capacity of the organisation to be agile and adapt (47.0%) are of paramount concern.

Interestingly, our survey results also demonstrate that those matters - all of which have the capacity to contribute to the identification and development of future businesses, products and processes - do not appear to be getting the time and attention in the Boardroom that many feel they warrant.

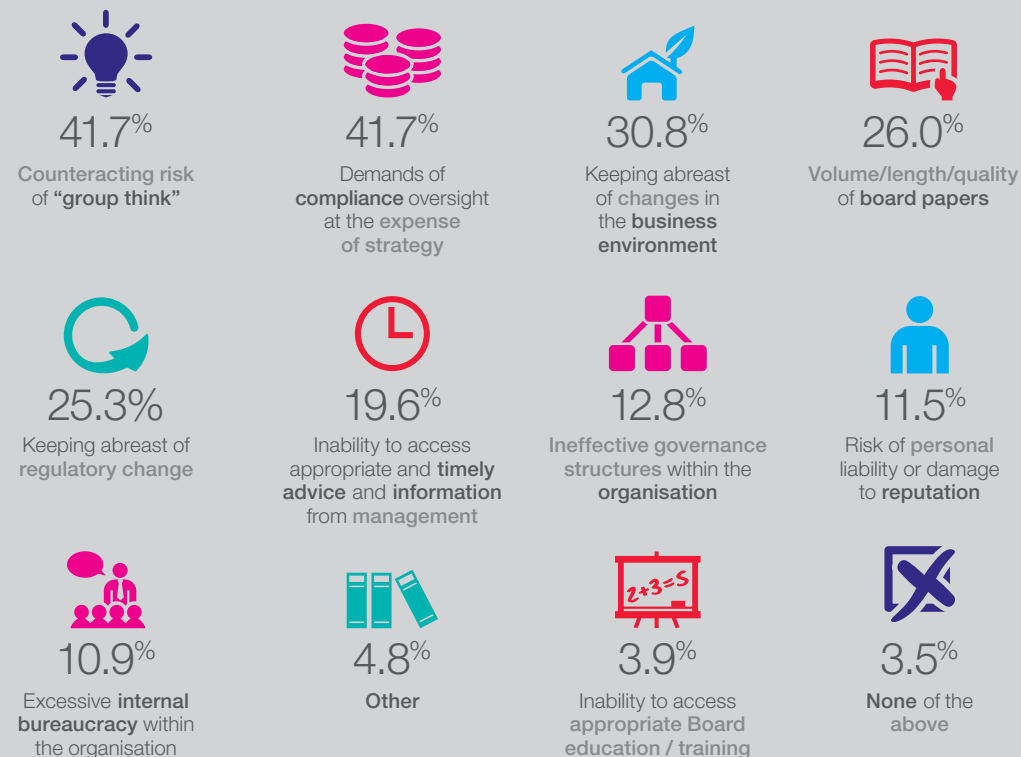
Other areas of concern correlate closely to the key issues identified as being matters that survey respondents felt should receive more time and attention from Boards, including developing the talent pipeline / succession planning (34.3%) and lack of innovation in the organisation (25.7%). Interestingly, our survey respondents also noted a concern with management being too focused on the short term (23.2%).

This is of particular significance in the current business environment, given the challenges posed by a low growth economy, weak business and consumer confidence, volatile stock markets and the emergence of new disruptive technologies that promise to change the way we do business.

At a personal level, counteracting the risk of “group think” (41.7%) and the demands of compliance and oversight at the expense of strategy (41.7%) were identified as the top ranking challenges facing individuals in performing their role as a director.

Survey respondents also acknowledged the challenge of doing business in a volatile, changing environment, with keeping abreast of changes in the business environment (30.8%), and keeping abreast of regulatory change (25.3%) cited among the other top issues. These issues clearly highlight the tension of needing to retain a critical, independent viewpoint, while ensuring that assessments and decisions are made on a properly informed basis.

From a personal perspective, what do you consider to be the biggest challenges in performing your role as a Director?



These challenges are exacerbated for non-executive directors - who perform their roles for their organisations on a part-time basis - who need to juggle competing time and work commitments, and are inherently reliant upon the executive management of their organisations for appropriate and timely advice and information on strategy, performance and outlook.

Striving for growth

In view of the growth imperative currently facing Australian Boards and directors, we also asked survey respondents what they considered to be the greatest inhibitors to growth in their organisation(s).

Of the top four issues highlighted by our survey respondents, it is notable that three - aversion to risk-taking (36.1%), management too focused on the short term (28.8%), and lack of incentives to promote innovation (28.1%) - are internal issues which the Board can directly influence through their oversight of strategy and remuneration structures, and supervision of senior management.

It is also interesting that stakeholder pressure / intervention regarding strategy - which is discussed further in section 5 - was cited as another key inhibitor to achieving growth, but that factors such as industrial relations laws, competition regulation and the corporate tax rate were not prominent issues.

Overcoming short-termism

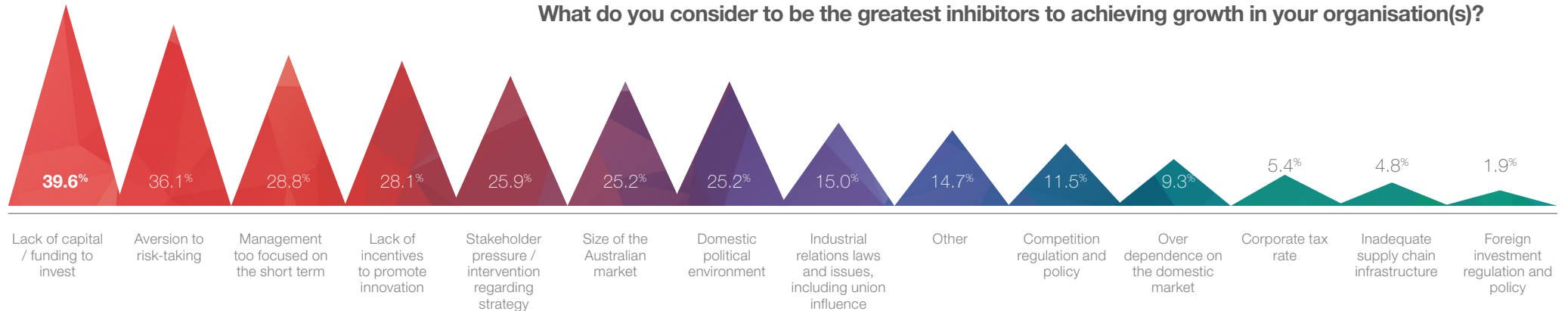
Consistent with our survey results, short-termism is a key concern across corporate Australia – in part because it has the capacity to distract Boards and management from focusing on securing the future of their organisations by keeping abreast of and embracing change, searching for opportunities and making investments to build new capabilities, businesses and products.

The challenge of short-termism is further highlighted in the context of CEO turnover (section 2) and stakeholder engagement (section 5).

A framework for fostering and managing long term value creation, and curbing an excessive focus on the short term has been proposed. This includes:

- creating a long-term outlook and culture;
- promoting transparent and accurate reporting practices that reflect, and educate the market on, long term considerations; and
- basing a meaningful proportion of executive remuneration on long-term performance measures, which include qualitative criteria.¹

What do you consider to be the greatest inhibitors to achieving growth in your organisation(s)?



¹ <http://www.companydirectors.com.au/~media/resources/director-resource-centre/publications/books/pdfs-various/curbing-shorttermism-louise-pocock-final1.ashx>

Navigating the regulatory burden

In light of concerns expressed in prior surveys in relation to ineffective regulation and red tape, we asked which legal/regulatory issues received the greatest attention, and which legal/regulatory issues caused the greatest concern, in 2015.

The issues which received the greatest attention included directors' duties and issues (88.5%), not-for-profit reporting requirements and changes to ACNC obligations (84.8%) and continuous disclosure laws and practices (83.1%).

By contrast, the issues causing greatest concern included interest by regulators in block chain technology (66.7%), cyber security / data protection laws and issues (65.3%) and ineffectiveness of regulation / excessive red tape (60.7%).

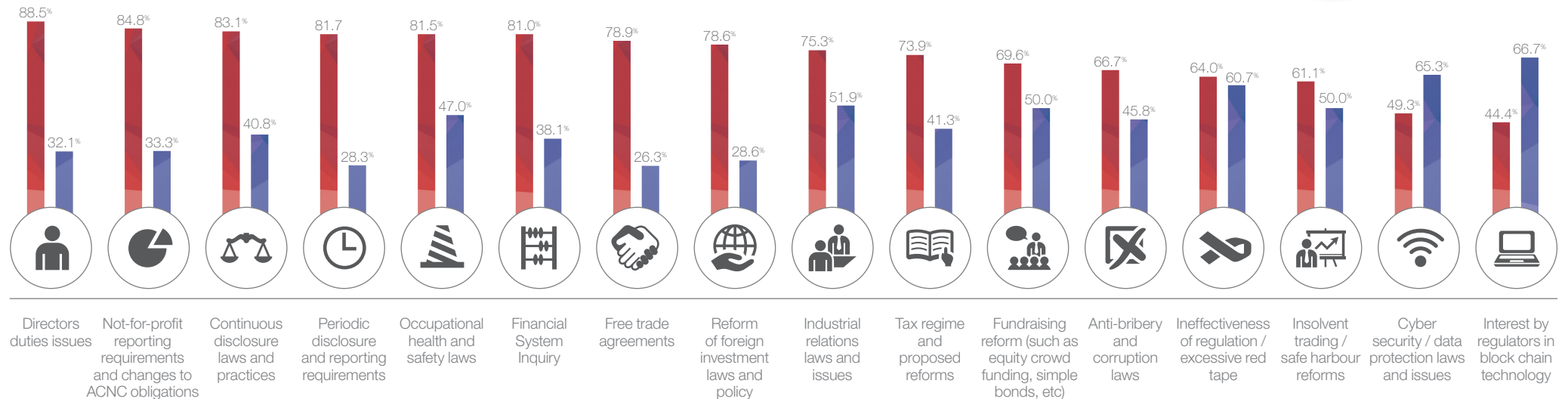
As for prior years, occupational health and safety laws, industrial relations laws and issues and tax regime and proposed reforms also ranked highly, with attention in 2015 also focused on the Financial System Inquiry, free trade agreements and the reform of the foreign investment laws and policy.

It is interesting that some of the "red hot" frustration expressed by directors in prior years in relation to regulation and red tape seems to have abated, with only 25.4% of our survey respondents citing excessive regulation and red tape as an area of concern for their Board(s).

Meredith Paynter, Partner
M&A



Of the legal / regulatory issues listed: ■ which have received the greatest attention from you this year? ■ which have caused you the greatest concern this year?



Insolvent trading reforms

In December 2015, the Federal Government announced the future introduction of a ‘safe harbour’ defence to personal liability for insolvent trading.

Insolvent trading law reform attracted the attention of many of our survey respondents. 61.1% of respondents confirmed that the issue had received attention in the past year. 50% of those respondents confirmed that the issue had caused them concern.

Access to funding and cash flows was cited by 34.6% of survey respondents as the greatest area of concern for their boards. However, only 2.5% of our respondents listed personal liability and the risk of prosecution for insolvent trading as their greatest area of concern.

In circumstances of financial difficulty...

The survey delved deeper to investigate whether directors felt differently where they actually believed that their organisation was in financial difficulties – which they clearly did. One survey respondent noted:

“Dealing with a company in financial distress is quite different to directing a successful established well financed business. It requires expert advice on solvency, financing, strategy, and directors’ duties.”

45% of our survey respondents had made decisions as a director in circumstances of financial difficulty. Of those, 90% considered the risk of personal liability or prosecution for insolvent trading to be relevant to their decision-making. 50% considered the risk to be very important.

There was also evidence that personal liability is a concern for directors in circumstances of financial difficulty. In particular, one survey respondent made the observation that:

“Personal liability of independent directors is an ineffective way to manage distressed companies in difficult times.”

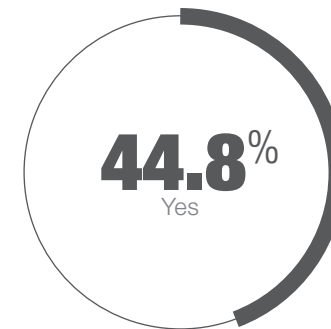
In the interim, the corporate insolvency law reform debate continues. Legislation to enact the ‘safe harbour’ defence is not expected until 2017 at the earliest and the Federal Government has not yet outlined the form of the defence in draft legislation.

The survey results clearly indicate that reform to the risk of personal liability for insolvent trading is an important part of broader reform needed to support restructuring activity. Given the importance of this issue, we expect that the director community will be looking closely at the proposed reforms, particularly once draft legislation is published.

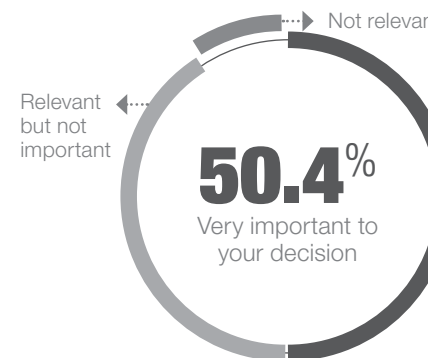
**Tim Klineberg, Partner
Restructuring & Insolvency**



In your career as a director, have you ever had to make a decision where you believed that the relevant organisation of which you were a director was in financial difficulties?



When making that decision, the risk of personal liability or prosecution for insolvent trading was:



Amongst their other roles, Boards have a key responsibility to appoint the CEO and approve the appointment of other senior executives, and to ensure that their organisations have appropriate management structures in place. Boards must also provide oversight and review performance, plan for succession and where necessary make, or direct, replacements.

As highlighted in section 1, our survey respondents did not rank “people stuff” amongst:

- the top issues absorbing the most time and attention of Boards – development and management of talent / succession planning ranked 9th at 36.1%, and improving diversity across the organisation ranked 11th at 27.2%; or
- the areas of greatest concern for Boards – developing the talent pipeline / succession planning ranked 5th at 34.3% and structuring executive remuneration to reward performance ranked 13th at 14.9%.

However, it is clear that attracting and retaining good people, developing capability within an organisation, providing incentives to reward performance, and managing the talent pipeline and succession are integral to an organisation’s performance and its capacity to prosper, particularly in the current environment.

Indeed, 69.8% of our survey respondents considered that development and management of talent / succession planning should receive more time and attention of their Board(s), and 74.8% of our survey respondents considered that improving diversity across the organisation should receive more Board time and attention.

Our survey results further highlighted the importance of the “soft stuff” of people management and organisational systems and structures, and the potential risks of not getting those issues right. Amongst other factors, our survey respondents considered that:

- the capacity of the organisation to be agile and adapt (47%) and maintaining a constructive relationship between the Board and senior management (22.9%) were key areas of concern for their Board(s); and
- the inability to access appropriate and timely advice and information from management (19.6%) and excessive internal bureaucracy within the organisation (10.9%) were the biggest challenges in performing their role as a director.

The high cost of C-suite churn

In that context, it is interesting that 2015 was particularly noteworthy for the extent of turnover within the senior ranks of organisations across Australia.

At the “top end of town”, 15 of the ASX100 companies had by mid-2015 announced the resignation or replacement of their CEO² and this trend of C-suite renewal continued for the rest of the year. Consistent with these figures, a recent survey by PwC confirmed that the majority of survey respondents indicated that their organisations had experienced, or are experiencing, a high CEO turnover rate³.

Interestingly, Australia’s CEO turnover rate has been identified as being, on average, one of the highest in the world, and is estimated to cost Australian shareholders approximately \$8 billion a year.⁴

While not all the departures from the C-suite were unplanned, unexpected or forced, it is worth reflecting on some of the causes and the broader implications of this turnover.

The particularly high C-suite churn rate appears to have been caused by the tough economic and business conditions, with lower growth rates and weak business and consumer confidence making it harder for Boards and management to keep delivering returns at historic levels. This has exposed “poor strategic decisions, which may have been camouflaged when the Australian economy was steaming along and tested the patience of investors and the resolve of Boards – often under public fire from investors and commentators.”⁵ In the current environment, investors are anxious for signs of a clear, considered strategy and its effective execution, and have little tolerance for allowing time for “proof of concept” or any fine-tuning needed to deliver promised results in the medium term. In 2015, a number of ASX listed entities experienced significant declines in shareholder value which ultimately led to “unplanned” exits of senior executives and/or the Chairman.

2 “Corporate Australia’s own chief executive killing season, but boards may go too” The Australian Financial Review, 20 June 2015, Simon Evans, Sue Mitchell and Jemima Whyte.

3 “15th annual CEO succession study – The value of getting CEO succession right (Australia)”, Strategy&, 2015.

4 “15th annual CEO succession study – The value of getting CEO succession right (Australia)”, Strategy&, 2015.

5 “\$8bn cost of CEO Churn”, Australian Institute of Company Directors, Vol 13 Issue 24, quoting, Varya Davidson, Strategy&.

“When you think about the long-term nature of companies and the importance of getting strategic settings right ... you'd like to think that there's going to be a CEO there who sees strategic plans through to fruition and is not just running on a short-term basis.”⁶

In some instances this can be exacerbated by executive remuneration structures which typically try to incentivise performance over both the short term (within the next 12 months) and the “long term” (over 3-5 years). However this can distort behaviours and focus by unduly rewarding (or penalising for) immediate tangible “results”, without necessarily recognising or rewarding progress or achievements that should set the organisation for a sustainable path to growth in the future. This clear tension was highlighted by our survey results, with respondents citing management being too focussed on the short term as a key area of concern (23.2%) and a key inhibitor to achieving growth in their organisations (28.8%), and also highlighting other key inhibitors to growth in their organisations as aversion to risk-taking (36.1%), lack of incentives to promote innovation (28.1%) and stakeholder pressure / intervention regarding strategy (25.9%). It is therefore not surprising that management feel pressured, directed and/or mandated to focus on delivering short-term results in order to be regarded as successful.

Comments from our survey respondents reinforced that a high rate of CEO turnover can create instability, uncertainty and paralysis across an organisation, and can result in the organisation incurring significant additional costs, and delay in progressing key priorities and implementing strategy.

This impact becomes more pronounced in a challenging market, where expected “BAU” performance is harder to deliver and the outlook is uncertain, and can highlight weaknesses in an organisation’s succession planning and their development of future leaders.

“A frequent change in CEO has an adverse impact on culture. It creates short term thinking with the CEO looking to produce quick outcomes. It also creates uncertainty over future direction and may cause a loss of confidence in the board.” Survey respondent

Planning for the future

Management of the talent pipeline and succession planning are therefore more important than ever – for ensuring that the organisation has the leadership, capabilities and experience necessary to manage its business, develop strategy and adapt to the future, and to reduce the costs and distraction associated with unplanned or poorly managed departures.

“CEO succession needs to be a proactive and institutionalised activity, not reactive and event driven, because it is costing billions of dollars.”⁷



involves a process of identifying and developing high potential talent within an organisation to be available and equipped to fill leadership positions in the future. It therefore mitigates the risk that an organisation will have limited internal candidates with the requisite skills and experience available and ready to assume those roles as and when they become available.

⁶ “Diversity tops directors’ 2016 to-do list” Australian Financial Review January 18, 2016, quoting Simon McKeon, AMP chairman.

⁷ “\$8bn cost of CEO Churn”, Australian Institute of Company Directors, Vol 13 Issue 24, quoting, Varya Davidson, Strategy&.

It has been reported that, globally, Boards have become significantly more effective in selecting the right chief executives, and planning smoother transitions from one to the next.⁸ However, in light of the risks associated with poor succession planning and C-suite turnover, particularly in a volatile, low growth environment, it is interesting that:

- 44.0% of survey respondents reported that their organisation(s) do not have a current succession plan for their Chairman and CEO; and
- only 27.1% of survey respondents reported that their organisation(s) have a current succession plan for both of these roles.

As reflected in our survey results, preparing for succession can seem like a “less immediate” priority, especially in a challenging business environment where running the business and hitting short term targets assumes great importance. However, the fallout from some of the recent departures of CEOs in Australia over the past year demonstrates that organisations who have successfully implemented succession planning are clearly better equipped to manage their change of leadership, and to mitigate any potential negative financial, operational and/or associated reputational fall-out.

“Boards themselves must proactively and visibly take ownership for succession and planning.”⁹

Ongoing succession planning can also assist an organisation to map out and execute its plans for achieving its strategic objectives beyond the short term, and provide stability and certainty across the organisation.

The search for the “right” directors

When survey respondents were asked which attributes were the key priorities for Board appointments in 2015, the three highest ranking priorities were industry sector knowledge (57.1%), business skills and experience (54.6%) and diversity (gender and/or cultural and other) (50.7%). These results are consistent with survey results from prior years, and are not of themselves surprising.

Interestingly though, technology skills and experience (14.3%) and innovation skills and experience including experience in a start-up (13.0%) featured as other key attributes, ahead of international experience and knowledge, which ranked higher in previous years survey results. This reflects the increasing focus (and feeling of a need to focus) on technology strategy and investment, understanding and managing IT / cyber risks and fostering innovation (as highlighted in section 3) and a sense around the Boardroom that many directors with “traditional” business skill sets and experience may be out of their depth and/or not able to appropriately oversee the proper management of these issues. Indeed, 18.1% of our survey respondents indicated that a lack of necessary skills/experience on the Board is an area of great concern for their Board(s).

“...all too often organisations leave their most consequential people decisions to board members who may be experts in other business domains but who are woefully uneducated about and inexperienced in evaluating C-suite talent.”¹⁰

By contrast, attributes related to human resources expertise and “people skills” were not specifically identified as key priorities for Board appointments. While it could be argued that such skills and experience should comprise a subset of broader “business skills and experience” (together with skills in areas such as strategy development, sales and marketing, operations etc.), it will be interesting to see if greater emphasis is placed on these specific attributes in the future, particularly in light of the key “people” responsibilities of the Board (including to appoint the CEO and approve the appointment of other senior executives) and the high costs to the organisation if these issues are not appropriately managed. Our prediction is that it will become increasingly important for directors and Boards to have specific skills to properly evaluate, or differentiate between, performance, competence, and potential.¹¹

8 “Why CEOs don’t get fired as often as they used to - How companies are lowering turnover in the top seat.” Harvard Blog Network 15 June 2015, Per-Ola Karlsson.

9 “\$8bn cost of CEO Churn”, Australian Institute of Company Directors, Vol 13 Issue 24, quoting, Varya Davidson, Strategy&.

10 “Why boards get C-Suite succession so wrong - New reports show they need better training on how to assess talent” HBR Blog Network, 15 May 2015, Claudio Fernández-Aráoz.

11 See footnote 10.

Do the organisation(s) of which you are a Director have a current succession plan for the Chairman and CEO?



“In an age where the ability of employees and managers to adapt and innovate is what determines the future of most organisations, corporate directors must begin to educate themselves on talent assessment.”¹²

44.0% do NOT have a current succession plan for the Chairman and CEO

¹² “Why boards get C-Suite succession so wrong - New reports show they need better training on how to assess talent” HBR Blog Network, 15 May 2015, Claudio Fernández-Aráoz.

THREE

Directing disruption

“Boards need to get on the front foot by setting digital disruption as a key strategy plank – disrupt or be disrupted”, Survey respondent

In the current environment, innovation is often occurring as a result of, and/or in response to, digital disruption – the “short fuse, big bang” of changes arising from new digital technologies. These disruptive changes are taking place at a pace and magnitude that are significantly transforming the ways that organisations operate and engage with their customers and other stakeholders.

As a result, established businesses are innovating to respond to changing trends or competition, meet new customer needs, or protect an already strong position. Conversely new entrants are innovating to find a niche and disrupt an established industry or business model through the use of new technology.

Organisations and Boards across all sectors and industries are increasingly feeling the need to find ways to “harness the bang”¹³ and focus more closely on technology strategy and investment, understanding and managing IT / cyber risks, fostering innovation to generate new ideas, products and business models in order to “defend their turf”, and to create new areas of opportunity and growth. In response to our question regarding the greatest inhibitors to achieving growth in their organisation(s), survey respondents highlighted an **“inability to envisage a different economic and operating environment”** and **“our own imaginations”**.

Digital disruption – a concern for boards?

Over 60% of our survey respondents expressed at least moderate concern regarding the impact of digital disruption on their organisation(s). While some describe corporate Australia as being a “digital laggard”,¹⁴ a significant proportion of survey respondents who indicated concern about the impact of digital disruption indicated that their organisation(s) have taken at least some steps to respond to digital disruption. Steps taken ranged from visits to Silicon Valley or other centres of digital innovation to understand more about the extent of the potential opportunities and risks, to the sponsoring of “hackathons” to encourage start-up companies to propose how they could assist organisations to change aspects of their business and forming venture capital funds to invest in early stage companies.

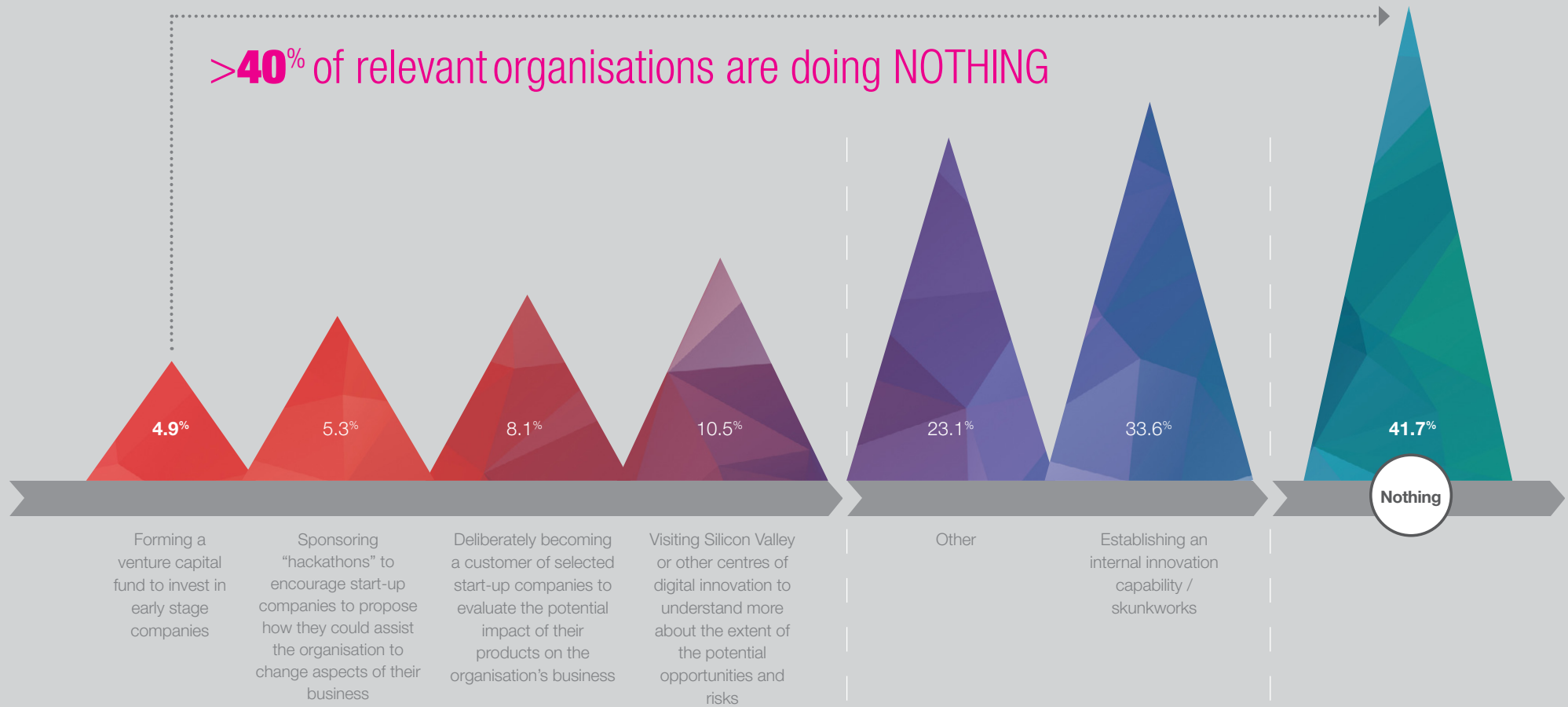
However the most common response to a concern about the impact of digital disruption centred around the establishment of internal innovation capabilities / skunkworks, with 33.6% of survey respondents who expressed concern regarding the impact of digital disruption indicating that their organisation(s) were taking that path. Development of internal innovation capabilities may involve seeking to attract and develop a digitally-adept talent pool, a change in mindset and values, and changing internal systems to keep pace with the efficiencies offered by new technologies.

¹³ Deloitte Australia has published reports entitled “Digital disruption: “Short fuse, big bang?” and “Digital disruption: Harnessing the ‘bang’: Stories from the digital frontline”

¹⁴ 29/12/2015 – John Durie – The Australian – ‘Innovation on the move’

If you are concerned, what steps (if any) are your organisation(s) taking to respond to digital disruption?

>40% of relevant organisations are doing NOTHING



The danger of doing nothing

Given the current focus on the risks and opportunities posed by digital disruption, those organisations and Boards choosing not to respond may be doing so at their own peril. Over 40% of our survey respondents who expressed concerns around the impact of digital disruption on their organisation(s) indicated that their organisation(s) have not taken any steps to respond, either offensively or defensively, to digital disruption.

However the steps that organisations and Boards can sensibly take to respond to digital disruption do need to be assessed in the context of the organisation, including its access to funding and its cost of capital, the regulatory environment in which it operates, the skills and capability within the organisation, as well as current business conditions. One reason why a significant proportion of directors surveyed reported that their organisation(s) have not (yet) taken responsive action may be the current low growth economic environment and the prospect of further waves of new technologies that may make current technology investments rapidly obsolete. Quite simply, organisations may not have available funds to commit to innovation initiatives, and/or may be unwilling to risk making potentially significant and risky investments in an environment that is more likely to demand a close focus on day-to-day business operations, managing costs and achieving short term returns. The inherent difficulty in measuring the results of innovation initiatives may also contribute to organisations and Boards treading carefully in allocating significant funding to these activities.

An alternative perspective is that the current uncertain, low growth environment has motivated some Australian businesses to take steps to adapt and evolve. Various companies including Telstra, Westpac and Commonwealth Bank have launched their own innovation labs.¹⁵ Other examples of innovation include the adoption of driver-less mining trucks by BHP and Rio Tinto in their efforts to lower costs amid falling commodity prices. Organisations that take steps to respond and adapt can generate real value for their shareholders - GE has estimated that using software to increase the velocity of their long-haul locomotives by 1% will generate over US\$3bn in value for their customers each year.¹⁶



GE estimated that using software to increase the velocity of their long-haul locomotives by 1% will generate over US\$3bn in value for their customers each year.

Dedicating dollars to disruption and innovation

While the benefits of a commitment to innovation in the current environment seem clear, many organisations do not have a defined budget for innovation initiatives, with only 22% of our survey respondents indicating that their organisation(s) set aside a percentage of annual earnings specifically for innovation projects. However, of those organisations that do set aside annual earnings, an average of over 8% was allocated specifically towards innovation projects.

And it is not just the tech-driven start-ups or new entrants that are focussed on innovation – as noted above, a range of government and established business organisations are putting a significant emphasis on innovation and focussing on the risks and potential rewards associated with digital disruption.

¹⁵ *Innovation centres: a waste of time, resources?*, Beverly Head, 21 August 2015, iTNews, online, <http://www.itnews.com.au/news/innovation-centres-a-waste-of-time-resources-401814>;
Telstra opens Gurrova innovation lab in Melbourne, David Swan, The Australian, 4 August 2010, Online

¹⁶ AmCham Access – Issue 03 Spring 2015 – pg 7

“The Australia of the future has to be a nation that is agile, that is innovative, that is creative. We can’t be defensive, we can’t future-proof ourselves. We have to recognise that the disruption that we see driven by technology, the volatility in change is our friend if we are agile and smart enough to take advantage of it.” Prime Minister Malcolm Turnbull

In particular, the Federal Government under Prime Minister Malcolm Turnbull has taken some early steps towards encouraging Australian businesses to embrace digital technologies and remove impediments for Australian businesses to adopt innovative initiatives by allocating \$1.1bn over the next four years to a national innovation agenda.¹⁷

Tax implications

The Federal Government's new focus on innovation is creating opportunities for organisations to access new tax concessions specifically directed towards innovation.

New tax concessions for early-stage investors in innovation start ups

The measures include a range of tax changes, including a specific regime to promote early-stage investment in start-ups. One measure is based on the Seed Enterprise Investment Scheme in the UK. It provides tax breaks for early stage investors by way of a 20% non-refundable tax offset based on the amount of their investment. In addition, a capital gains tax exemption will apply on the disposal of their interest in the start-up.

This is explicitly aimed at increasing the capital available for small start-up ventures by providing a focused tax concession.

Continuing focus on employee equity for start ups

The Federal Government is also continuing to focus on facilitating the offer of employee equity in start-up ventures. The current tax regime continues to place major constraints on offering employee equity, both in terms of cost and commercial complexity.

The new measures are aimed at supplementing the tax concessions for employees in eligible start-up companies. These tax concessions provide a significant tax benefit to employees by taxing them under the CGT provisions on the ultimate disposal of the interests. Unfortunately, the corporate prospectus relief available in relation to offers to employees in start-up companies continues to be limited.

Working with industry, the Federal Government is seeking to establish standardised offering documents to reduce the complexity of offering employee equity in start-up ventures. These documents will be available to taxpayers for use at no cost.

Andrew Clements, Partner
Taxation



¹⁷ Innovation statement: At a glance, Australian Financial Review, 7 December 2015, Online <http://www.afr.com/news/politics/innovation-statement-at-a-glance-20151206-glgwza>

What do you need to know about blockchain as a director?

The expected cost savings from using blockchain to manage transactions are huge (Santander estimated it could reduce banking infrastructure costs by US\$15-20bn per year by 2022), but we are still only scratching the surface of its possible use-cases.

Blockchain is a new technology that revolutionises the sharing and recording of information on a distributed digital ledger. There are two key elements of the blockchain technology: the “chain” and the “block”.

First, the “chain”. The chain is a ledger of transactions, each transaction following the one before. Just as early land title was documented through a package of land deeds showing all of the transactions which led from the original grant to the current ownership, so control of a unit on the ledger passes down a chain of ownership. Each transaction is documented (compared with existing databases where only the current owner is listed).

This chain is made up of “blocks” (hence, blockchain). Each block is a record of all of the transactions made in a certain period of time (e.g. 10 minutes). Each block is created by “miners”. These miners collect all of the transactions that people are trying to make in that time period. Then, they verify the transactions by checking whether the transferor owns what it is trying to transfer. After collecting these units, the miner distributes the block to all participants, thereby effecting all of the transfers in that block. Continuing the analogy, this is like those packages of land deeds being checked by other people each time a transaction happens, to make sure that the transaction is valid.

This technology is exciting because, for the first time, each participant has the true record of the ledger. It is exceptionally secure, fast and transparent (or encrypted, whatever is preferred). This allows for the widespread use of “smart contracts” by its users. For example, these contracts have already been used to automate certain company secretarial tasks by encoding the company constitution onto a blockchain.

Kate Jackson-Maynes, Partner
Financial Markets & Regulations



Scott Farrell, Partner
Financial Markets & Regulations



Are you feeling cyber-resilient?

The results of our survey confirm the anecdotal evidence that cyber-resilience was a hot topic for many directors and Boards in Australia in 2015. ASIC produced a “Cyber resilience: health check” publication in March 2015, which helped guide thinking in the domestic market. As highlighted in section 1, 83% of our survey respondents considered that their Boards should devote more time and attention to understanding and managing IT and cyber risks. This was consistent with the finding that 74% of our survey respondents considered that their organisation(s) needed to do more to be cyber-resilient and 65.3% of our survey respondents regarded cyber security and related data protection laws as one of the legal and regulatory issues that caused them the greatest concern in 2015. Despite the limited time spent by Boards on understanding and managing IT and cyber risks, 72% of survey respondents felt that they understood the most valuable data held by their organisation(s) and where and how that data is used and stored. That knowledge is clearly critical (although not sufficient) to appropriately manage IT and cyber risks.

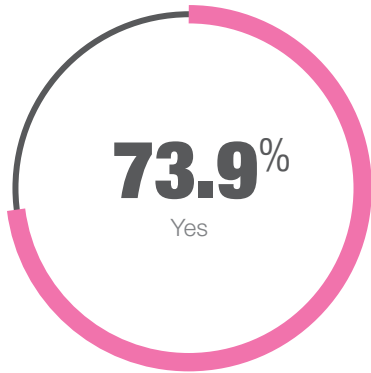
Patrick Gunning, Partner
TMET/IP



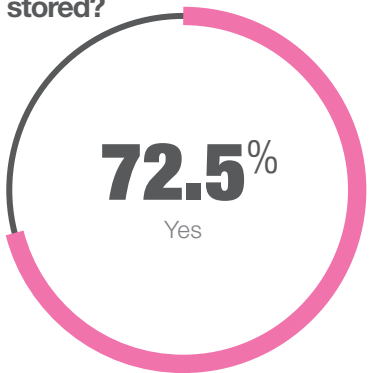
Cheng Lim, Partner
TMET/IP



Do you think that organisation(s) of which you are a director need to do more to be cyber-resilient?



In your role as a director, do you feel that you understand the most valuable data that is held by your organisation(s) and where and how that data is used and stored?



What to do when cyber breaches happen

It is interesting to compare the high degrees of attention and concern shown by survey respondents in relation to understanding and managing IT / cyber risks, with the actual experiences of cyber security breaches. Only 15% of our survey respondents reported that a cyber security breach had been brought to the attention of the Boards on which they sit during 2015. Just over half (51%) of those breaches were reported to a regulator or customers. 87% of the breaches did not damage the organisation's reputation or cause the organisation to incur material costs.

In our view, the level of concern reflects the fact that cyber security breaches could be very serious, although many, or even most, affect a small number of customers or involve anodyne information.

In 2016, the Federal Government will introduce legislation to require reporting of data security breaches involving a serious risk of harm to individuals. The exposure draft legislation requires reporting to both the Privacy Commissioner and to affected individuals. We expect this new regime will lead to higher levels of breach reporting than the 51% identified by our survey respondents this year. It remains to be seen whether plaintiff lawyers in Australia will follow the North American trend of filing class actions shortly after organisations notify individuals of data security breaches.

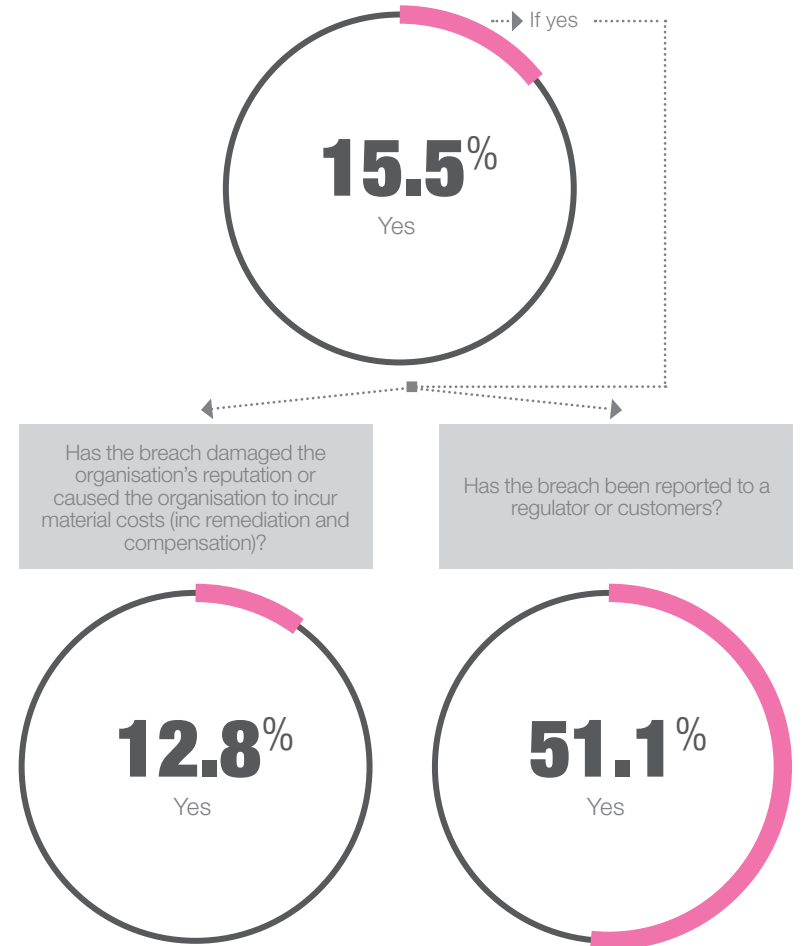
Patrick Gunning, Partner
TMET/IP



Cheng Lim, Partner
TMET/IP



Have any of the organisation(s) of which you are a director experienced a cyber-security breach in the past 12 months which has been brought to the attention of the Board?



FOUR

Corporate culture, it's the vibe

Over recent years, corporate culture has become an area of increasing focus for Boards, management and regulators, with a growing recognition by stakeholders of the influence of corporate culture on an organisation, its performance and the conduct of its officers and employees. As an example, the ASIC Annual Forum 2016 is entitled "Culture Shock".

This focus on corporate culture has been exacerbated by some recent high profile incidents and various perceived attempts by employees to "pass-the-buck" for their alleged misconduct. For the organisations affected, it can have a range of serious implications beyond needing to reprimand, (re)train or dismiss the employees concerned, including public embarrassment and damage to its brand, reputation and stakeholder relations, and the prospect of fines and other penalties.

In 2016, corporate culture is shaping up to be the new compliance battleground for regulators, and an additional challenge for directors and Boards, with ASIC calling for sanctions "for individuals and companies where they enable a poor culture that leads to breaches of the law by employees".¹⁸

What is corporate culture?

The concept of "corporate culture" can be difficult to define and the views of regulators and other stakeholders regarding corporate culture differ widely.

ASIC defines corporate culture as 'the mindset of an organisation.'¹⁹ This suggests that in ASIC's view, culture and conduct are inter-linked and co-existent, with a bad corporate culture condoning, encouraging, and potentially even rewarding, bad conduct. Conversely, a good corporate culture can detect and punish bad conduct, and promote and reward good conduct.

There was no consensus from our survey respondents on what corporate culture means. Responses ranged from 'a combination of understanding and having strategies to manage the complex expectations of employees, board, stakeholders, investors & brand', 'a nebulous construct that is difficult to measure and is not constant over time' to 'box ticking for regulators' and 'not much'.



the DNA of the organisation **ethical, honest, transparent** **MBA speak** box ticking for regulators *not much* a uniform vision **how we behave** how we do things here **values and integrity values and ethics applied** Board setting the standard expected across the organisation

¹⁸ <http://www.abc.net.au/news/2015-06-03/asic-considers-criminal-sanctions-for-poor-company-culture/6517684>

¹⁹ Greg Medcraft, Chairman Australian Securities and Investments Commission to Law Council of Australia BLS AGM seminar (Melbourne, Victoria), 20 November 2015.

The Chairman of ASIC, Greg Medcraft, has commented that there are many building blocks for corporate culture. He lists:

- peer pressure in the form of industry disciplinary panels;
 - effective internal whistleblower policies; and
 - individual and corporate accountability,
- as being essential for setting and maintaining corporate culture.²⁰

Significantly, a good corporate culture is not merely demonstrated in appropriate policies and codes of conduct. It directs and encourages compliance with those policies and codes on a day-to-day basis. As one survey respondent commented “[Corporate culture] are the real values, not the printed ones.”

As part of their oversight function, corporate and financial services regulators have also been active in asking organisations and Boards to explain why they have failed to take action against employees for conduct which is inconsistent with the policies and standards adopted by the organisation.

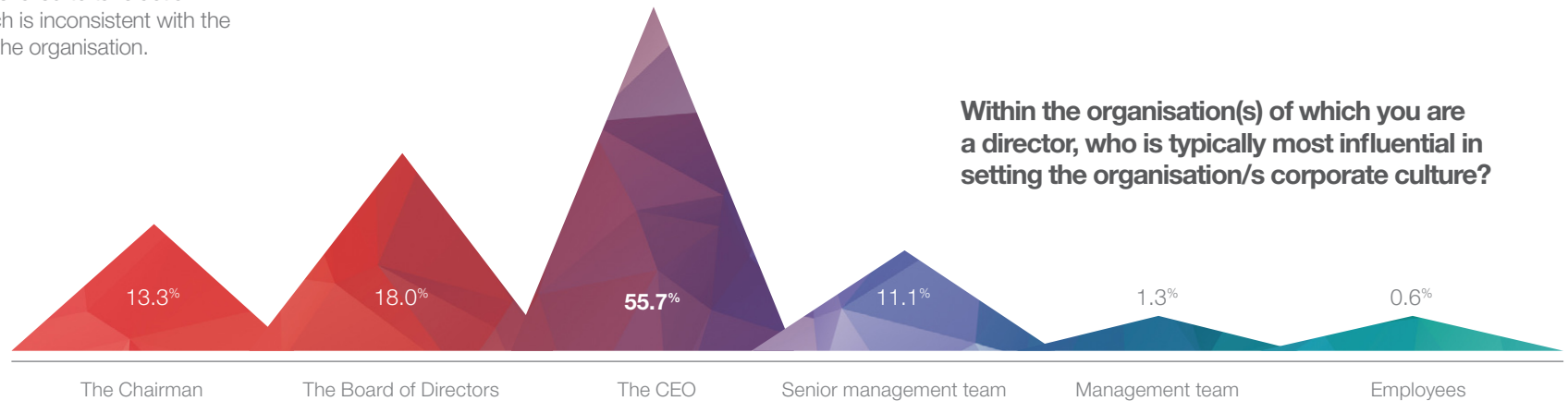
Who is responsible for setting and maintaining corporate culture?

If it is accepted that corporate culture is an important aspect of an organisation’s DNA, then the next question is who is responsible for setting and maintaining that corporate culture and to what extent should those people be accountable for the impact (or failure) of that corporate culture. Again, different stakeholders have different perspectives on this issue.

Both regulators and the law itself appear to be looking to the Board and senior executives of an organisation. As one survey respondent said, “[Corporate culture] develops within the company management with either the Chair, CEO or both being the driving force.”

This is consistent with our survey results. 55.7% of our survey respondents listed the CEO as most influential in setting an organisation’s corporate culture. This was followed by the Board of directors (18.0%), the Chairman (13.3%) and the senior management team (11.1%). These responses are particularly interesting given the current high turnover rate for CEOs in Australia (see section 2). Frequent leadership changes clearly pose some additional challenges for organisations in setting and maintaining a good corporate culture.

Apart from the internal organisational benefits of a good corporate culture, in some circumstances the failure to maintain and enforce an appropriate corporate culture can create the risk of liability, and assist a prosecutor in establishing that a law has been breached.



Within the organisation(s) of which you are a director, who is typically most influential in setting the organisation/s corporate culture?

²⁰ Greg Medcraft, Chairman Australian Securities and Investments Commission to Law Council of Australia BLS AGM seminar (Melbourne, Victoria), 20 November 2015.



1 effective communication

For example, under the Commonwealth Criminal Code, it is an offence to bribe a foreign public official, Commonwealth public official or an employee or agent within the private sector. A company can be liable for this offence if it can be established that the corporation 'expressly, tacitly or impliedly authorised or permitted the commission of the offence' by, among others, having a poor corporate culture – that is, by having a corporate culture that directed, encouraged, tolerated or led to non-compliance with the relevant provision under the code.²¹ Similarly, a company can be found guilty if it failed to create or maintain a corporate culture that required compliance with the relevant provision.²² In these instances, law-makers have effectively mandated that the company is to be held responsible for failures arising from a bad corporate culture, or the absence of a good corporate culture.

“In respect of culture, boards and management play a critical role in setting the culture of firms. If we find a firm's culture is lacking it is a red flag that there may be broader regulatory problems. ASIC will be addressing culture not just in markets but in financial services more widely, and we will be assessing the link between culture and conduct.”²³ Greg Medcraft

²¹ *Criminal Code* 1995 (Cth) 12.3(c).

²² *Criminal Code* 1995 (Cth) 12.3(d).

²³ Greg Medcraft, Chairman Australian Securities and Investments Commission to the Parliamentary Joint Committee on Corporations and Financial Services, 14 August 2015

What happens when corporate culture fails?

There have been several instances over the past 12 months where corporate culture has been alleged to fail, including the dismissal of traders for improper use of internal communications and the misuse of corporate credit cards. One of those traders subsequently lodged an unfair dismissal claim against his employer, claiming that a “perverse” corporate culture was to blame for his behaviour - this claim has since been discontinued.

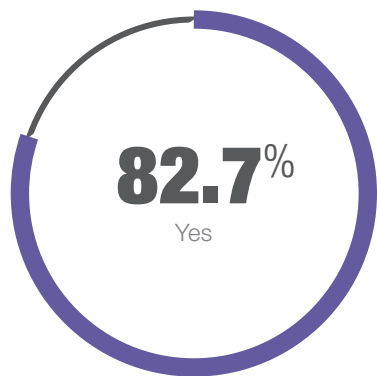
This raises the question - to what extent can (or should) corporate culture be blamed for this type of (mis)behaviour? The relevant trader's central complaint was that he was exposed to a culture that 'openly condoned the conduct and behaviours which were inconsistent with its code of conduct, values and policies', and that by being a witness to, and emboldened by, a culture that was consistently in breach of the organisation's code of ethics, dismissing him for breach of the code would be grossly unfair.

In 2004, the “culture made me do it” defence was unsuccessfully argued by another group of traders charged over rogue trading that caused multi-million dollar losses and exposed serious system failures in their organisation. Elizabeth Sheedy, an Associate Professor at Macquarie University, has described the “culture excuse” as ‘pretty flimsy’, noting that research has shown that culture has a ‘significant effect, but is not conclusive.’²⁴

Interestingly, an overwhelming majority (82.7%) of our survey respondents considered that an organisation should be held accountable for an employee’s misconduct where such misconduct was directly attributed to the organisation’s corporate culture. Survey respondents commented that ‘it becomes an unwritten aspect of their employment contract to behave in certain ways’, ‘culture tells employees what is acceptable’ and the organisation should be responsible because it was ‘complicit in failure’, and the conduct was ‘a monster of their creation’ and ‘indicates systemic problems’.

‘Fish rots from the head.’
Survey respondent

Should an organisation be held accountable for an employee's misconduct where such misconduct was directly attributed to the organisation's corporate culture?



While it is hard to argue against the proposition that corporate culture should contribute to positive compliance outcomes, and the broader “people” benefits associated with having a “good” corporate culture, the real challenge for directors and Boards is to determine how best to influence, support and manage a positive culture across the organisation that promotes the right mix of values and behaviours, without detracting from performance and a growth mindset.

Corporate culture and whistleblower programs

In looking at corporate culture, ASIC focuses on the ‘three C’s’ (i) effective **communication**; (ii) encouraging **challenge**; and (iii) guarding against **complacency**, and (among other things) places importance on corporate whistleblower programs to encourage individuals to identify problem areas for Boards.

While this is positive, there is a risk of whistleblower programs being used by disgruntled employees for strategic purposes in employment disputes, which can present real challenges for Boards and management.

Other commentators have focussed on the link between remuneration and conduct (for example, incentive structures in the financial services sector have been singled out as a driver of bad conduct), and the role of the CEO and the importance of testing a CEO candidate’s ability to influence “culture” at the selection stage, and the need for leadership change if this is not being achieved.

Once an organisation’s remuneration, leadership and policy framework is set, the further challenge is one of oversight. Reporting on employee surveys, ‘whistleblower’ calls, email monitoring, employee training and disciplinary outcomes will all need to be on the agenda for the “Culture” sub-committee of the Board if regulators have their way.

**Andrew Gray, Partner
Labour & Employment**



24 The Australian, ‘Can Culture be Blamed for Bankers behaving Badly?’ published 23/1/16.

FIVE

Rising stakeholder influence, a challenge or an opportunity?

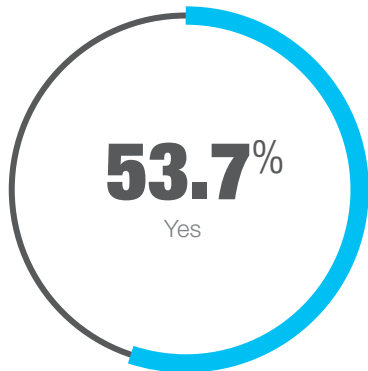
Directors are facing an increasing number of challenges in effectively engaging with their organisation(s)' stakeholders. Principal among these challenges is the need to respond to the rise in stakeholder pressure exerted on Boards and interventions regarding strategy.

Feeling the pressure

As outlined in section 1, 62.1% of our survey respondents noted that engaging with stakeholders (such as shareholders, industry bodies, customers, regulators etc.) was one of the issues that absorbed the most time and attention of their Board(s), and 49.3% felt that it should receive more time and attention.

In that context, it is arguably not surprising that 53.7% of our survey respondents indicated that their organisation(s) have either changed or improved their strategy or policies as a result of stakeholder pressure.

Have the organisation(s) of which you are a director changed / improved their strategy or policies as a result of stakeholder pressure?



Changes cited as being made as a result of stakeholder pressure include:

- Focusing on earnings above cost of capital;
- Increased focus on longer term priorities;
- Narrowing the business focus;
- Tightening the risk appetite and framework, and increasing focus on risk identification;
- Changing remuneration structures and increasing transparency on remuneration
- Improving board diversity; and
- Pursuing various environmental, social, and governance (ESG) initiatives.

It is worth noting that some survey respondents – presumably from organisation(s) that had resisted changing their strategy or policies as a result of stakeholder pressure - queried the motives and utility of stakeholders raising their concerns.

“Generally a concern that impacts them personally with no consideration as to how it impacts other stakeholders”. Survey respondent

Challenge or opportunity?

Rising stakeholder pressure – and most notably, shareholder activism – presents both a challenge and opportunity for Australian directors and Boards.

While several survey respondents indicated that improvements in areas such as strategic focus, governance and accountability resulted from stakeholder “pressure”, directors remain wary of activists whose agenda can be seen to stifle the company’s strategy and longer-term growth prospects. 20.6% of our survey respondents indicated that stakeholder pressure / intervention regarding strategy was an area of greatest concern for their Board(s), and 25.9% considered it to be one of the greatest inhibitors to achieving growth in their organisation(s).

In recent times, growth constraining activism has generally manifested in two forms.

“Anti-Growth Brigade”

Perhaps unfairly, certain types of investors have been dubbed by former Queensland Treasurer, Keith De Lacy, as being part of “the anti-growth brigade”,²⁵ for whom returns are subordinated to ESG objectives.

During the 2015 AGM season, the Australian Council of Superannuation Investors (ACSI) - consisting of Australia’s 30 largest non-profit funds - listed carbon risks, corruption, and human rights as key areas on which ACSI will engage with Boards,²⁶ indicating that investors raising ESG concerns - both institutional and retail - may have an increasing level of influence on corporate Australia going forward.

²⁵ “Dividends, diversity, ‘anti-growth brigade’ keeping directors up at night”, Joanna Mather, Australian Financial Review (Online), 17 January 2016.

²⁶ See footnote 25.

“Uber-Capitalists”

Distractions from a focus on longer term growth and profitability may also come from shorter-term focussed investors such as hedge funds or pension funds seeking to exert control or influence through various legal devices and novel tactics. While shareholder activism reached a high-watermark in the United States last year, with a record 355 activist campaigns announced against US incorporated companies,²⁷ Australia has also seen increasing activist interventions.

Over the past six years, a number of listed companies including Antares Energy, Qantas, Fairfax Media, Brickworks, David Jones and Billabong International have been targeted. A recent survey revealed that, among a group of Australian investors controlling \$550 billion in funds, two-thirds would publicly support an activist campaign to gain Board control or influence company strategy.²⁸

However, the current volatility and downward pressures in the share market may cause activist hedge funds to temporarily retreat and give listed Australian companies a reprieve from so-called “uber-capitalist” activism as a falling market will exacerbate downside risk by compromising their ability to make gains on an exit of their investment.

“Performance, it’s always performance. Even when the questions are governance focussed they are driven by performance issues.” Survey respondent

As noted in previous Directions Reports, Australia’s regulatory framework is seen as being particularly conducive to activism. The “two-strikes rule” can provide an effective tool in the activist’s arsenal by setting the lowest global threshold for leveraging a Board spill (given it only requires a 25% vote against the remuneration reports in two consecutive years).²⁹

Further, directors can be removed by a simple majority (50%) of votes cast in a general meeting of shareholders.³⁰ By comparison, most US States permit staggered boards, where directors may only be removed ‘for cause’.³¹

However, the Federal Government has recently stripped one tool from the activist’s kit bag, with the abolishment of the ‘100-member rule’, which previously enabled just 100 shareholders to call a general meeting, and had been utilised by shareholders to remove managing directors. Although shareholders holding 5% of the voting shares (in aggregate) remain able to call a general meeting, the repeal of the 100 member-rule is expected to dampen the power of activist shareholders with minor holdings. For example, 5% of CBA’s voting shares equates to billions of dollars – far exceeding the amount that is likely to be held by 100 small shareholders.

Stakeholder engagement in the digital age

Information has long been the activist’s most potent tool: whether “white (true), grey (questionable) [or] black (untrue)”.³²

Our survey results suggest that companies and Boards will increasingly have to shift their efforts to the digital realm in order to engage with stakeholders and respond appropriately to activists. While 63.3% of our survey respondents indicated that meetings with directors are the most influential or persuasive way for stakeholders to present their concerns to their organisation(s), 18.9% identified social media as being the most influential or persuasive, compared to 23.2% identifying the traditional forum for shareholder engagement – attendance and voting at AGMs.

A 24/7 news cycle, combined with the speed and reach of social media, provides both companies and stakeholders with a potent avenue for engagement. However, as highlighted in previous Directions Report, social media is a double-edged sword and can be harnessed in both constructive and destructive ways.

As one commentator notes, “[w]hen activists play fast and loose with the truth, the public has a high tolerance for it. The overwhelming sentiment is that “they’re only trying to help”.”³³

All of this illustrates that “[t]he next round of the battle may well be conducted from the computer keyboard rather than in the boardroom.”³⁴

27 “Sharkrepellant Spotlight”, John Laide, FactSet (Online), 16 December 2015.

28 http://www.sandoncapital.com.au/site/images/pdfs/GPS_Activism_Thought_Leadership_Sleeping_Giants_Nov_2015.pdf

29 “Shareholder Self-Protection and Activism in Australia”, David Friedlander, 1(1) Law Society of New South Wales Journal 75, June 2014

30 Section 203D Corporations Act 2001 (Cth).

31 See, eg, §141k Delaware General Corporation Law. Delaware is the state of incorporation for over 60% of US publicly listed corporations.

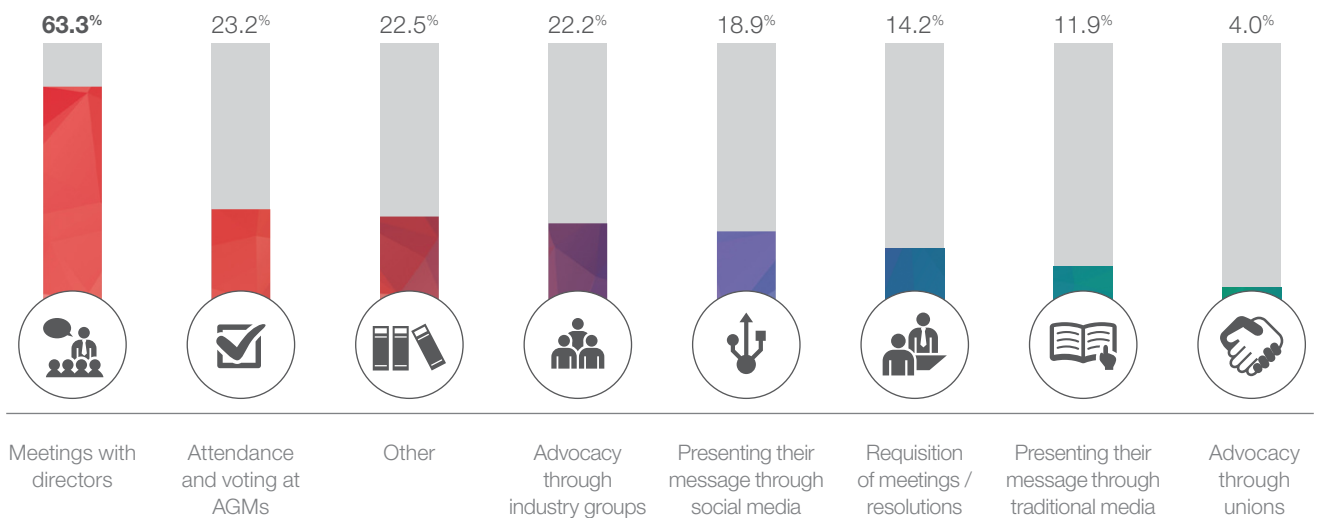
32 “Toughen up and use social media to fight activism”, Kathryn Logan, Australian Financial Review (Online), 28 June 2015.

33 See footnote 32.

34 “Court decision may stem the tide of activists targeting AGMs”, David Friedlander, Nigel Hunt & Evie Bruce, Australian Financial Review, 4 November 2015.

“Protestations that social media – and activism in general – aren’t game changers are nonsense. If it were not for activists’ canny use of social media to campaign relentlessly, coal seam gas projects in NSW would be running to the schedules forecast in reports and environmental approvals.” Survey respondent

Over the past year, what have you observed to be the most influential / persuasive ways stakeholders have presented their concerns to your organisation/s?



The 2015 AGM Season

Consistent with the findings contained in the last Directions Report, our survey respondents had mixed views on the 2015 AGM season. Some survey respondents indicated that the AGM “is a complete waste of time and money” and a “theatre of no substance with small shareholder attendance and nit-pickers only” while others indicated that the AGM was still useful - “AGMs are an excellent forum for all directors to be personally accountable to members”, “our AGM was highly successful this year due to great care taken in preparation and delivery” and “the highlight is a cup of tea with members!”.

“They tend to go in waves and will depend upon the profile and performance of the organisation...when things are good, the members are quiet.” Survey respondent

This cross-section of views is reflective of previously expressly concerns that while AGMs provide a forum for communication and engagement – particularly with retail shareholders – the continuing trend for low attendance at the meeting (as distinct from participation via proxy or online voting) raises questions about the formality and cost of AGMs.

“AGMs are in transition as an effective medium given their delayed timing... professional investors and other like the ASA are dealt with outside the meeting and thus there is relatively little real discussion/questioning at AGMs. On the whole I think there is an opportunity to re-think their role, content, timing etc.” Survey respondent

**Meredith Paynter, Partner
M&A**



Earnings surprises

The issue of earnings guidance and updates has become increasingly relevant in a low growth and volatile environment, as earnings downgrades have become more prevalent. Recognising the difficulties associated with deciding whether and when an earnings update is warranted or appropriate under ASX's continuous disclosure regime, the ASX released an updated version of Guidance Note 8 in July 2015 which provides additional clarity around the provision of earnings guidance and earnings surprises.³⁵

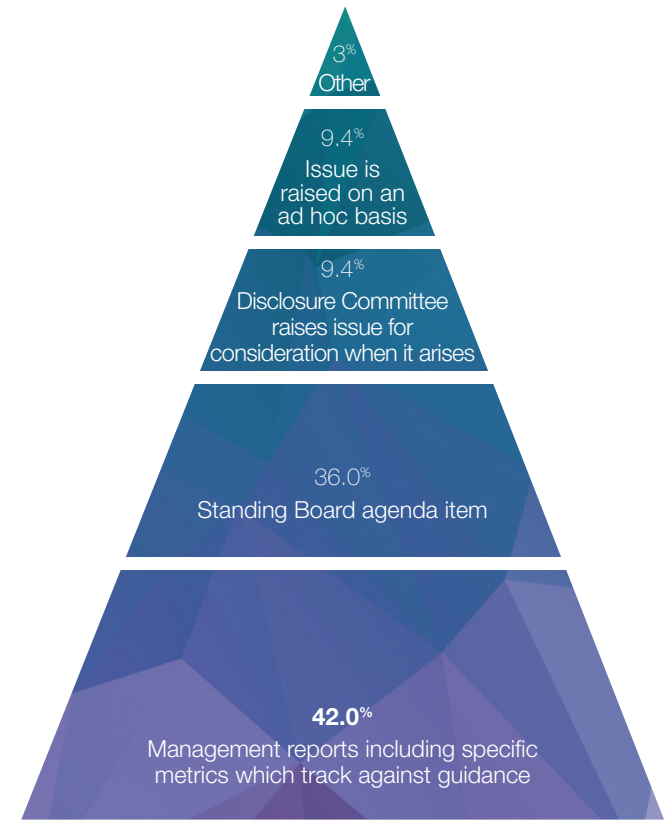
The revised Guidance Note 8 clarifies that there is no expectation on an entity to publish earnings guidance. Despite this, of the survey respondents who sit on Boards of listed entities, approximately half indicated that their organisation(s) provide earnings guidance, forecasts or financial outlook statements. While this may provide shareholders with transparency into the value and performance of the business, publishing earnings guidance also exposes entities to enhanced disclosure obligations and associated risk and scrutiny from regulators and shareholders. These risks range from scrutiny by ASX and ASIC (such as receiving an "ASX aware" letter) to the threat of a shareholder class action. It was evident in 2015 that entities continued to face difficulties in applying Listing Rule 3.1, with a number of listed entities facing the threat of, or being served with, class action proceedings over a decline in share price allegedly attributable to a failure to comply with continuous disclosure obligations.

Our survey results indicated a varied approach to how listed entities manage their market guidance:

- just under half of our survey respondents (42.2%) indicated that the Board tracks results against guidance through management reports;
- 35.9% of survey respondents specified that market guidance is a standing Board agenda item; and
- surprisingly, only 10% of survey respondents indicated that the internal disclosure committee brings the issue to the Board's attention when it arises.

Listed entities that publish earnings guidance should consider whether the benefit to shareholders (and the market more generally) derived from providing guidance outweighs the additional compliance burdens and the associated risks. Their Boards and senior management should also ensure that effective protocols are in place to ensure that disclosure issues (and in particular, earnings forecast deviance issues) are raised and appropriately escalated as soon as they arise.

**Nicola Charlston, Partner
M&A**



Within the organisation(s) of which you are a director, what processes are in place for directors to consider whether or not statements made to the market should be revised or updated?

³⁵ Following a major re-write in 2013, ASX released a revised version of Guidance Note 8 on 1 July 2015 containing additional guidance around the provision of earnings guidance, earnings surprises and dealing with analyst forecasts, estimates and briefings. The revised guidance note is available here: <http://www.asx.com.au/regulation/rules/asx-listing-rules.htm>.

In a country of just over 24 million people, within a global community of approximately 7 billion, it is unsurprising that, when talking about growth, the conversation in Australian Boardrooms often turns to cross-border investment. It is therefore surprising that only a relatively small number of Australian companies have successfully taken the step of investing overseas, with just one third of Australia's top 2000 companies having at least a 10% stake in an offshore market.³⁶

Inbound investment on the rise

2015 was a record-breaking year for M&A in Australia, with 467 deals completed, representing a combined \$134.9bn and marking a 76.5% increase by value compared to 2014. Around half of that was domestic M&A and half was inbound M&A investment (\$70bn and \$64.9bn respectively). Australian outbound M&A activity was markedly lower at just \$29.4bn.³⁷

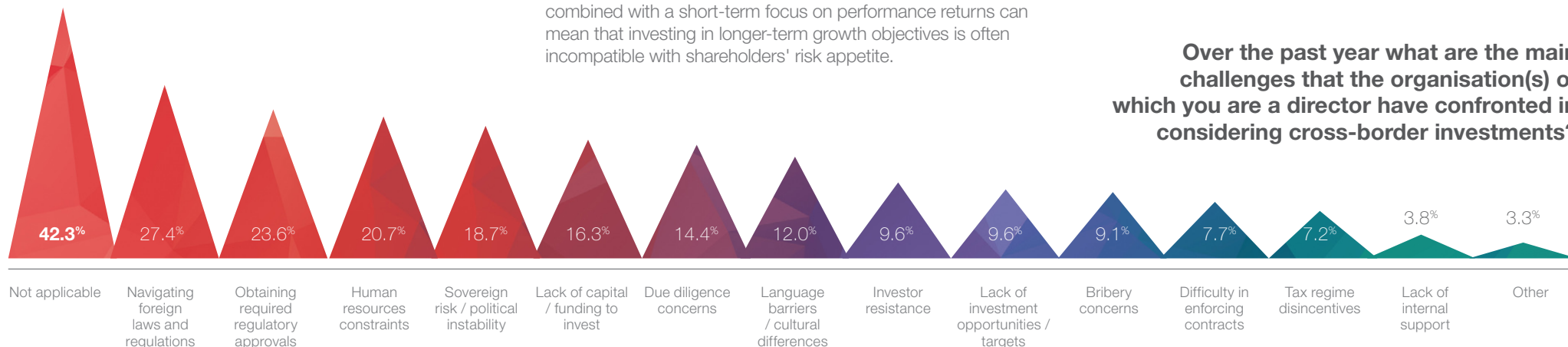
Consistent with the Mergermarket data, the depreciation of the Australian dollar, coupled with low interest rates, have made Australian assets even more attractive. Outbound M&A however seems to have been largely unaffected by the devalued currency.

While there is no simple explanation for why Australian companies are not investing overseas, it is clear that cross-border expansion is a longer-term strategic play. The impact of short CEO tenure and leadership change (see section 2), combined with a short-term focus on performance returns can mean that investing in longer-term growth objectives is often incompatible with shareholders' risk appetite.

Navigating regulations at home and abroad

Doing business in Australia remains challenging across many sectors³⁸ and business leaders regularly point to competition, tax and industrial relations laws stifling domestic growth. That said, even with the challenges of operating domestically, Australian companies are, more often than not, choosing to stick with what they know.

This sentiment is reflected in our survey, with just under half (47.8%) of our survey respondents stating that they do not intend to invest overseas in the coming year. Of these respondents 28.8% report that this is due to a primarily domestic focus.



Over the past year what are the main challenges that the organisation(s) of which you are a director have confronted in considering cross-border investments?

³⁶ Overseas Investment of Australian Companies, Austrade April 2015

³⁷ Mergermarket, Australia M&A report Q4 2015

³⁸ According to the World Bank – Ease of Doing Business report 2015, Australia dropped to 13 in 2015 from 12 in 2014



Over the coming year which regions do you expect to be the main focus for cross-border investment for the organisation(s) of which you are a director?

Even for those companies who are looking seriously at opportunities for cross-border investment and expansion, shareholder pressure may cause them to re-think their strategy (see section 5).

Encouragingly, of the 52.2% of survey respondents who are looking to invest internationally next year, 24.9% are looking to Asia Pacific with 19% indicating that their organisation(s) are looking to China. With the level of growth in the region significantly exceeding the levels of more advanced economies in 2015, it is clear why.

However, while more Australian companies are considering their 'Asia strategy', getting shareholder support is often only the first step in the process. This support can quickly wane if seeing a return on the investment takes significantly longer than expected. And it almost always does - survey respondents reported a number of key challenges that they were faced with when engaging in cross-border investments. These included, navigating foreign laws and regulations (27.4%), followed by obtaining required regulatory approvals (23.6%) and human resources constraints (20.7%).

As free trade agreements such as those with Japan and South Korea and most recently, the significant agreement with China, come into force, barriers and tariffs are reduced/removed. While this may assist to get investments across the line, it is important to consider all the elements necessary to achieve success overseas.

Perhaps the real challenge facing Australian directors and Boards looking East is to successfully navigate domestic pressures and short-termism to ensure their organisation(s) can reap the benefits of closer economic ties with our Asian neighbours.

"Short-term risk aversion may be safe, but no truly great company was built playing safe." Survey respondent



Where are the big ticket growth opportunities in 2016 – a focus on China

As Australian Boards look towards Asia, there are huge growth opportunities for forward thinking businesses, driven in part by the recently ratified China Australia Free Trade Agreement. Of particular note are:

Food and agribusiness

With Australia's vast land and optimal climate, agribusinesses see huge export opportunity across Asia. Arguably the biggest of these opportunities is in the sale of high quality Australian products to the growing middle class across the region, particularly in China. In China alone, the growth in demand for powdered infant formula, increased beef consumption and significant Chinese investment in the wine sector all present significant opportunities for Australian producers.

Health

An increasing middle class and a growing ageing population result in increased demand for healthcare. As a result, China is set to become Australia's largest market for pharmaceuticals and vitamins within two years. The reduction and removal of tariffs in the sector means that we also expect to see successful players in Australia investing in the development of hospitals and aged care facilities in China

Financial services and FinTech

There are enhanced opportunities for Australian financial services businesses both in providing services to Chinese clients (in China and offshore) and in accessing Chinese investments. We also expect China to continue to take a lead in FinTech globally. This is likely to result in Australian start-ups and established financial services looking for best practice models and ideas. We also see an opportunity for Australian start-ups and incumbents looking to China for financing and capital.

E-commerce

As the e-commerce market continues to boom in China, the recent free trade agreement makes it easier for Australian companies to sell online directly to Chinese consumers. We expect the number of Australian brands on China's e-marketplaces to triple in 2016.

Infrastructure

Australian corporates and funds in the infrastructure space have the opportunity to invest directly in more than 1,000 proposed domestic infrastructure PPP projects in China.

Michael Barker, Managing Partner
M&A, Private Equity

Jonathan Grant, Partner
M&A, Public/ECM



Huge growth opportunities for forward thinking businesses

The Report

This Report examines key issues and challenges faced by Australian directors and Boards in 2015 in a disrupted, volatile and low growth environment. It reflects on directors' responses to our survey, along with our experience and expertise in advising Australian and international businesses, including on corporate governance, mergers and acquisitions, tax, workplace relations, cyber resilience and regulatory issues.

The King & Wood Mallesons team that worked on this Report and our survey included Meredith Paynter, Nicola Charlston, Miriam Kleiner, Robert Kelly, Anthony Hong, Ned Sutton, Joe McQuillen, Amelia Acherstraat, Jake Miyairi, Samantha Maslen, Tim Klineberg, Andrew Gray, Patrick Gunning, Cheng Lim, Andrew Clements, Paul Schroder, Jonathan Grant, Kate Jackson-Maynes, Anna Bennett and Mike Barker with the support of the Corporate Affairs, Business Development and Design Teams.

The Survey

This Report captures the responses of over 300 directors across a wide range of sectors and industries to an online survey conducted in November - December 2015.

Survey participants were asked to respond to a number of multiple choice and free-form questions relating to six key themes: the focus of the board; talent, capability and succession; corporate culture; stakeholder engagement; cyber security, digital disruption and innovation; and cross border investment.

The survey was conducted by King & Wood Mallesons, with the support of the Australian Institute of Company Directors (AICD), to gain a better understanding of the issues and challenges facing Australian directors and Boards in the current economic and political environment.

About KWM

King & Wood Mallesons is a new breed of law firm combining local depth with a global platform. Offering a different perspective to commercial thinking and the client experience, 2,700 lawyers across more than 30 international offices are working with clients every day to understand local challenges and navigate through regional complexity. With access to a global platform, we are providing commercial solutions and transforming the way legal services are delivered.

How do we do this? By focusing not just on what you want, but how you want it. Working in close partnership with clients, our relationships are built on delivering a market leading experience and providing access to deep legal insights and local connections, with the benefit of a global platform.

As the only firm in the world able to practise Chinese, Hong Kong, Australian, English, US and a significant range of European laws, we open doors and unlock opportunities for clients as they look to unleash the fullest potential of the Asian Century. Our ability to connect emerging opportunities, with market leading capability, is pushing the frontiers of what can be achieved - connecting Asia to the world, and the world to Asia.

KING & WOOD
MALLESONS
金杜律师事务所

Our Corporate Head Office Advisory Practice

Our Corporate Head Office Advisory practice draws on a dedicated multi-disciplinary team of market leading practitioners from our corporate, restructuring and insolvency, dispute resolution and tax practices to deliver innovative and pragmatic solutions to boards, general counsel, senior executives and company secretaries. We provide tailored solutions for all kinds of enterprises, from our ASX-listed clients to not for profit companies.

We have deep experience dealing with the most sensitive of risk issues that arise at the corporate head office level as well as providing guidance on market practice and market trends as they emerge. Some of the areas where our clients benefit from our experience include:

- continuous and periodic disclosure issues and company reports;
- “bet the company” litigation;
- regulatory investigations and dealings with regulators;
- directors and officers duties and rights, indemnification and insurance;
- constitutions, committee charters, governance policies and governance processes;
- executive remuneration and employee incentive arrangements;
- preparing for shareholder meetings, analyst briefings and dealings with proxy advisers;
- shareholder activism, contested board elections and meeting requisitions;
- independent legal advice to disinterested directors in related party dealings or other sensitive areas;
- insider trading issues;
- cyber resilience concerns;
- internal investigations; and
- takeover response planning.

About AICD

The Australian Institute of Company Directors (AICD) is proud to partner with King and Wood Mallesons.

AICD is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 37,000 includes directors and senior leaders from business, government and the not-for-profit sector.

While not the view of AICD, this report provides important commentary and analysis by King & Wood Mallesons on the issues and challenges facing the director and broader governance community.

We look forward to discussing the issues emerging from the 2016 Directions report with our members and to our continuing collaboration with King and Wood Mallesons.

AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

Key Contacts



Meredith Paynter
Partner, Sydney
T +61 2 9296 2277
meredith.paynter@au.kwm.com

Meredith Paynter is a Partner in the Sydney office of King & Wood Mallesons, and is the sector leader for the Industrials, Consumer, Agribusiness and Health sector practice.

Meredith specialises in private and public company mergers and acquisitions and capital markets transactions. Meredith advises clients across the food and agribusiness, financial services, entertainment, health and industrials sectors, and regularly deals with financial intermediaries and investment banks. Meredith also regularly advises on corporate governance, securities law and ASX Listing Rule matters.



Nicola Charlston
Partner, Melbourne
T +61 3 9643 4366
nicola.charlston@au.kwm.com

Nicola Charlston is a Partner in the Melbourne office of King & Wood Mallesons where she practices in corporate and commercial law with an emphasis on private and public company mergers and acquisitions.

Nicola has experience in a range of public and private treaty transactions including takeovers, corporate restructurings, joint ventures, capital raisings and business acquisitions. Nicola also regularly provides advice to clients on general corporate issues, including compliance with ASX Listing Rules and Corporations Act requirements as well as directors' duties.



KING & WOOD
MALLESONS
金杜律师事务所

The Power of Together

kwm.com

Asia Pacific | Europe | North America | Middle East

King & Wood Mallesons in Australia is a member firm of the King & Wood Mallesons network. See kwm.com for more information.

