Directors have vested in them the management and direction of the many commercial, statutory, not-for-profit and community corporations that have been so instrumental in the delivery of profound benefits to mankind and its standard of living. Non-executive directors have a vital role to play in the prudent governance of these corporations in the interests of all stakeholders of the corporation. There is a disparity of views and expectations between various sections of society, including parliamentarians, regulators, judges, journalists and practising directors, about the proper role and responsibility of non-executive directors. This publication seeks to identify the extent of that disparity, stimulate debate and encourage steps to help close the "expectation gap".

For more information visit our website www.companydirectors.com.au
MIND THE EXPECTATION GAP

THE ROLE OF A COMPANY DIRECTOR

WHITE PAPER
The Australian Institute of Company Directors is a member institute for directors dedicated to having a positive influence on the economy and society by promoting professional directorship and good governance. Company Directors delivers director development programs, information and advocacy to enrich the capabilities of directors, influence the corporate governance environment in Australia and promote understanding of and respect for the role of directors. With offices in each state of Australia and more than 30,000 members, Company Directors represents a diverse range of organisations from the top ASX 200 publicly listed companies to not-for-profits, public sector entities and private companies.

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The statements, opinions and commentary expressed in this publication may or may not represent the views of the Australian Institute of Company Directors. However, the Australian Institute of Company Directors strongly encourages discussion and debate on the issues discussed in this white paper.

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About the author

Steven Cole FAICD has more than 35 years of professional, corporate and business experience through senior legal consultancy, as well as a range of executive management and non-executive director appointments to ASX listed, proprietary, statutory and NFP boards.

Steven recently stepped down as a national Board member of the Australian Institute of Company Directors, and as the President of the Western Australia Division. He currently serves on the National Education Advisory Committee and the Corporate Governance Committee.
Preface

For a number of years the Australian Institute of Company Directors has been concerned about the confusion surrounding the role and responsibility of non-executive directors and the lack of understanding about what a non-executive director is and does. This concern was the inspiration for this white paper.

The phrase “expectation gap” has been used to describe the divergence between public expectations of the roles and responsibilities of directors and directors’ perception of their roles and responsibilities. It was used by senior company director John Ralph AC FAICD(Life) in 2006 in his foreword to the Australian Institute of Company Directors’ publication *Chairman of the Board – a Role in the Spotlight*.

Debate on the proper role of directors was reignited in 2010 following a series of lectures and seminar papers entitled “The Role and Duties of Australian Company Directors: a Restatement” by Dr Robert P Austin, at the TC Bierne School of Law, University of Queensland. Dr Austin, formerly a judge of the Supreme Court of New South Wales, delivered a seminal decision on directors’ duties in Australian Securities and Investment Commission v Rich.¹

In his lectures, Dr Austin reviewed the current law on the duties and liabilities of directors and argued that there is a pressing need to clarify, and even codify, the basic legal propositions about directors’ duties and liabilities. A number of other reviews and reports over recent decades have also called for reform in this area. Whether or not the full scope of Dr Austin’s suggestions is supported, it is hoped that those responsible for legislation in this area will carefully consider Dr Austin’s views.

Unlike Dr Austin’s erudite legal analysis, this white paper is designed to give practical guidance on the topic to a broad audience. It aims to provide those who deal with corporations a better understanding about what the role of the non-executive director is and explain how the role differs depending on the nature of the corporation and the circumstances confronting the corporation.

This white paper has been written for practising directors in Australia, the Australian public who deal with corporations in their everyday lives, and parliamentarians, regulators, judges and the media. It is provided in the hope that a more informed understanding of the proper role of the director will help close this “expectation gap”.

¹ (2009) 236 FLR 1; (2009) 75 ACSR 1.
Foreword

Corporations, and those who manage and direct them, play a vital role in the economic and social wellbeing of our society. Corporations come in many shapes and sizes including:

- public listed commercial corporations such as BHP Billiton Limited, Commonwealth Bank of Australia Limited, Woolworths Limited, Telstra Corporation Limited and Wesfarmers Limited
- statutory corporations and authorities which deliver essential services to communities around Australia such as water, electricity, gas, transport, health and regional development
- private and family companies, which operate a wide range of business enterprises, including light industry, trades, professions, hospitality and retail
- incorporated not-for-profit (NFP) charitable and community organisations which provide health, education, social welfare, cultural and recreational services to our society.

All of these corporations operate under the management and direction of people who act as directors. It is estimated that there are more than two million people in Australia acting as a director of a corporation – around one in seven of all adults in Australia.

It is generally accepted and required by the law, that those who take on the role of a director, even as a director without remuneration for a worthwhile charitable cause, must act in good faith and apply themselves diligently and with integrity in the interests of the corporation.

But how far should this responsibility extend, particularly for those directors who are “non executive” and whose primary role, in accordance with accepted corporate governance practice, is to provide objectivity and oversight of corporate management, to provide accountability to the relevant stakeholders of the corporation, and to assist in the delivery of corporate performance consistent with the law and the organisation’s stated objectives?

Many people believe that corporate boards and their directors (both non executive and executive) should be so closely involved in the affairs of the corporation that they can ensure nothing can go wrong.

This view is fundamentally flawed, both in law and in practice, and has lead to unrealistic expectations about what directors should be doing in areas that are the responsibility of corporate managers.

If these expectations were to be met, all directors would have to become, in effect, full time employees of the organisation. This would undermine the non executive director’s independence of outlook and objectivity which are vital for effective corporate governance.

This “expectation gap”, and the response to it by our parliamentarians and regulators,
is placing an increasing regulatory burden on corporate directors. The results are more time spent on corporate compliance and conformance, and less time available for strategy, entrepreneurship, risk management and prudential oversight to enhance effective corporate performance. The regulatory burden is adversely impacting financial outcomes, business efficiency and business reputation.

If it is to maintain its international competitiveness, Australia needs to find the right balance between corporate performance and regulatory compliance.

Finally, these unrealistic expectations are leading to an unjustified loss of public confidence in our corporate leadership.

There are good reasons for this “expectation gap” to be closed. The current misconceptions about the proper role and responsibility of directors (especially non executive directors), do not encourage good corporate governance. Awareness of the issues, through better communication, can help restore trust and allow boards and their directors to focus on their proper objectives – enhanced corporate performance for the benefit of all stakeholders. This is important, as the whole community has a stake in how well our corporations perform and contribute to our national wellbeing.

The challenges of public company life are not getting easier but the role of the limited liability company lies at the heart of our free enterprise system. The need to understand that one of the greatest values of this system is to allow failure, without always seeking to apportion blame, lies at the very core of free enterprise values. We grow, learn, become more efficient and allocate capital better when failure is part of the system.

Tony Howarth
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1. Introduction – corporations and the functions of directors

The “miracle” of the limited liability corporation

The Limited Liability Corporation is the greatest single discovery of modern times ... even steam and electricity are far less important than the limited liability corporation.

Nicholas Murray Butler, President of Columbia University, 16 November 1911

If Nicholas Butler was alive today, his sentiment would surely extend to the computer chip and the internet, along with steam and electricity.

Corporations are virtual creations designed to deliver economic outcomes for the betterment of their investors and society. Through legislation and regulation, they are given a statutory “licence to operate” by society, with general acceptance that the limited liability corporation has delivered significant benefits to mankind and its standard of living.

Limited liability corporations have succeeded because they:

• allow the effective marshalling and deployment of resources
• encourage investment by limiting the liability of investors
• enable the orderly and efficient management of business, despite diversity of ownership
• attract and empower professional management expertise
• facilitate enterprise through the assumption and management of risk
• stimulate economic growth and employment
• share the fruits of the enterprise with a diverse stakeholder base.
Corporations have a vital relevance to the economic and social framework of the community including in terms of production of goods and services, employment generation, tax contributions made and improvements to the social well being. Many in society may not fully appreciate this relevance and we need to work to ensure better alignment of perception and reality.

Belinda Hutchinson

The success of the limited liability corporation has been so striking that over recent decades the corporation has become the standard structure through which business enterprises are operated, whether small owner/operator businesses, large public national and multinational businesses, charitable and NFP ventures or public sector trading enterprises.

Large corporations, especially multinationals, have developed significant economic, social and even political influence and power while our communities, both business and social, have become dependent on the integrity and resilience of the services they provide.

In recognition of the effectiveness of the corporate model, governments have utilised corporations for the provision and delivery of essential public sector community infrastructure including utilities, transport, health, education, communications and even security.

Most members of society have become financially dependent upon corporate performance, and exposed to corporate non-performance and under-performance, through direct and indirect investment in commercial corporations, including through superannuation and pension funds.

To put matters in perspective, directors of companies incorporated under the Corporations Act 2001 (Cth) (Corporations Act) comprise a surprisingly large percentage of Australians – around 2 million people, or about 9 per cent of the entire Australian population (men, women and children). There are about 1.77 million Corporations Act companies registered in Australia. These statistics do not include community based incorporated associations and government/statutory corporations which are estimated to number more than 500,000.2

Most of these corporations are small. There are approximately 2,000 public companies listed on the Australian Securities Exchange with around 8,000 unique directors who sit on the boards of those listed corporations. The vast majority of corporations in Australia are small to medium enterprises (SMEs), family trustee

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companies, self managed superannuation funds, tradesmen, farmers and small business proprietors. Directors serve on these and also on charitable and community NFP corporate boards and councils.

**Uniformity of corporate legal obligations**

Laws and the standards of knowledge, behaviour and legal expectation that apply to directors, despite some exceptions, are relatively uniform, regardless of:

- the size of the corporation
- the commercial or community nature of the corporation
- the sophistication of the corporation’s business and operations
- the resources available to the corporation and its directors and officers
- whether the director is executive or non executive
- the governance framework of the corporation.

These distinctions are often vitally relevant but commonly ignored, or not understood by society, its parliamentarians, regulators and judiciary.

**Control of corporations**

By their constitutional design and their legislative mandate, control of corporations (whether public, private, government, NFP or otherwise) generally resides in a board, council, committee or other governance body (for the purposes of this publication generically referred to as “a board”) made up of directors, councillors, committee persons or others elected or appointed to the board (generically referred to as “directors). Typically the directors will elect one of their members as the chairman. An excellent commentary on the role and responsibility of a chairman is the Australian Institute of Company Directors publication *Chairman of the Board – a Role in the Spotlight*.

This control resides in the directors as a collective\(^3\) (i.e. the board), not in each director individually. However, the duty and responsibility for this control of the corporation are owed by each director individually and personally, as the board does not have legal entity status in its own right.

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\(^3\) Section 198A (1) of the Corporations Act 2001 (Cth) – Replaceable Rules (as mirrored by the constitution of most corporations) provides that “the business of a company is to be managed by or under the direction of the directors”.
Ultimately, boards are charged with ensuring the funds of the shareholders are being prudently managed. That doesn’t mean preventing every mistake and it doesn’t mean micro-managing the company. There’s some confusion in the community as to the role of the board.

John Ralph “Company Director” Magazine Volume 27, Issue 01, p. 20

Consistent with internationally and nationally recognised “good” corporate governance practice, boards usually delegate many of their powers and functions to executive employees of the corporation. Boards retain a strategic oversight and monitoring role to ensure intended outcomes for the benefit of the shareholders or members of the enterprise, depending upon the nature of the corporation (generically referred to as “shareholders”).

* Retention of prudential oversight and direction

**FIGURE A:** illustrates the classic corporate management model.
In the case of large public and NFP corporations, this is delegated to the chief executive officer (CEO) and then through sub-delegation to the executive and management team. In the case of a small proprietary corporation, this delegation is usually made to the managing director who is often the sole director and company secretary, as well as the principal shareholder.

Figure A (on page 4) illustrates the classic corporate management model.

**The “hearts and minds” of corporations**

Directors have been described as the “hearts and minds” of corporations. The deliberations and resolutions of directors set the corporation’s strategic direction, policies and ethical values. By analogy, the executive management team of a corporation might be described as the “arms and legs” of the corporation, as they provide the “doing” of the corporation and implement the decisions of the board and its delegates.

As a model of business enterprise, the limited liability corporation has been quite successful. It has delivered significant benefits and taken on a pervasive role in society. Given that the limited liability corporation has been around for centuries without fundamental change in principles and structure, it is reasonable to assume:

- there would be a sound understanding throughout society of the roles and responsibilities of directors
- that understanding would be shared by all shareholders, directors, regulators, parliamentarians, judges, journalists and other members of society
- the “hearts and minds” of the corporations, in other words the directors, would be respected for their endeavours.

Unfortunately, this is not the case.

Being a director used to be an honour – directors were regarded as incredibly important, their visibility in terms of publicity and disclosure was not extensive. Now, while it is a very good thing to be a director, I would hardly call it an honour. Directors’ decisions are regularly challenged and what they say is fully disclosed. And while I think these are positive changes, it does mean the job is harder. You need more skill and technical ability to handle it.

David Gonski “Company Director” Magazine Volume 27, Issue 01, p.20

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4 Australian Securities and Investments Commission ASIC Summer School “Corporate liability versus directors’ personal liability – have we gone too far or not far enough?” February 2008 – www.asic.gov.au.
Types of directors

The role and responsibility of the non-executive director (NED) are the focus of this white paper.

A NED of a corporation has no executive or management authority or power in his or her own right. Each NED is one element of the collective composition of the board and one element of the “hearts and minds” of the corporation. The authority and power resides in this collective, through board resolutions.

As a member of the board, a NED assists the board to deal with its primary roles, which are:

• strategic direction determination and oversight
• corporate policy determination and approval
• setting the cultural tone for the corporation
• appointment of the CEO
• risk management oversight and monitoring
• overseeing and monitoring the performance of the CEO and the executive management team
• counselling and mentoring the CEO and the executive management team
• governance framework and oversight.

The overall aim of the board is to facilitate the delivery of corporate performance outcomes in pursuit of the corporation’s stated objectives.

The current emphasis on non-executive director independence should not cause the board to lose sight of the importance of strong performance, with an emphasis on skills and an effective partnership between the board and senior management.

The concept being peddled by some so-called experts that non executive directors are remote strangers and the board is primarily an agent for the discipline of management, rather than also an advisor and/or mentor, is just wrong and will not lead to better performance.

Don Argus

Some NEDs can also be regarded as “independent”, and therefore provide objectivity of thought and perspective to boardroom deliberations.5 Usually an independent NED is not:

• a major shareholder of the corporation
• a material customer of the corporation

5 “Independence” is not a term which is defined in the Corporations Act although some guidance is given as to the accepted understanding of the term in the context of a NED in Recommendation 2.1 of the ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations.
• a material supplier of goods or services to the corporation
• a person who recently has provided material executive or consulting services to the corporation (for example, a recently retired CEO, auditor or lawyer of the corporation)
• materially associated with any of the foregoing persons or entities.

Independent NEDs assist by assuring integrity and objectivity of perspective in the deliberations of the board, especially in its relationship to the management team of the corporation.

There is a fundamental conflict between the expectations and benefits of independence and objective oversight by independent NEDs, and the expectations and benefits of directors being fully informed and intimately aware of all aspects of the company’s affairs. There is a balance and a trade off necessary.

David Gonski

In contrast, an executive director (or ED) participates both as a director on the board of a corporation and, through his or her assigned executive role as chief executive officer, chief financial officer or otherwise, is also empowered with delegated executive management authority by the board. In this capacity, he or she not only implements board decisions, but also acts as a decision-maker within the scope of authority that has been delegated by the board.

The “expectation gap”

In business, we all know how important it is for any company to have appropriate and clearly delineated roles, responsibilities and accountabilities for its key decision-makers if it is to be managed well. This is equally true when considering the role of non executive directors (NEDs). Unfortunately, in the mind of the public and the media, and indeed the law in Australia, this is not the case.

There is a degree of blurring and misunderstanding of the appropriate division of roles and duties between directors and management, which is out of kilter with the realities of running a modern corporation.

This white paper highlights several key questions including:
1. What are the roles and responsibilities of directors in our corporations?
2. How are those roles and responsibilities distinguished from the corporation itself and its executive management team?
3. What does a NED really do?
4. What is the public’s perception of the role of a NED, and how does that compare with reality in both practice and at law?
5. To the extent to which there is divergence between public perception and reality in both practice and at law, what is the extent of this “expectation gap”?
6. How might such a gap be closed to better align expectations, whether by legislative reform, practical governance reform or education, so that expectations might be realistically based?

This white paper is based on the proposition that accepted principles of good corporate governance, designed to ensure the optimisation of effective corporate performance, support a clear separation between the roles of the board and its directors and the executive management team. Directors and boards that ignore this practice do so at their peril and at the risk of criticism by their shareholders and stakeholders, unless special circumstances otherwise warrant.

Arising from this, it is argued that:
• there is an expectation gap between public perception, the law and governance in practice
• this expectation gap impacts effective corporate governance
• unless the expectation gap can be closed, there is a real risk of negative consequences which will impede optimal corporate performance for the benefit of all relevant stakeholders.

This risk needs to be addressed. Optimising corporate performance is too important an issue to be left without appropriate risk management.

The presence of this expectation gap was highlighted by the editor of the Australian Financial Review on 20 December 2010 when commenting upon the New South Wales Court of Appeal decision in the James Hardie Case,6 concerning Justice Gzell’s earlier finding of culpability and breach of duty by that corporation’s NEDs:

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“The reaction to the success of [the non-executive directors of James Hardie] appeal from asbestos victims and the building union confirms that there is a gulf between what the community expects of non executive directors and what is reasonably practicable in this part time role.”

This white paper is intended to raise awareness and to stimulate debate on this issue. Hopefully it will prompt action to close the expectation gap, to better align law and practice so that corporate performance might not be put at the risk of unintended consequences arising from that expectation asymmetry.

In addition, it may improve the public perception of the valuable role played by NEDs as the “hearts and minds” of the limited liability corporation.
2. What is the role of the corporation in society?

“Legitimacy” of corporations

To properly appreciate the role and responsibility of a NED, it is essential to understand the proper role of the corporation in society, as the public usually assesses the performance of NEDs through the perspective of corporate endeavour and outcomes.

It is no wonder that there are divergent views of the proper role of the NED when the “legitimacy” of the role of commercial corporations in society is confused.

Although governments have “legitimacy” through their democratic electoral mandate, commercial corporations do not have the authority of governments, nor the social standing of other community institutions (whether religious, educational or otherwise).

Except where shareholder returns and values align with broader social outcomes, the “licence to operate” of commercial corporations is largely found in narrower economic terms. These terms equate to the delivery of shareholder returns and value, which shareholders are entitled to insist on under our current laws.

Until recently a commonly endorsed view was typified by the US economist and author Milton Friedman when he said:

Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible.

This view, at least in absolute terms, has probably lost its currency. Today corporations and society often interact in many ways, other than on pure monetary

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terms. These interactions influence the behaviours and actions of corporations. Over recent decades this influence has included the development of concepts of corporate social responsibility and environment, social, governance that are now gaining significant support.

There has been a significant evolution of governance responsibility of companies over the last 30 years or so. The focus only on shareholder outcomes has given way to a broader responsibility for the company, embracing not only its shareholders, but also extending to other stakeholders.

Graham Kraehe

Powers of influence

Society has the power to influence corporate behaviour and action through various interactive tools and means. These create an environment which places the dynamic tension between corporate activity and the community’s social requirements in relative balance.

This is graphically portrayed in Figure B (on page 13), the “The Corporate Societal Mandate”.

In a formal manner, through legislation and regulation, society gives corporations the mandate to exist and operate. Society, through legislation, regulation and judicial interpretation, can temper or qualify that mandate and exert control over corporations and their activities, including those entrusted with their management and direction.

In a less formal manner, different sections of society can influence the behaviour of corporations to deliver outcomes aligned to their objectives. These informal powers of influence include:

- an investor’s ability to invest in, or divest himself/herself of, a corporation’s securities, a decision which may be affected by the views of proxy advisors
- an employee’s ability to commit, or withhold, his/her services to the corporation
- a customer’s/supplier’s ability to support, or boycott, a corporation or its services/products
- a social influencer’s (for example, media, special interest groups, an aggrieved or satisfied customer or employee) ability to generate publicity which impacts positively or negatively upon a corporation’s reputation, brand, services or products.

Exercising these powers can have subtle or profound effects on a corporation, its future activities and its financial performance. In a developed, democratic nation such as Australia, where information flow is free and the powers of different sections
**FIGURE B**: The Corporate Societal Mandate.
of society are open to exercise, the interactions between corporations and society generate correlative outcomes.

A corporation, through its directors (including its NEDs) will be influenced by and will assess and weigh the relevance of these formal and informal inputs in the:

- definition of the corporation’s values and culture
- formulation of the corporation’s mission and objectives
- development of the corporation’s strategies and their implementation
- way the corporation operates its business and undertakes its affairs
- manner in which the corporation engages with its stakeholders and society.

Over recent decades, various sectors of the community have realised that they have power to influence directors and how corporations behave. This is accentuated by improving levels of education and affluence in society, and contemporary information and communication technologies.

Directors, in turn, have realised that the sustainability of their corporation’s performance is dependent on continuing community support and approval.

Concepts of corporate social responsibility and environment, social, governance have continued to gain favour. It is now accepted in Australia that corporations and their directors may (and indeed in some circumstances must) have regard to the interests of broader stakeholders (beyond direct shareholders) when weighing the organisation’s best interests and sustainability.\(^8\) In the UK, legislation now stipulates that directors must have regard to broader stakeholder and community interests when discharging their formal duties and powers.

A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- the likely consequences of any decisions in the long term
- the interests of the company’s employees
- the need to foster the company’s business relationship with suppliers, customers and others
- the impact of the company’s operations on the community and the environment
- the desirability of the company maintaining a reputation for high standards of business conduct
- the need to act fairly as between members of the company.\(^9\)

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\(^9\) UK Companies Act 2006, Section 172(1).
This is a far cry from the provocative assertion of Milton Friedman in *Capitalism and Freedom*. Also, the UK’s more prescriptive legislative stipulation is beyond the current principled based, or permissive approach, currently applicable under Australian law, which allows directors relative freedom as to how they balance all these competing expectations in the best interests of the corporation.

This changing landscape of expectation and requirement is a trend that NEDs are very aware of, and have proper regard to, in the fulfilment of their responsibilities.

**Competing expectations**

The public holds many views about the correct role of the corporation within our society, as well as the prioritisation of interests the corporation, and its directors, should be serving. It is not uncommon for a person to hold many different views on this subject depending upon the particular lens through which they are viewing the situation at that particular time.

For example, as a shareholder of the corporation, an individual might expect the corporation to contain expenses and to optimise its return to shareholders, but on the other hand:

- as an employee of the corporation, expect an appropriate salary, security of employment and a safe work environment
- as a customer of the corporation’s products or services, expect reliable quality at a reasonable price
- as a supplier of goods or services to the corporation, expect timely payment of invoices and continuity of engagement
- as a person living in the neighbourhood of the corporation, expect it not to interfere with the neighbourhood’s quality of life through environmental or noise pollution
- as a member of a just and fair society in which the corporation operates, expect it to operate within accepted bounds of human rights with respect to its workplace policies.

Figure C (on page 17) illustrates these relations and expectations. The prevalence of calls for regulatory intervention and the propensity of our parliamentarians and regulators to respond to that populist pressure, where a corporate outcome result does not meet the expectation of that sector of society, should be noted.

Yet even when they are shareholders, members of society may have quite disparate views of whether the corporation and its directors are performing to expectation:

- as a short term shareholder, or even day trader, their expectations are for share price growth and dividend return in the short term, with minimal regard for the longer term
• as a longer term investor, their expectations are more likely to be satisfied by the corporation delivering superior total shareholder return, in an ethical, responsible and sustainable manner over the longer term
• as an investor interested in regular dividend returns at the expense of capital growth, or vice versa.

Directors are accountable to shareholders but their duty is to act in the best interests of the company. If a shareholder is a long-term shareholder then their interests are likely to be aligned with the interests of the company but this is not always the case for short-term shareholders.

Catherine Livingstone

Many corporations have thousands of shareholders within their ranks, each expressing their expectations of the corporation. This array of disparate expectations and demands creates numerous permutations of often conflicting and complex outcomes and responsibilities for corporations and their directors, particularly in the context of the director's overriding duty at law to act in the corporation's best interests. It is essential that these are synthesised and managed if the corporation is to have any hope of operating in an effective way.
**Figure C:** Society role/expectation matrix.
3. The role of a NED in practice

Overview of a director’s role

Don Argus, the former Chairman of BHP Billiton Limited and an experienced NED, has expressed the following nine main principles that have guided his career as a director:

1. Every board of directors owes its primary duty to the company itself. No stakeholder (shareholder, employee, customer or any other) is entitled to preferential treatment. The only exception is when a company is insolvent, at which point directors must regard creditors’ interests over other groups.

2. Directors must look to the company’s short, medium and long-term interests. Short-termism, such as focusing solely on this year’s shareholder returns, leads to poor corporate governance and damages a company’s long-term health.

3. Directors must strike a complex balance between many competing interest groups (stakeholders) that play a role in the daily life of the company’s business and are affected by its actions.

4. In discharging their fiduciary duty, directors should disregard their own interests. Their purpose is to safeguard the company’s inheritance, set the framework for the future well-being of its business and then drive that business forward within the law and best practice.

5. The real key to effective corporate governance is a properly functioning board where mutual trust and respect lead to open, informed and timely debate on any and every aspect of a company’s affairs.

6. There is no distinction in the eyes of the law between executive and non-executive directors. Directors need to understand that they are collectively (not just individually) charged to look after the company’s best interests.
7. Every board must be collectively satisfied that each director’s skills are appropriate for the industry and the company.

8. Directors should, of course, ensure compliance with relevant regulations and codes. However, they have a much broader responsibility to develop a long-term corporate governance strategy that addresses the interests of all stakeholders and is aligned to the ongoing role that their company is to play in society.

9. In developing this strategy, directors should make themselves aware of the wide range of issues that need to be addressed, in addition to financial transparency, from the perspectives of both legal compliance and the company’s long-term interests.

The role of a NED has evolved significantly over the last 50 years, and especially over the last 25.

The NED has a vital role to play on the board, especially independent NEDs who bring not only the benefit of their knowledge, intellect and understanding, but also the benefit of their life’s experiences and perspectives, including through their diverse vocational, educational, cultural, gender and age backgrounds, which they are expected to apply with objectivity and independence of mind. The importance of this diversity should not be underestimated for an effective board.

In particular, a director’s responsibilities are not limited to merely turning up to monthly, bi-monthly or quarterly board meetings. Contemporary roles and responsibilities of NEDs at least include:

- attendance at both regular and special board meetings often called on short notice and irrespective of whether the meeting participants are all physically located at the same place and in the same time zone

Many people look at the number of board meetings disclosed in the annual report and assume that is the total time that directors spend. Board days are just the tip of the iceberg.

Catherine Livingstone

- attendance at standing board sub committee meetings, such as audit, risk, nomination and remuneration committees, as well as ad hoc committees. The roles of such committees are an increasingly important and demanding aspect of corporate governance in this age of enhanced governance expectations. However, caution has been expressed by Don Argus that care needs to be taken to guard against “the corrosive impact on
The role of the NED is more involved now, especially with the rise of the relevance and importance of board committees. It used to be that an audit committee met twice a year. Commonly for major ASX listed companies they now meet before each monthly board meeting.

Michael Chaney

- attendance at strategic planning days, risk management workshops and other specially dedicated planning and decision making times and events
- attendance at shareholder meetings, whether the annual general meeting or special/extraordinary general meetings
- receiving, reading and analysing board and board sub committee agendas and information packs (which are often lengthy, complex and challenging including technical reports from executive management as well as from independent consultants and experts on particular aspects of the corporation’s affairs) and preparing for the relevant meeting. The time, reflective consideration and diligence to be applied to this aspect of the NED’s role are significant
- gaining and maintaining understanding and familiarity with the business and affairs of the corporation which is likely to include:
  - understanding and staying informed of the corporation's financial statements and financial capacity
  - keeping abreast of industry and economic developments and market trends relevant to the corporation and its business
  - visiting the corporation’s business sites
  - outside formal board meetings, talking to and interacting and engaging with senior management personnel, with the approval and sanction of the CEO
- monitoring, reviewing and approving of ASX continuous disclosure announcements and media releases by the corporation
Continuous disclosure is effective in Australia. It forces companies to keep the public informed in circumstances where previously they may not have seen a need to.

James Strong

- maintaining relations and developing trust and confidence with fellow board members, as well as the CEO and senior executives, in order to enhance the quality and process of decision-making at board and board sub committee meetings, usually through formal or informal meetings outside the boardroom

Managing interpersonal relations and dynamics both amongst board members and with senior executive management is a challenging and time consuming task. It is often harder than the substance of the issue being deliberated on. This is not to say you want everyone thinking and behaving the same. The diversity of perspectives and approaches is what ensures the integrity and soundness of decisions made. You need open-minded people, driven by values within a collegial and respectful culture.

Ted Evans

- participating in board effectiveness reviews and evaluation processes for directors, and for the board chairman or lead independent director, also facilitating such reviews and evaluations for the CEO and other directors, all usually outside structured board and board sub committee meetings
- making “down time” available to think about and reflect upon the corporation, its business and its affairs and the contribution the NED can best make in progressing the corporation’s strategic direction, performance and affairs
- periodically participating in and discharging a board representative role at work sites and at corporate staff events to enhance cultural and human resource relations within the corporation
- on occasions, perhaps for the chairman, attendance at industry and corporate events by way of promotion of the corporation and its prospects to the broader investor markets and the public
- at times of critical corporate need or crisis, active engagement at multiple board or board sub committee meetings, and even as the circumstances may dictate, engagement in a counselling role in support of the CEO and other senior executives, especially in the face of absence or depletion of a
sufficient executive management team to deal with the issue at hand, or even at other times when the executive management may wish to draw upon the experience and counsel of the board

• at all times in the public forum, representing the relevant corporation to which the NED is appointed, with expectation of the NED being able to properly discharge that responsibility to the advantage of the corporation.

The Appendix contains generic samples of a board agenda, an annual board calendar and the terms of remit for a small public listed corporation’s audit, risk, nomination and remuneration sub-committees. They may help give an indication of the scope and complexity of the matters regularly assessed by a board and its directors.

**Balancing the complexity**

The second chapter of this white paper considered the disparate societal views of the proper role of the corporation in our society. It recognised that even shareholders may hold quite different expectations of acceptable performance of a corporation, depending on whether the shareholder has a long term or a short term investment horizon or a dividend or capital growth focus for their investment.

NEDs must have due regard to all of these factors as they go about their various functions. NEDs seek to find balance in the complexity of outcomes that may arise and acknowledge that in finding that balance, compromise is inevitable.

NEDs usually must make decisions and judgments on behalf of corporations:

• within prescribed time deadlines
• without the availability of all relevant information
• knowing that future events and circumstances cannot accurately be predicted and thus present risks to the delivery of the anticipated, or intended outcome, relevant to the decision or judgment taken by them.

Being sufficiently across all relevant information is a challenge. But you need to know enough to know what you don't know, what you need to know, and what you don't need to know.

*Catherine Livingstone*

By contrast, the performance of corporations and their boards, and the decisions and judgments taken by NEDs in the course of their role and responsibilities, are usually assessed and judged by regulators, the courts, the media and the public with the benefit of hindsight, without time constraints and with access to all information possible that may be relevant to the decision or judgment made and
its probable consequences. Hindsight is truly 20:20 vision, but 20:20 hindsight vision is not available to the board when the decision needs to be made.

**When the going gets tough**

At times of corporate need or crisis, the role of the NED becomes more challenging, taking on heightened responsibility and usually involving extra time commitment and complexity of issues. Such need or crisis may include:

- times of solvency stress when the quality and reliability of the corporation’s financial affairs and cash flow forecasts (usually prepared by the executive management team) become particularly critical and subject to intense scrutiny and analysis. At such times NEDs face the prospect of personal liability for corporate debts incurred and statutory breaches if they “get it wrong”, despite best endeavours

  Insolvency destroys corporate value – even the sniff of it. It is during times of solvency stress that the mettle of the board is really tested. It is not a time for the faint hearted. It is a time when it is handy to be able to draw upon experience and old war wounds.

  Rick Lee

- dealing with a contested takeover, especially a management buy-out, when the prospect of a conflict of interest for the executive management team means the NEDs may have to take a very hands on role in the management of the takeover defence, without the benefit of full involvement of, and support from, the executive management team
- the sudden departure of the CEO for any reason (health, personal, resignation or removal)
- a catastrophic business event such as a mine disaster, an oilwell explosion, a major environmental risk at a power station, a major product recall or a material ethical embarrassment where the reputation and standing of the corporation and its directors and officers may be questioned and its business prospects imperilled.

  In many of these circumstances the board and its NEDs may be without the benefit of any executive management input. Alternatively they may have to discount the input of the executive management team and seek alternate independent advice and consultancy services if the executive management team has failed to adequately deal with the matter, or has materially contributed to the advent of the need or
crisis. In any event, NEDs will need to become more engaged in operational and management issues than usually is the norm in order to provide closer guidance, direction and support to the corporation.

While undertaking research for this white paper, some NEDs reported attending up to 100 plus board and board sub committee meetings over a six-month period in recent years, in order to properly respond to a crisis with which their corporation was confronted.

During the global financial crisis, when many corporations had to raise capital in short time frames, many boards faced extraordinary demands. One board on which I sit met 42 times in one year, including 30 times in four months. This would not be an isolated experience.

Graham Bradley

NEDs need to plan their other vocational, professional, domestic and social commitments so that they are able to respond to these times of corporate need or crisis, even though it may be impossible to predict when such times may arise.

In particular, if NEDs need to take on executive management roles and responsibility at such times, it is likely that all their skills, experience, judgment and acumen will need to be drawn upon and be made available for the benefit of the corporation.

The responsibility and pressure this puts upon NEDs at these times is very significant, and probably little understood or recognised.

**Other necessary qualities and attributes**

To cope and successfully deal with the complexities and demands of contemporary corporate endeavour in a proper governance environment, directors need to have relatively high levels of:

- knowledge
- intellect
- understanding
- reasoning
- intuition
- interpersonal skills.

This is especially true for NEDs, given their relative separation from the executive function and the day-to-day operational management of the corporation, and their part time roles in the corporation.
These capabilities include, but go beyond mere skill, experience and competence, although these attributes can also be of vital importance. These capabilities must be present in the board as a whole and desirably should be possessed by as many directors as is reasonably possible.

Boards function as enquiring, analytical and deliberative decision making bodies where the output is the product of the collective contributions and inputs of all directors. As in any group or team dynamic, it is rare that all team members have the same attributes and degrees of capability. In the boardroom, some directors will have more developed capability or experience. This does not necessarily diminish or devalue the contributions of the others. Other directors will bring different strengths and perspectives to the board table. The quality and effectiveness of the collective decisions of all directors is what is important.

Additionally, NEDs need to apply themselves actively and diligently to their role including being available and being engaged.

Being available means more than just attending routine board, board sub-committee, strategy and shareholder meetings. It also includes:

- participation, as appropriate, between board and board sub-committee meetings for corporate promotional and strategic purposes
- time to prepare for meetings and to develop better understanding and knowledge of the corporation and the industry and economic context in which it operates
- time for less formal but important occasions when board trust, confidence and culture is forged
- time to cope and deal with special board and board sub committee meetings to address urgent issues that may arise (for example, a corporate crisis, a takeover, a sudden loss of CEO)
- not being “over committed” or allowing other vocational, professional, domestic and social commitments and circumstances to unreasonably intrude upon a board member’s availability for the benefit of the corporation.

Managing availability can be quite intrusive upon a director’s personal life. In particular, given the scope and importance of the role of a NED, the range of issues likely to be confronted and needing to be addressed in busy corporate endeavour, and the unpredictability of time and circumstance when the NED may be called upon to support the needs of the corporation, even when a NED is not actually engaged in the business of the corporation, or preparing for it, the NED is in a constant “24/7 standby mode”.

Being engaged refers to the level of active and effective interest taken by the director in the affairs of the corporation in order for the corporation to gain optimal
benefit from the director’s potential contributions. Engagement includes directors:

– having read and fully considered board and board sub-committee papers in advance of meetings
– giving the full benefit of their knowledge, experience and perspective on issues relevant to the corporation, especially if, by virtue of their knowledge, experience or skill, they have a unique contribution to make
– actively participating in board and board sub-committee deliberations to ensure optimal decision making
– being attuned between board and board sub-committee meetings to the best interests and affairs of the corporation.

You can’t expect non-executive directors to be over every aspect of the company. Their objectivity and independence is what is valued. You want experienced people who can test issues, make judgments and ask the right questions.

Leigh Clifford

Ethical awareness

In addition to all the legal duties described in Chapter 6 that are imposed upon directors, other core values and attributes for NEDs include:

• integrity – being honest in all things and true to the roles and duties entrusted
• fairness – behaving fairly and equitably, in the interests of the organisation, with proper regard to the legitimate interests of relevant stakeholders
• confidence – honouring and upholding the confidence that others place in the board and its directors, and the confidentiality of the office of a director.10

This demands a high order of ethics and values to identify, consider and exercise judgment in potentially compromising circumstances.

In particular, NEDs need to be cognisant of the potential for conflicts of interest to arise and for these potential conflicts to be properly dealt with.

It requires an understanding of the spirit of the law as well as the letter of the law; an appreciation of the importance of a good corporate reputation, and the personal reputation, and the need to properly manage stakeholder expectation.

10 Extract from the Australian Institute of Company Directors’ “Guide for Directors and Boards – delivering good corporate governance.”
If you have to start worrying about what the letter of the law is, then you have a problem. Good boards are driven by values.

Catherine Livingstone

NEDs need to make judgments about what can and should be done, and also whether if what is being done is “right”.

The subtle combinations of circumstances and events that create ethical dilemmas would challenge and compromise many lay people who do not have the skills, experience, awareness and acumen of a competent and experienced NED.

The challenge of being “one out and one back”

One of the greatest challenges for the NED is the tension that comes from being:
- a member of the board, but having no power or authority over other directors on the board in the decision making
- accountable, as a member of the board, to the shareholders for the performance of the corporation, yet operating in a non-executive role, without executive and management authority for the day-to-day operations of the corporation.

There is a clear line between the roles of the board and management. It may move over time depending on the company's circumstances, but it is always there. Unfortunately the regulators do not always respect this line. If you ignore this line then you are fundamentally changing the construct of a NED. The regulators seem to want boards to have the same responsibilities as management but this violates the independence of NEDs.

Catherine Livingstone

The span, scale and scope of management of many corporations is vast. Authority can only effectively be exercised over those engaged in the corporation's business operations and activities by means of relatively sophisticated governance structures and management systems. Under these structures and systems, authority is delegated and accountability is maintained through reporting structures and cultural alignment between those with delegated authority and the corporation itself, as determined by the directors meeting as a board.

As mentioned earlier, accepted principles of good governance state that there should be a clear separation between the roles of the directors and the board and
the executive management team. Directors and boards which ignore this accepted practice do so at their peril and at the risk of criticism by their shareholders and stakeholders, unless special circumstances otherwise warrant.

A non executive director actually is not empowered to effect executive outcomes. His or her primary powers, through decisions made by the board, are to guide, influence, incentivise and cajole the management team to effect executive action consistent with the corporation’s strategy and policies. The integrity, ability and application of the executive management team are essential.

John Morschel

The detached oversight role of the NED has been described by one senior NED\(^ {11}\) as being “one out and one back”\(^ {12}\), referring to standard bred trotting or pacing race terminology – representing a strong position from which to monitor the race, and to respond or attack but a difficult position from which to control the pace of the race by the “pacemaker”\(^ {13}\).

This is often little understood by the general public which tends to assume that all directors, including NEDs, have control over every facet of the corporation’s business and affairs, both strategic and operational. NEDs in particular need to find the balance between this “damned if you do and damned if you don’t” dilemma.

The non-executive directors are there as a foil to guide, challenge and make insightful interventions when appropriate. By necessity they must act with imperfect information, knowledge and time constraints. If they did not maintain this objective independence, the value of their role would be diminished.

David Gonski

It is for this reason that, in general terms, the Corporations Act\(^ {14}\) and the common law stipulates that the “management and direction” of the corporation lies with the directors (as a collective board), and gives the directors authority to delegate their power of management to competent people. The Corporations Act\(^ {15}\) and common law also absolves the directors from personal liability if the delegation is properly

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11 David Richardson – Chair, Solco Limited.
12 “one out and one back” refers to a trotter or pacer being positioned second in the outside line of racers so as not to be “punching the breeze” and so as not to be “hemmed in on the rail”.
13 The “pacemaker” is the lead horse on the inside line of horses close to the rail.
14 Refer Note 3.
15 Section 190(2) of the Corporations Act 2001 (Cth).
effected, even if the delegate fails to properly execute the delegation, or defaults in the proper exercise of the delegated power.

The importance of this legal position is fundamental to the proper governance of corporations.

**Remuneration – illusions and reality**

In recent years a significant amount of commentary concerning the large remuneration packages of a small and select number of CEOs and other corporate executives has appeared in the media. Unfortunately, the quality and integrity of much of this information has often been distorted and sensationalised.

This information has mislead the general public into assuming that all directors are the beneficiaries of considerable remuneration largesse, conferred by themselves for their own benefit.

Nothing could be further from the truth.

Although the average total remuneration for the CEOs of the 100 or so largest public listed corporations in Australia is somewhere in the vicinity of $4–5 million per year,¹⁶ these are the corporate elite, like our sporting and entertainment elite. However, they represent only 0.00005 per cent of all CEO’s or managing directors of corporations in Australia. Remuneration packages for the CEOs and managing directors of most other corporations outside this elite group are generally a very modest fraction of these levels.

In the case of NEDs, the median total remuneration (inclusive of fixed salary, superannuation and other benefits) of the NEDs of larger public listed corporations in Australia is about $150,000 per year¹⁷ (remember that public listed corporations represent less than 0.01 per cent of all corporations in Australia), and of smaller public listed corporations is about $50,000 per year. Although such a salary may appear significant for a part-time position relative to the average wage of the working Australian, in respect to the skills and experience required to discharge the role, the nature and demands of the role and the personal liability and reputational risks assumed by the NED, such a salary package is, at best, modest to reasonable.

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¹⁷ Refer to Note 16.
I have no doubt that there is much confusion amongst the general public which may perceive there to be little difference between the remuneration levels of non executive directors and those of relatively well paid full time senior executives – aren’t they all directors?

Ted Evans

It is also important to note that shareholders must approve the maximum remuneration pool which is divisible amongst NEDs by way of fees for their services.

For NEDs of statutory, proprietary and NFP corporations, the remuneration base usually is only a fraction of the levels given to NEDs of public listed corporations, with the vast majority of NFP board service undertaken on a gratuitous basis (refer to Chapter 4).
Research conducted by the Australian Institute of Company Directors in its “Directors’ Social Impact Study” in February 2010 revealed the NFP sector in Australia is large and diverse. Some NFPs deliver welfare, health, education, sports, arts, culture, emergency and social advocacy services to the community. Others have members who join to access professional development and support, develop networks around common interests or to promote community engagement in the environment, cultural heritage and the arts.

There are more than 500,000 NFPs in Australia, contributing $43 billion or 4.1 per cent of the nation’s GDP. The NFP sector is one of the nation’s major employers providing 8.6 per cent of Australia’s employment as well as involving about 20 per cent of the overall population in a volunteering capacity, with volunteers contributing an estimated 623 million hours per annum for the public benefit.

Most of the NFPs in Australia are managed and directed by NEDs who willingly volunteer their time and expertise free of charge, notwithstanding the commitment, responsibility and personal liability that they take on by doing so.

The not-for-profit sector would be challenged if it were not able to draw on the skills and experience of directors of publicly listed corporations.

Catherine Livingstone

The research also revealed:

• about 60 per cent of respondents served on NFP boards, many holding multiple NFP appointments
• the median NED respondent devotes between 6 and 20 hours per month to NFP corporations
• almost 75 per cent of respondents contributed their time voluntarily, without fee
• community services, health and education accounted for 84 per cent of NFP organisations on which NED respondents served.

Despite working for free, these organisations may still be of considerable size and influence. From the Australian Institute of Company Directors’ research, the average director’s primary NFP has a turnover of between $5 and $20 million, staff of 21 to 100 and manages a volunteer workforce of up to 50 people. NEDs of such NFPs have a similar personal legal exposure to those of a paid NED of a for profit public company of comparable size.
The differing roles of NEDs

Although the legal role and responsibility of directors is relatively uniform regardless of the size, nature and circumstance of the corporation to which they are appointed, there are important distinctions in the roles that NEDs are likely to play, and the circumstances that NEDs are likely to encounter.

The public ASX listed corporation

NEDs of public ASX listed corporations have heightened roles and responsibilities and commensurate liability, substantially arising from the confluence of the following:

- due to the large sums of money involved, and the receipt of and involvement with funds and investments from the general public, accountability and probity expectations are very high
- the scope and scale of the corporation’s business and affairs are likely to be significant in value, span and complexity
- multinational corporations have obligations and responsibilities for laws and compliance requirements of other countries along with Australian requirements. In addition, a multi cultural or at least multi located board of directors of a multinational corporation poses extra challenges to the establishment of trust and confidence between directors (due to more limited opportunities to engage personally with one another), and also in the practical process of board meetings and meeting dynamics due to geographic and logistical challenges
- as well as the usual federal and state legislation and general law (encompassing both the common law and equity) which apply generally to corporations and their directors, the ASX Listing Rules, the ASX Corporate
Governance Council’s Corporate Governance Principles and Recommendations, and extra provisions within the Corporations Act (and subordinate regulations), add to the already considerable legislative and regulatory legal compliance requirements with which NEDs need to be aware

- the public nature of the corporation’s business and community profile is likely to bring enhanced public and media attention and scrutiny and the fulfilment of the role and responsibility of its NEDs, with personal liability and reputational risk if not handled with care.

**The private/SME corporation**

Many directors of private/SME (small to medium enterprise) corporations are also executives who perform both board and management functions for the corporation. Due to the expected enhanced knowledge of the business and financial capacity of a corporation by an ED compared with a NED, such EDs have heightened roles, responsibilities and liabilities as directors of the relevant corporations.

For a NED of a private/SME corporation, the following factors warrant special care:

- the availability of fewer executive management personnel, and even those who are available may have fewer formal qualifications and less depth of experience. Likewise there may be limited resources to obtain expert external advice
- formal governance structures, protocols and practices are likely to be less developed
- a major or dominant shareholder, who is also the CEO or at least a senior executive of the corporation, and possibly also the chairman of the corporation, may be present and may have a determining influence over most aspects of the corporation’s business and affairs
- there is greater risk of volatility in the business and financial affairs of the corporation, with less resilience to material market, financial and business risks
- there is greater prospect of EDs being in the majority over NEDs at board meetings, with the risk that such meetings may over focus on operational issues compared with strategic issues
- there is greater prospect that the tenure of office of the NED is at the effective whim of the major shareholder/ED and as a consequence the NED’s independence of perspective may risk being compromised by a perceived need to support the views of the major shareholder in order to retain office.
The not-for-profit corporation

Many NFPs operate on limited resources (financial, human, physical and otherwise) and are accountable for public funds, commonly from government appropriation and grant, or from charitable donation. The following special risks arise for NEDs serving on the boards of NFPs:

- as the corporation has received and is dealing with public funds and donations, accountability and probity expectations are very high
- the NED’s professional expertise may be called upon in an executive or quasi-executive role due to the lack of available in-house executive skills and lack of financial wherewithal to outsource the expertise required. NEDs need to take care in such circumstances that they do not also take on professional liability risk to the corporation in the delivery of that professional service
- despite the NED freely volunteering his/her time and expertise as a director, his/her personal liability exposure will nevertheless be the same in all material respects as if he/she was a director of a for-profit corporation
- the formal governance structures, protocols and practices of the NFP commonly may be underdeveloped
- the presence of influential and possibly high profile individuals on the board of the NFP who are passionate and well meaning about the cause of the NFP, but who may lack many of the essential skills and expertise required of a director for effective corporate governance and performance to be achieved
- due to the “hand to mouth” funding model of many NFPs and the insecure nature of their future funding, questions concerning the corporation’s “going concern” status and solvency often arise.

The statutory authority corporation

Most statutory authority corporations have been established to assist governments in the better delivery of a community service than potentially could be delivered by a department of government itself. They are often established by an Act of Parliament. That same piece of legislation not only enables the statutory authority to operate, but often also constrains the scope or freedom within which such a corporation may operate. For a NED sitting on the board of a statutory authority, the following aspects warrant attention:

- there is potential for conflict between the statutory mandate of the corporation and the political agenda of the government then in office, as represented by the relevant minister
in many government agency authorities, the legislation commonly gives the minister the right to “direct” the board if the minister is dissatisfied with the strategic direction the board is taking, or a decision that the board is about to make.

It is important to understand the scope of the real delegation of authority to the board of a corporation and the real standing of decisions made by that board.

James Strong

• directors of the corporation are commonly appointed by the minister with minimal or little say or influence by the board and the other directors as to the board’s appropriate composition and skills mix
• the enabling legislation may also specify that the board is to be comprised of a number of “representatives” from different sectors of the community or stakeholder groups referable to the corporation (not uncommon for university boards or, for example, where an advocacy presence of a union or consumer group may be prescribed). This can risk the effectiveness of board collective decision-making if at times some board members may be participating and voting in the best interests of their represented group or cause, rather than in the overall best interests of the corporation
• the minister commonly appoints and remunerates the CEO. This can significantly diminish the power of the board and its NEDs from having material influence over the performance of the CEO and the executive management team, although the board still has accountability for overall corporate performance
• on a positive note for directors, the enabling statute may include a provision which has the effect of materially limiting the personal liability of the corporation’s directors, provided they act in good faith, although care needs to be taken if such provisions are to be relied upon.

The subsidiary corporation

Although some larger corporate groups operate with a decentralised governance and management structure, with devolution of most board decision-making to the operating corporate divisional level, larger corporate groups typically operate with a centralised governance structure. With this model many important strategic, corporate, governance and business decisions are made by the parent corporation and its board in the overall interests of the group. Theoretically, this is in the best interests of each member of the group due to their inter dependence upon one another.
With such a governance structure, the board function of the subsidiary is more a formality to replicate the decision of the parent corporation board and to formalise resolutions where that is strictly required.

This practice can create dissonance and special challenges for a NED of such a subsidiary, who may feel relatively disempowered with greater risk exposure by such a governance structure.

It must also be remembered that the duty of a director is to the corporation to which he/she is appointed, not to the corporate group or the parent or holding corporation, if the corporation is the subsidiary of another.

Section 187 of the Corporations Act legitimises such a governance regime by allowing a subsidiary corporation, and its board, to act in the best interests of its parent or holding company so long as:

– the subsidiary corporation's constitution empowers it to do so
– the NED acts in good faith in the best interests of the parent company
– the subsidiary corporation is not insolvent at the time and does not become insolvent by reason of the director's act.

Particular tensions can arise where the corporation is a foreign subsidiary of a multinational corporation, and the laws and requirements of the foreign jurisdiction do not align with the aspirations and understandings of the parent or holding company and its board. Experienced NEDs of such foreign subsidiaries appreciate both the sensitivity, and the importance, of their role to ensure sound governance.

As a director on the board of an international subsidiary, the local subsidiary director must accept a certain amount of legitimate strategic direction from its 100 per cent shareholder. But they still must be satisfied with the integrity of that direction and the execution of its implementation.

David Gonski
6. The reality of the role and responsibility of a NED

The legal role and responsibility of a NED

This white paper does not aim to provide a definitive exposé of the various duties and responsibilities of a NED either at common law, in equity or under legislation. Suggestions for further reading in these areas is provided in the Appendix.

Anyone pursuing these references will quickly note that the law on directors’ duties and responsibilities is extraordinarily complex, imprecise, confusing, imperfect and very much in need of reform and clarification.

As mentioned earlier, despite some exceptions, laws that apply to directors are relatively uniform regardless of the size, status, type, sophistication or governance framework of the relevant corporation. Surprisingly perhaps, this uniform “one size fits all” model and legislative framework is historically robust, having survived over the hundreds of years that corporations have operated in our social structure. However, given the proliferation of state and federal laws over recent decades which seek to regulate the governance of corporations and impose personal liability on directors, the suitability of the model does warrant review.

The historical “one size fits all model” for corporate regulation has largely stood the test of time and can continue to do so, but only if it remains principles-and-values based to allow its just interpretation and application to the particular circumstances of the relevant corporation and its directors. Corporate governance is too complex a matter for all outcomes to be envisioned and prescribed by regulation.

Ted Evans
In general terms under the Corporations Act and at general law, and subject to the many technical nuances of the law and its interpretation, the corporate duties of a NED can be summarised as follows:

1. Collective board responsibility
   Responsibility for the management and direction of a corporation and its affairs is a collective and indivisible duty of all of its directors on behalf of the corporation, meeting and taking decisions as a board.

2. Directors must be in a position to guide
   Directors have to take reasonable steps and efforts to place themselves in a position to guide and monitor the management of the corporation.

3. Delegation
   NEDs do not have to give their continuous attention to the affairs of the corporation, and the directors acting collectively as a board, are able to delegate (but not abrogate) most of their responsibilities, although matters fundamental to the corporation might not be capable of delegation and might require the direct application of the minds of the directors themselves.

4. Scope of legal responsibilities and duties (generally)
   A director is charged with the responsibility to personally perform his/her general role as a board member, along with all other directors, unless specific duties or responsibilities have been:
   • delegated to a particular director by a duly authorised resolution of the board
   • conferred upon a director by reason of a provision in the corporation’s constitution, such as a managing director, or even a governing director in some proprietary companies
   • delegated by necessary implication to a director holding a particular recognised office within the corporation, such as the corporation’s chief financial officer who may also be an ED.
   Under these circumstances the director is protected against personal legal liability, if the director:
   • becomes familiar with the fundamentals of the corporation’s business and affairs
   • receives and reviews available information concerning the corporation and its affairs
• keeps him/herself reasonably informed of and monitors the corporation’s activities within the scope of the director’s role
• participates in and calls (as appropriate) meetings of directors
• participates and engages in deliberations and votes at meetings of directors
• draws matters to the attention of the board and/or the senior executive team, if reasonably perceived by the director to be important and relevant to the corporation and its affairs
• is diligent and enquiring with respect to matters concerning the corporation and its affairs within the scope of the director’s role
• performs functions delegated to him or her by the corporation (expressly or by way of necessary implication)
• is familiar with the corporation’s financial statements, and makes further enquiry where appropriate
• maintains a reasonably informed view of the corporation’s financial capacity, and solvency
• discharges the range of duties imposed upon a director at common law, equity and under the Corporations Act including:
  – to act with care and diligence
  – to act only for a proper purpose and in the best interests of the corporation
  – not to abuse the position held by the director
  – not to misuse corporate information received by the director
  – to avoid and resolve any conflict of interest that may arise
  – to not inappropriately fetter his or her discretion as a director, for example by making board decisions at the behest of another person.

5. Special duties as to insolvent trading
A director must not allow a corporation to continue to trade if the corporation is unable to meet its debts as and when they fall due for payment.

6. Safe harbours
There are several “safe harbour” defences prospectively available to a director where the director is accused of failing to properly exercise his or her duties:
(i) Business judgment rule
Generally the impugned director will be absolved from what might otherwise be a breach of duty to act with care and diligence if:
• the director makes a “business judgment” (which means an actual decision to take or not take action – not merely passive inaction or failure to make any decision to act or not act)
• the decision is made in good faith, for the proper purposes of the corporation
and in circumstances where the director has no material personal interest in the outcome of the matter
• the director has informed himself or herself of the subject matter referrable to the decision to the extent to which they “reasonably” believe appropriate
• the director rationally believes the decision to be in the corporation’s best interest, with a statutory presumption that the director’s belief is rational unless no reasonable person in such a position would hold such a belief.

(ii) Reliance on information or advice from others
Generally the impugned director also may be absolved from what might otherwise be a breach of duty if:
• the director reasonably relies on information or advice provided by others
• the director believes on reasonable grounds the competency/authority of the person providing the information or advice
• the decision of the director is made in good faith after the director has made his or her own independent assessment of the information or advice provided (having regard to the director’s own knowledge of the matters to hand and the complexity of the corporation), unless the opposite is proved.

(iii) Delegated authority
Although section 190(1) of the Corporations Act imposes a direct responsibility on directors for the exercise of authority by a delegate, a director’s liability for a default in the performance or judgment by the delegate of the authority delegated is excused if:
• the director believes on reasonable grounds at all times that the delegate would exercise the power properly
• the director believes on reasonable grounds, in good faith, and after proper enquiry (if the circumstances warrant the need for enquiry) that the delegate was reliable and competent in relation to the power delegated.

(iv) Insolvent trading defences
Section 588G of the Corporations Act sets a high standard for directors who allow the corporation to which they are appointed to trade while it is insolvent. However, a defence may be available to a director if:
• there were reasonable grounds to expect the corporation was and would remain solvent
• there were reasonable grounds to believe a competent and reliable person was responsible for providing adequate information about solvency (and was doing so), and on the basis of that information, the corporation was and would remain solvent
• the director, for illness or other good reason, did not take part in the management of the corporation at the relevant time
• the director took all reasonable steps to prevent the insolvent debt being incurred.

Reporting and disclosure obligations, especially for public listed corporations

In addition, there are a raft of other statutory obligations upon companies under the Corporations Act. Some of these impose prescriptive disclosure or reporting requirements, and some materially prescribe the behaviour of directors. The general nature of these requirements is to foster transparency and accountability to shareholders and others and to prevent the risk of directors and officers abusing their positions. These obligations include:
• the corporation's financial statements being prepared in accordance with accounting and audit standards
• disclosing the remuneration payable to directors and senior executives
• disclosing which directors attended board meetings
• disclosing any dealings by directors in securities in the corporation promptly following the dealing, or even seeking corporate permission before the dealing
• directors and others not dealing in securities while in possession of materially price sensitive information (“inside information”) which has not been disclosed generally to the public
• directors and others not entering into transactions with the corporation without fully informed shareholder consent (“related party transactions”)
• immediately disclosing to the market, price sensitive information (information which may materially affect the price or value of securities issued by the corporation) in the corporation's possession, unless the circumstances allow the corporation not to disclose the information and to keep it confidential
• directors not participating in board deliberations or voting where the subject matter before the board may give rise to a conflict of interest.

These represent a small selection only of the various other obligations and restraints for directors, including NEDs, under the Corporations Act and related legislation – including complementary regulations, guidelines and practice notes, which run to a voluminous set of texts of more than 2,500 pages of closely scripted technical legal pronouncements.
Fiduciary duties

Many of these duties and responsibilities have had their origins in the responsibilities and duties attaching to a fiduciary. The duty of a fiduciary involves reasonably strict obligations of fidelity, loyalty, trust and confidence.

This duty of a fiduciary generally arises where there is a special relationship between two parties, and one party (the fiduciary) has an advantage of power, information or influence over the other. In the case of a director, the fiduciary obligation arises because the director has been appointed by the shareholders to a position of stewardship and accountability, with management and direction authority over the corporation and its affairs to the virtual exclusion of the shareholders.

There are five elements attributed to the rules relating to the duties of a fiduciary:

1. the fiduciary must avoid having an interest that may conflict with the fiduciary’s duty
2. the fiduciary must avoid having an engagement with a third party that may give rise to a conflict with the fiduciary’s duty
3. the fiduciary must not misappropriate property under the fiduciary’s care for the fiduciary’s or another’s benefit
4. the fiduciary must not misuse the fiduciary’s position for the fiduciary’s or another’s benefit
5. the fiduciary must not divert a business opportunity which arises as an incident or consequence of the fiduciary’s office.

Dynamic nature of directors’ duties

Directors’ duties both at general law and under corporate legislation are largely based on the notion of what a “reasonable person” would do in the director’s position given the actual role and responsibility of the director’s office, and the corporation’s circumstances.

The concept of a “reasonable person” is an objective one, which responds to changes in society’s expectations. A director in 2011 will be held to a different, and probably relatively higher, level of accountability than a director would have been in 1951, although the fundamental test for a director’s duty in both years was substantially the same. The variable element is what a reasonable person, at the relevant time as a director, would have done in those circumstances.

As suggested by Neil Young QC,18 NEDs can face challenges in meeting their obligations including:

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18 Australian Securities and Investments Commission ASIC Summer School “Corporate liability versus directors’ personal liability – have we gone too far or not far enough?” February 2008 – www.asic.gov.au.
• obtaining enough information and the correct type of information to make reasonable and diligent judgments and to adequately monitor the performance of the corporation and its senior management
• declining or delegating tasks and responsibilities that a NED lacks the time to undertake with appropriate prudence
• understanding the corporation’s (often complex) compliance systems, financial and technical information and commercial risks well enough to make reasonable business judgments
• grappling with disclosure obligations and the adequacy of proposed disclosure statements, without the same access to information and control that other officers of the corporation may have, for example the CEO.

Risks of setting the bar too high

The socio economic trends discussed in this white paper have fuelled society’s expectations of corporate performance and the role of the director. These expectations have ratcheted up significantly over recent decades. Not only are society’s expectations of directors now greater than the obligations of directors under the law, but these expectations are not reasonably achievable in practice. To meet these expectations, other compromises would be necessary. The consequences of those compromises would pose other threats and hazards and would risk prejudicing the benefits to be gained by society from the “miracle” of the limited liability corporation.

Duty, responsibility and accountability

It is useful to clarify the difference between the terms duty, responsibility and accountability, which often cause confusion:

• “duty” implies a legal obligation of a director that has consequences in terms of liability if it is not complied with
• “responsibility” implies matters and issues that directors should have regard to, and seek to address, in the performance of their roles
• “accountability” implies requirements of disclosure and acquittal to shareholders, regulators and the securities trading market (if applicable), for the directors’ performance of their role.
US President Harry Truman said “the buck stops here” and by analogy in general terms directors must accept responsibility for the sound and prudential management of the corporation. However, there is a fundamental difference between responsibility and liability. Even President Truman did not assume personal liability for his decisions, just the responsibility to do his job.

John Story

Extra duties and liabilities

The Corporations Act is only the tip of the iceberg in terms of laws that impact upon corporations and that impose responsibilities, duties and liabilities upon directors. Some of the other more significant laws and regulations which are relevant include:

- competition and consumer protection legislation regulated by the Australian Competition and Consumer Commission (ACCC)
- financial advisory and consumer protection legislation regulated by ASIC
- taxation laws regulated by the Australian Taxation Office (ATO)
- banking and financial institutions legislation, prudential standards and guidelines regulated by the Australian Prudential Regulation Authority (APRA). For example APRA Prudential Standards impose “fit and proper” threshold tests upon directors as well as other statements of legal requirement which may well extend, and at least confuse, the generally accepted duty of a director and the accepted governance principle of differentiating between directing and managing. For example:

“The Board ... is ultimately responsible for the sound and prudent management of the regulated institution.”19

The burden of regulatory compliance requirements is seriously impinging on the time available for boards to deal with important strategic matters which deliver true economic value to the corporation and its stakeholders generally.

Belinda Hutchinson

In addition there are numerous other legislative and regulatory enactments particularly concerning the environment, workplace relations, and practices and occupational health and safety.

19 APRA Prudential Standard APS 510 “Governance”. 
Based on research by national law firm Minter Ellison\textsuperscript{20} which identified more than 700 separate pieces of legislation across the various Australian states and territories imposing liability upon directors in connection with their corporate office, the Australian Institute of Company Directors presented “The Boardroom Burden Report Card 2009”\textsuperscript{21} (updated in 2010\textsuperscript{22}). These reports measured the business friendliness of each state and territory in Australia in terms of:

- the content of laws imposing liability on director
- the number of those laws in operation
- the procedural fairness with which they are administered.

As commented upon in the Executive Summary to the Australian Institute of Company Directors’ Report “Impact of Legislation on Directors” November 2010:

In many cases, directors can be found liable simply by virtue of their position, regardless of their actions, which is known as “derivative liability”. In some areas of legislation, there is a reverse onus of proof for directors (despite the fundamental legal and human rights principle is to be innocent until proven guilty).

Our social justice system is premised upon principles of personal liberty and due process. Those principles must be fiercely guarded and they should only be compromised in appropriate justifiable circumstances. Yet at the same time, it is recognised that corporations are “virtual beings” at law and pose challenges to the “natural order” of legal control – for example, they cannot be incarcerated, and their financial strength may diminish the impact of fines and penalties as both a deterrence and as a punishment for breach.

There is a growing groundswell of opinion amongst directors that laws imposed upon directors, which offend established fundamental human rights of personal liberty and due process, including the presumption of innocence, would cause public hue and outcry if applied to any other sector of society (other than corporations and their directors). Directors believe these warrant critical review and re-assessment as they are unprincipled and dangerous reactions in the context of the Rule of Law. Some believe that many of these laws have been introduced as a result of political expedience to placate social pressure, fuelled by modern communication means and media sensationalism, to address populist concerns that “there ought to be a law against it” and to assist in securing “a soul to be damned and a body to be kicked”\textsuperscript{23}.

\textsuperscript{20} Protecting your Position, Bruce Cowley (Minter Ellison – Lawyers) – July 2008.
\textsuperscript{23} “Did you ever expect a corporation to have a conscience when it has no soul to be damned, and no body to be kicked” – Edward, First Baron Thurlow, 1731-1806.
In any other area of the law many, not just the civil libertarians, would call it a breach of basic human rights, especially where the derivative liability involves the reversal of the normal onus of proof. 24

**Good governance responsibilities**

In addition to legislation and regulations at both federal and state/territory levels of government, and in addition to duties and responsibilities arising at general law, there are other securities’ market and/or industry based codes and rules recommending a raft of practice and behavioural guidance for directors of corporations, with varying degrees of mandatory or persuasive force and influence.

For example:

- for public corporations listed on the Australian Securities Exchange (ASX), there is both the ASX Listing Rules, which have contractual and, in some respects, even legislative effect, by virtue of certain enabling provisions of the Corporations Act, as well as the ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations which have industry acceptance effect, by the need for corporations to report against their requirements on an “if not, why not” basis if they wish to remain listed on the ASX

- for statutory authorities, under the auspices of the various public sector commissions (or equivalent) of the various federal and state and territory governments, commonly there is another set of governance principles against which statutory authorities, and their directors, are expected to benchmark themselves in the performance of their functions

- for any corporation whose financial accounts need to be audited, or at least prepared in accordance with accepted accounting standards, there is another internationally and nationally recognised set of requirements and expectations covering financial, accounting and risk management.

Corporations and their boards often incorporate the basics of these various rules, codes and principles into a corporate governance or board charter, which further contractually binds directors, including NEDs, to their terms. Such a charter usually includes commentary on and provisions relating to:

- a corporate code of ethics

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• remits for standing board sub committees (audit, risk, remuneration and nomination)
• protocols and requirements for director, including NED, induction, evaluation and development
• board meeting protocols
• auditor selection and sign off requirements
• a job description for the CEO
• an explanation of how authority is delegated from the board, to the CEO, to the senior executives and to the management team
• conflict of interest protocols
• share trading protocols and restraints for directors and their related interests
• continuous disclosure protocols.

Such a charter represents yet another compliance requirement for NEDs.

In addition, an array of authoritative texts and writings on sound governance practices, as well as nationally and internationally respected professional associations (for example, the Australian Institute of Company Directors and the International Corporate Governance Network) and standards councils (for example Standards Australia) suggest appropriate standards of governance for corporations and their directors.

As previously mentioned, much of the law concerning the duty and responsibility of a NED is premised on the notion of what a reasonable person would do if they had the relevant skills and were acting as an NED, given the circumstances of the corporation. These broader industry benchmarks and expressions of sound governance practices can materially help inform the courts as to what is a reasonable standard of corporate governance practice in the community, and therefore what a reasonable person would do.

Perhaps it is also useful to highlight some of the initiatives for sound corporate governance:
• the Australian Institute of Company Directors, as part of its “Guide for Directors and Boards – delivering good corporate governance,” has adopted a values or principles approach to assist directors, structured around the following key values, and then expanding on those values with principles and guidance commentary. These are designed as guidance only, not as a code or standard giving rise to a compliance duty. These values are:
  Integrity – being honest in all things and true to the roles and duties entrusted to you and the board.
  Leadership – providing a strong and positive exemplar of appropriate decision-making, attitude and behaviour on behalf of the organisation.
Competence – developing and fostering the existence, maintenance, development and application of appropriate skills, knowledge, personal aptitudes and acumen required for a director, and the board of the organisation.

Enterprise – guiding the organisation towards fulfilment of its organisational objectives or purpose by setting appropriate strategic direction and appetite for risk, fostering entrepreneurial approaches and assessing whether the organisation’s resources and organisational culture are aligned to achieve those objectives or that purpose.

Fairness – behaving fairly and equitably, in the interest of the organisation, with proper regard to the legitimate interests of relevant stakeholders.

Commitment – dedicating adequate engagement by giving the necessary time, thought, care and diligence so that the interests of the organisation are appropriately served.

Confidence – honouring and upholding the confidence that others place in the board and its directors, and the confidentiality of office of a director.

Respect – behaving respectfully to others whether or not you agree with their input.

Accountability – accepting responsibility for the proper discharge of the roles and responsibilities of the board and giving account to those to whom the responsibility is owed.

Transparency – within reasonable commercial confidentiality constraints, being frank, open and without pretext in the manner the board accounts to shareholders and stakeholders.

• The ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations are directed more to the corporation and its formal functional governance structures, highlighting the following eight principles:
  1. Lay solid foundations for management and oversight
  2. Structure the board to add value
  3. Promote ethical and responsible decision making
  4. Safeguard integrity in financial reporting
  5. Make timely and balanced disclosure
  6. Respect the rights of shareholders
  7. Recognise and manage risk
  8. Remunerate fairly and responsibly.

Each of these principles are further broken down into a number of recommendations, guidance and commentary to create an important and valuable reference.
FIGURE D: Sources of Corporate Compliance Obligation.
• There are many other statements of corporate governance codes and principles, most of which are themed between those of the Australian Institute of Company Directors (reflecting a values or principles based approach) and those of the ASX Corporate Governance Council (reflecting more a corporate structural and functional approach). A distinguishing feature of Australia’s approach compared to those taken by many overseas jurisdictions (especially the US, and from places and associations following the US approach) is that Australia’s approach is more descriptive and less prescriptive, and is flexible (through the “if not, why not”, “comply or explain” principle which is common in Australia and the UK).

These statements of good governance practice all help to shape the role and responsibility of the NED, and how it is manifested in practice.

Figure D (see page 53) portrays the various sources and nature of requirements for corporate compliance obligations of corporations and directors.
What is the genesis of the public’s view?

Over recent decades, the public has increasingly gained exposure to corporate activity, including corporate failure and even underperformance, through:

- the growing role and influence in society of corporations
- society's increasing dependence on corporations as generators of employment, as major contributors to the nation's taxation purse and as providers of essential community infrastructure and services
- direct and indirect (through superannuation and pension funds or other investment vehicles) investment in shares and securities of corporations.

Despite society's participation in the benefits of the evolution and globalisation of corporate endeavour, the general public appears to retain a view of directorial responsibility consistent with that of a small business owner/operator. Reality has changed. So must the expectations that society and the law have of directors.

David Gonski

Along with these trends, other evolutionary developments within society, especially over the last 50 years, have included:

- greater levels of education
- the growth in affluence
- the growth of social influence, voice and connectivity, especially arising from the information technology revolution of recent decades and the strong influence of the media in its various forms, including print, television, radio or social media
• consumerism trends, supported by political policy to garner support at the election box, where consumers are demanding protection from exposure to harm arising from business activity, underperformance or failure and by increased scrutiny and enforcement action by regulators
• the acceptance by our courts of class actions by multiple plaintiffs, supported by litigation funders, mitigating the effect of the former power asymmetry between a large well resourced business/corporation and an individual relatively under-resourced claimant.

Australians have a unique culture of being prepared to question and critically assess the performance of those charged with authority and responsibility. This creates a healthy but very challenging environment for Australian directors, especially compared with many of their overseas counterparts.  

Rick Lee

These phenomena have driven ever-increasing community and business expectations of the standards of performance by corporations and the corporation’s directors. Other factors relevant to these escalating expectations include:
• the publication of numerous authoritative texts on corporate governance practices
• nationally and internationally respected professional associations and standards councils promoting appropriate corporate governance practices
• the growth in institute education and training courses, degrees and diplomas relating to corporate governance
• the emerging profession of a NED with appropriate skill sets for NEDs being identified and widely applied
• the evolving focus on corporate governance performance versus corporate governance compliance (tick the box approach)
• the community’s heightened expectations of accountability of corporations and their directors when dealing with public investors’ money.

There is without doubt a strengthening movement, particularly amongst aspiring and emerging directors, to seek to pursue a career as a NED in a structured and professional manner by ensuring they are well educated in the “science” of governance, as a lifelong learning commitment, to assist them to better gain skills in the practice of directorship, as their practical experience and boardroom acumen grows.  

Dianne Hill
The role of a NED is starting to gain the hallmarks of a professional calling. Certain skill sets are perceived as both necessary and desirable especially for independent NEDs. Directors, and the corporations to which they are appointed, are also fuelling the drive for the recognition of special skills. They highlight the importance of director skill sets by:

- providing descriptions of individual director's skill sets and experience in investor and shareholder communications (annual reports and prospectuses)
- enlightened statements of applied corporate governance practices in annual reports and prospectuses
- the director, by merely standing for office, thereby expressly or impliedly representing that he or she holds the requisite skills to perform the functions of a director of that corporation
- the mandatory provision to the public of details of directors' fees, perceived by general community standards to be relatively generous, often without distinction being drawn in the public perception of the profound differences in practice between the remuneration of EDs and NEDs.

This leads to a society that is concerned about, and more demanding of, directors and the performance of the corporations to which they are appointed. It culminates with a public analysis of a director as follows:

- In respect to the personal skill/experience base of the relevant director, if there is a relatively high skill/experience base, then high expectations of sound performance should reasonably be assumed. However, even if the director has a relatively low skill/experience base, high expectations are still assumed that the director will ensure that proper counsel is taken, and skills/expertise enlisted, to deliver sound performance.
- That a reasonable person without the requisite suite of skills, experience or time to act effectively would not agree to act as a director of a public listed corporation.

The challenges faced by our parliamentarians, our regulators, our judges and our media in response

Despite logic and reason suggesting these leadership groups should be informed about the roles of the limited liability corporation in our society and the role and responsibility of its directors, these groups are subject to other forces which influence and colour the views they may take and express. The views of these leadership groups in our society are influential in the formulation and reinforcement of the views of society generally. If their views substantially reflect and pander to the insufficiently informed views of the public generally, then a non-virtuous circle of re-enforcement occurs, fostering its own misconceived basis of logic.
Parliamentarians

First, with respect to our parliamentarians:

• Australian parliamentarians are elected to represent the voice and interests of their electors and also to apply their skills in the best interests of the nation. In order to gain electoral support in a competitive electoral environment, they are likely to promote policies and legislative agendas designed to be popular amongst their electorate so to attract support. Current legislation concerning director remuneration and director/board elections (“two strikes rule” and “no vacancy” restrictions) are examples of this, where despite broadly based industry and expert condemnation of the proposals, the political resolve remains towards the populist demand.

• There should be a correlation between the laws which regulate our society and the social mores that underpin our society, with expectation that our government’s legislative agenda should progressively reform our laws to maintain their contemporary alignment with those mores. The legislative reform regimes over recent decades concerning enhanced consumer protection, environmental protection, and occupational health and safety standards are examples of this. However, care should be taken to fully assess the consequences of legislative enactments, which may have risk of unintended consequences.

The lack of significant business experience of most of our parliamentarians poses distinct challenges in their setting appropriate regulatory frameworks. Principled based guidelines are to be preferred over prescriptive governance regulation.

Graham Kraehe

• Regrettably, with parliamentary representation becoming a career in itself, rather than a service to the community, fewer of our politicians have high level practical business and corporate skills and understanding to take a leadership role in correcting the “expectation gap”.

• Our parliamentarians rely on government officers and bureaucrats for advice and input on the benefits and risks associated with matters coming across the desk of a parliamentary minister who has portfolio responsibility for an important aspect of Australia’s social, security or economic wellbeing. Frequently, the careers and life pathways of these officers and bureaucrats have not given them practical exposure to, and experience in, many of the business and corporate issues that fuel this “expectation gap”.

Given the unintended consequences associated with so much of the current prescriptive regulation of corporate governance, perhaps our politicians should take more time concentrating on the policy horizon rather than focusing on the detail of the shore.

John Morschel

**Regulators**

Second, with respect to our regulators (ASIC, ACCC, APRA, ATO, Fair Trading):

- In contrast to the relative freedoms of our parliamentarians, the mandate of our regulators is prescribed in the relevant enabling legislation governing the regulator.
- Although there may be opportunity at the margins for interpretative application of their legislated mandate, regulators largely act as the servants of the law which is determined as a combination of the output of our parliamentarians and the decisions of judges as the common law evolves and legislation is subjected to judicial interpretation.
- However, the regulators do have enforcement discretion and the responsibility to liaise with the legislators as to the practical appropriateness of legislative enactments. Quotes in 2010 from Tony D’Aloisio, then Chairman of ASIC, that the role of ASIC included “taking on the hard cases” and “testing the limits” of the law in relation to aspects of director and corporate conduct speak for themselves as to the corporate regulator’s approach. However, recent comments by Tony D’Aloisio reported in *The Australian* on 30 March 2011, and referred to later in this publication, may mitigate the apparent severity of this approach.

**Judiciary**

Third, with respect to our judiciary:

- There are two primary sources of our laws – legislation (refer to parliamentarians above) and the common law, which has evolved over the centuries in response to society’s needs and its changing mores, as our society continues to evolve in response to demographic, technological, social, economic, moral, religious and other developments.
- In regards to interpreting legislation, judges are primarily bound by parliament’s expression contained in the legislation, although they do have interpretative discretion at the margins.
- Judges’ contribution to the evolution of the common law is largely to reflect society’s needs and changing mores.
Several cases in recent years have highlighted that how boards operate is not well understood. There is an urgent need for the judiciary to gain a better understanding of current governance practices.

Catherine Livingstone

• Similar to parliamentarians and their government officers and bureaucrats, and despite numerous notable exceptions, the careers and pathways of many of our judiciary have not given them practical exposure to, and experience in, business and corporate affairs.

Media

Fourth, with respect to the media:

• This group again acts, at least to some extent, as the servant of society, reflecting society’s needs and changing mores, especially to the extent to which it reports and comments on political, environmental, economic and social issues arising from our communities and their social interaction.

The media loves personalising its reporting. A successful corporate outcome is usually attributed to the CEO and the executive team. As a perceived role of the board is to ride shotgun and make sure things don’t go wrong, if they do go wrong, then it is the chairman and the directors in the cross-hairs.

Michael Chaney

• However, this group also has a social leadership role and influences social norms in setting the terms of community discussion. It does have freedom other than as a servant of society, which is tempered by the commercial imperative of the business side of the media to sell copy or airtime by satiating society’s demands for populist product, including sensationalising and simplifying complex business related stories and issues. This sensationalist approach to the media’s reporting style is obviously not confined to business related stories.
Unfortunately, we do not have perfection on this Earth. But inevitably the focus, particularly on the media, is on the more sensational aspects of news in their competition for ratings and for entertaining their readers and viewers. So it’s not unusual for the controversial, the notorious, the infamous and the titillating to dominate our newspapers and television, whether it’s business or any other aspect of life. So while in no way diminishing the culpability of those who may behave badly, it is important to maintain perspective and be aware that usually, the minority is being portrayed not the majority.  

In summary, despite each of these groups being relatively enlightened and informed and despite their leadership responsibilities for the greater good of our nation as a whole, the source of accountability for each of their primary roles reflects on society and the contemporary social mores and commonly accepted expectations that our society has of the law by which it is governed and the institutions which affect it.

So why is it surprising, when around one in seven adults in Australia are directors, that there should be such confusion about the role and responsibility of a director? This raises another question – is there something else driving this outcome and giving rise to the “expectation gap”?

**A “soul to damn and a body to kick”**

When society is offended by a corporation’s conduct in the exercise of its licence to operate, society will seek retribution, not only against the corporation itself, but also against the “heart and mind” of the corporation (the directors). This retribution can also extend to the corporation’s executive and management as the “arms and legs” that actually carried out the conduct which offended the relevant section of society.

My sense is that the real nature and role of a board has been relegated to the background in an effort to find a way to put blame on behalf of shareholders. The response is to satisfy the concern of those with a case against a minority of those in corporate governance roles.  

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However, it is accepted that a very small minority of directors have contributed to this mindset of society by their inappropriate conduct and behaviour. A few examples from Australia and elsewhere stand out:

- In 1962 Lord Boothby of the UK lampooned the then perceived role of the NED when he was quoted as saying:
  
  No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company. You look both grave and sage and on two occasions say “I agree”, say “I don’t think so” once, and, if all goes well you get £500 a year. If you have five of them, it is total heaven, like having a permanent hot bath.

- The financial collapses of corporations such as Reid Murray and Cambridge Credit in Australia in the early 1970s highlighted the exposure of the Australian public to economic downturns and corporate exposure.

- The excesses and unscrupulous corporate behaviour of a number of the “four on the floor” Australian entrepreneurs from the 1980s including Alan Bond, Christopher Skase, Laurie Connell and others still generate community scorn.

- Various major corporate collapses in the late 1990s and early 2000s including Enron and Worldcom in the US, and HIH in Australia, revealed the derived wealth and access to corporate perks of a number of the directors (primarily executive) of those corporations, yet the apparent disregard for shareholder and broader stakeholder interests.

- The banking and finance industry collapses around the world during the 2008 global financial crisis, including major banking institutions in the UK, Europe and the US, and Opes Prime and Storm Financial in Australia, which profoundly impacted the domestic welfare and savings of the public. They also exposed the extraordinary remuneration packages enjoyed by a number of senior executives and EDs vested with the management and control of those financial institutions which failed, largely due to unmanaged, and not understood, risk exposure positions.

- At an everyday level, members of the public are frequently being induced and ripped off by unscrupulous business people, perhaps operating through a “$2 corporation” or a “phoenix company”, with promises of future benefits that are too good to be true (and which commonly are). Often they leave behind a trail of unsatisfied creditors who have dealt in good faith with those unscrupulous business people.

Unfortunately the inappropriate conduct and behaviour of this tiny number, often not even connected with Australia, and which is publicised by the media seeking to satisfy the public’s appetite for the sensational and notorious, has materially
influenced the overall image and reputation of directors generally, including NEDs. The fact that the vast majority of NEDs who provide their services with integrity, professionalism, discipline, acumen and commitment and at a level of remuneration which is reasonable and fully justifiable, and in the case of the charitable/NFP sector usually gratuitously, is obscured by the attention given to the behaviour of a few.

Worst case examples often fuel populist short term pressure from the electorate, to which politicians react, without understanding the full consequences of the regulatory response.

James Strong
8. The risk of unintended consequences and productivity impacts

**Risk of unintended consequences**

The foregoing commentary has helped describe the evolution of the issues that have given rise to the current confusion between the views of various sections of society of the role and responsibility of directors. From this it can be seen that:

- directors fulfil proper and valuable roles and responsibilities which are recognised at law, albeit there may well be a legitimate case for legal reform to refine and clarify the law’s application
- tension exists between the public’s perception of the role and responsibility of directors, especially NEDs, and in reality, both at law and in practice
- this tension has created an “expectation gap”
- due to the continuing socio economic trends referred to earlier in this white paper, left unaddressed, this “expectation gap” is likely to widen
- if this “expectation gap” is not effectively addressed, society may suffer certain unintended consequences as the corporation and its directors position themselves to avert, or minimise, the impact of the burden of this “expectation gap”.

One of the main ways this “expectation gap” manifests itself is in the increased burden of corporate red tape, regulation and compliance being imposed upon corporations and their directors. Without doing justice to the proliferation of legislation giving rise to this regulatory burden, which was touched on in Chapter 6, the following are some contemporary examples of such regulatory requirements and processes:

- current legislative changes concerning corporate executive remuneration including “claw back” provisions and caps on deemed termination
payments, as well as the newly legislated “two strikes” rule and “no vacancy” restriction on board composition

- personal director liability under our taxation laws for corporate fault arising merely because the person is holding office as a director, notwithstanding the person may have had no involvement with the impugned conduct, or opportunity reasonably to influence it
- the effective “reversal” of the onus of proof for corporate directors and officers under certain state based occupational health and safety and environmental laws where the accused effectively has to prove his or her innocence, in contradiction to established principles of the Rule of Law
- the failure to appreciate and respect the differing roles in corporations and their governance between the executive management team and the non-executive directors – refer APRA Prudential Standard APS 510 “Governance”
- the estimated 400 (plus) separate regulatory licences, consents and approvals necessary to be obtained incidental to the development of a “greenfields” resource project in Western Australia.

The list could go on and on.

Current trends indicate that legislation is becoming more and more onerous. COAG needs to do a thorough review. Although Australia fared well during the GFC, too much is attributed to regulation, and governments have continued to add to this legislative load. We have to compete against growth economies like China and India and need to focus on productivity and innovation. If we don’t take a pragmatic principled based approach to regulation, Australia will get bogged down and be left behind.

Belinda Hutchinson

These unintended consequences may include:

- the time distraction from constructive enterprise value creation by directors on behalf of the corporation, its shareholders and broader stakeholders through a disproportionate focus on the burden of this dissonance
- the loss of an entrepreneurial corporate governance and value creation culture in favour of a risk averse, compliance focused, culture
- the imposition of cost and efficiency burdens on corporations and their directors arising from the foregoing, thus rendering the corporations and their processes less efficient and less competitive in relative terms

Reputational risk is a big challenge. You are absolutely putting your reputation on the line and you may not have full control over it. Resigning from a board is a big and public decision. It might not always be open to you if it is not in the best interests of the company.

Catherine Livingstone

• despondency by directors, and the avoidance by people with talent, experience, and of ability and integrity, to undertake corporate office as directors, to avert exposure to the liability and reputational risks of office
• the vacation of public corporate endeavour in favour of private equity endeavour, where the exposure to burdensome regulatory intervention and public scrutiny is substantially reduced
• Australian corporations seeking overseas, rather than Australian, business opportunities where regulatory and liability risks may be significantly less.

There is a real risk with all of this that good people with the necessary experience and skills will just not serve as the risk/reward equation does not stack up. This may lead to boards making inferior business judgments and doing things they wouldn’t, and shouldn’t, otherwise do.

John O’Sullivan

Without attention and redress, these unintended consequences risk damaging the fabric of the “miracle” of the limited liability corporation and subverting the benefit of its bounty to society.

**Australia’s productivity and international competitive advantage**

It is generally accepted that corporate Australia weathered the global financial crisis better than its North American and European counterparts. It is also generally accepted that Australia’s corporate regulatory regime, in tandem with corporate Australia’s relatively strong and principled based governance culture and approach, were contributing factors to this outcome. Where the balance lies as to the relative weighting of these two factors in their contribution to this outcome is open to conjecture in the absence of informed research. Certainly in such absence, any claim for primacy of relevance to the outcome by either contributing factor would be unfounded.
Australia’s weathering of the GFC has been a credit to corporate Australia and Australia’s systems of corporate governance regulation and practice. However, the role that regulation alone has played in this outcome is a card that has been significantly overplayed by our regulators in recent times.

John Story

In an open market economy, investment tends to flow to venues where capital and business markets operate with integrity and where investors can have confidence of doing business measured in terms of financial impost, administrative burden, risk exposure and its management and amelioration, and reward outcomes.

Productivity gains are not only an essential driver of business performance and Australia’s international competitive advantage, but also an essential element of the social and community dividend to be reaped by the Australian community as a consequence of those gains.

Although the business and corporate sector, including its participants in the form of corporations and their directors and officers, do require a degree of regulation to ensure that capital and business markets operate with integrity and assurance, if the degree of regulation becomes burdensome relative to the delivery of that integrity and assurance, unintended consequences are likely to include:

• reduced productivity
• reduced investment inflow
• reduced new market entrants
• reduced social and community dividend.

Well intentioned but overzealous regulation is like barnacles on the hull of a boat. As the barnacles grow, they impede the vessel’s performance. That is why we must avoid excessive regulation and why our regulators need to be trimmed back from time to time. For example, to remain competitive when compared to our international peers, we need a better safe harbour defence; we need to get rid of all of the deemed criminal liability provisions in state legislation; we need to fix our draconian insolvency laws; and we need to cap the fines for misleading or deceptive conduct. Many investors are deterred from doing business in Australia while these issues remain unaddressed.

Graham Bradley
9. The case for reform and redress

Authoritative tribunals and commissions

A large number of parliamentary inquiries and commissions and other bodies have recognised and made recommendations concerning many of the existing inadequacies in our society’s current laws and expectations as to the role and responsibility of directors. Some of these are listed below, with extracts of some key recommendations arising from their considerations.

(a) CAMAC – 2006 – Personal Liability for Corporate Fault

The following extracts from the 2006 report by the Federal Government’s Corporations and Markets Advisory Committee (CAMAC) entitled “Personal Liability for Corporate Fault” are particularly instructive of the contemporary issues identified, even if they have not been acted upon by the Australian legislators to date.

- CAMAC identified two principal areas of concern:
  - “a marked tendency in legislation across Australia to include provisions that impose personal criminal sanctions on individuals for corporate breach by reason of their office or role within the company (rather than their actual acts or omissions) unless they can establish their available defence”
  - “considerable disparities in terms of personal liability provisions, resulting in undue complexity and less clarity about requirements for compliance”

- CAMAC made a number of telling observations and comments including:
  - “[CAMAC] is concerned about the practice in some statutes of treating directors or other corporate officers as personally liable for misconduct by

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their company unless they can make out a relevant defence. Provisions of this kind are objectionable in principle and unfairly discriminate against corporate personnel compared with the way in which other people are treated under the law.”

– “The encouragement of corporate compliance with applicable laws – which [CAMAC] supports – does not justify a general abrogation of the rights of individuals”

– “[CAMAC] is of the view that, as a general principle, individuals should not be penalised for misconduct by a company except where it can be shown that they have personally assisted or been privy to that misconduct, that is, where they were accessories”

– “[CAMAC] also considers that, generally speaking, there should be a consistent approach across all corporate and non corporate organisations in regard to personal liability for organisational fault. In principle, officers of companies incorporated under the Corporations Act should not be exposed to personal penalties for organisational fault that a legislature would not be prepared to apply and enforce more generally”

– “[CAMAC] also sees a need for a more consistent, as well as a more principled, approach to personal liability across commonwealth, state and territory jurisdictions. A more standardised approach would reduce complexity and aid understanding. It would assist efforts to promote effective corporate compliance and risk management, while providing more certainty and predictability for the individuals concerned.”

(b) Other government commissioned reports:

(i) The report in 1989 by the Federal Government Senate Standing Committee on Legal and Constitutional Affairs entitled *Company Directors’ Duties*29 noted the trend towards imposing personal liability on directors for corporate fault and recommended further consideration of the appropriate mix of individual and corporate liability for corporate misconduct.

(ii) The potential downside of an over emphasis on director personal liability was highlighted by the government’s Corporate Law Economic Reform Program Paper No 3 – *Directors’ Duties and Corporate Governance* (1997)30 when it observed that:

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"The understandable motivation behind the [personal] liability regimes in these areas is to provide a significant incentive for directors to put in place effective risk management arrangements to ensure the corporation complies with its obligations. While the imposition of financial penalties on corporations for breaches of legislation provides some incentive towards compliance, it is considered that in certain key areas there is a need to place additional personal responsibility on directors who, in contrast with the shareholders who ultimately bear the costs of the financial penalty, have it within their means to seek to ensure compliance.

However, if directors risk personal liability for breaches incurred by the corporation, irrespective of the directors’ culpability, they may be increasingly reluctant to serve on boards or may become overly concerned with compliance issues and processes rather than wealth creation. Certainly, it would be an unfair and unnecessary burden on directors if they can potentially be made responsible for breaches by their corporation, even where they have taken all reasonable steps to prevent such breaches”.

(iii) The Australian Law Reform Commission (ALRC), in 2002, also commented on the increasing trend towards deeming corporate officers to be personally liable for corporate misconduct due to their position in the company, and noted:

“proof of knowledge of or involvement in the [corporate] contravention is not an essential element; generally, involvement in the management of the body corporate will be sufficient (at paragraph 8.28)”; and

“the harshness of attributing liability to an individual merely because of the office that individual holds within a body corporate, often in conjunction with a reversal of the onus of proof (at paragraph 8.84)”.

(iv) In its 2006 report Rethinking Regulation, the Regulation Taskforce noted inconsistencies across jurisdictions in provisions imposing personal liability on corporate directors and officers for corporate fault, with consequential complexity and uncertainty for individuals in these roles, and recommended that the Council of Australian Governments initiate reviews to achieve more nationally consistent regulation of various matters.

This “expectation gap” is serious and it is growing. The law and judges are holding non-executive directors to duties and responsibilities which are impossible for them in practice and reality to meet. There needs to be a universal business judgment rule that works based on good faith, honesty, absence of personal conflict and reasonable decision making in all the circumstances. There needs to be balance in the consequences of business failure, perhaps even some limitation of liability for non-executive directors along the lines of the professional standards legislation.

John O’Sullivan

(c) Council of Australian Governments (COAG) – Reform Council 2008-2009

The Council of Australian Governments (COAG) agreed to seek increased harmonisation of various laws around Australia, including laws concerning the liability of corporate directors.

Despite a slow start to the process with respect to directors’ liability (refer to COAG Reform Council Report as at 30 September 2009), and the need for further enlivenment of the reform agenda at the February 2011 COAG round table, a set of principles (albeit criticised by the Australian Institute of Company Directors for not going far enough) at least has been enunciated by which all jurisdictions are recommended to audit their laws with respect to the liability of corporate directors, as follows:

(A) “Ministers recommend the following principles for adoption on a national basis in relation to corporate liability and the circumstances in which directors may also be liable for corporate fault:
1. Where a corporation contravenes a statutory requirement, the corporation should be held liable in the first instance.
2. Directors should not be liable for corporate fault as a matter of course or by blanket imposition of liability across an entire Act.
3. A “designated officer” approach to liability is not suitable for general application.
4. The imposition of personal criminal liability on a director for the misconduct of a corporation should be confined to situations where:
(a) there are compelling public policy reasons for doing so (e.g. in terms

of the potential for significant public harm that might be caused by
the particular corporate offending); (b) liability of the corporation is not likely on its own to sufficiently promote
compliance; and (c) it is reasonable in all the circumstances for the director to be liable
having regard to factors including:
(i) the obligation on the corporation, and in turn the director, is clear;
(ii) the director has the capacity to influence the conduct of the
corporation in relation to the offending; and
(iii) there are steps that a reasonable director might take to ensure a
corporation’s compliance with the legislative obligation.
5. Where principle 4 is satisfied and directors’ liability is appropriate, directors
could be liable where they:
(a) have encouraged or assisted in the commission of the offence; or
(b) have been negligent or reckless in relation to the corporation’s offending.
6. In addition, in some instances, it may be appropriate to put directors to
proof that they have taken reasonable steps to prevent the corporation’s
offending if they are not to be personally liable.

(B) Ministers recommend the following action with a view to ensuring that
legislation imposing liability on directors for corporate fault operates fairly
and can be clearly justified:
1. A legislative review by each jurisdiction to identify those existing offences
for which directors’ liability, or removal of that liability, is appropriate in
accordance with the above principles.
2. Harmonisation following cross-jurisdictional comparison in key policy
areas.
3. A harmonised legislative approach to provisions imposing directors’ liability
around key concepts and definitions, including the clarification of the term
“director” and matters raised by the panel.
4. Greater clarity about the offences for which directors may be liable through
a specific listing or schedule approach.”

Unfortunately this COAG reform agenda has made little progress. However,
from the foregoing authoritative reports, there is clear acceptance of:
• grave concerns with respect to the current regime
• a compelling need to address and rectify the current regime
• economic and social risks of failing to do so.
Some of my friends who are highly successful business people think I am imprudent being a director of a large public company. When you consider the risk of reputational damage, risk to your personal assets and the potential for liability, there are substantial risks in being a director. My concern is – what will this mean for the replenishment of boards? How will we be able to attract the best people?

Belinda Hutchinson

Despite these authoritative recommendations over at least the last two decades, and despite the case for the risk of “unintended consequences” being firmly made by respected peak industry and governance organisations like the Australian Institute of Company Directors and others, regrettably there has been minimal legislative or regulatory response to the dilemma, and the “expectation gap” continues to grow.

Pleasingly, perhaps a light is starting to emerge at the end of this long, dark, tunnel. In an interview reported in *The Australian* on 30 March 2011, the retiring ASIC Chairman Tony D’Aloisio, in response to a question concerning the need to re-examine the laws applying to directors, is quoted as saying:

“... the duty of negligence does look a very high standard when you consider that board members are advisers and they are not really involved and do not have the knowledge that management has.”

Further, in response to a question concerning ASIC’s regulatory enforcement role he added:

“I think part of the issue here may be the law itself ... the law has moved too fast in imposing obligations on non-executives ...”

When even Australia’s “top corporate cop” starts blowing the whistle in this manner, then surely it is time for action to be taken.

The confusion and inconsistencies evident in the current regime are material contributors to the “expectation gap” that currently exists, and it is suitable for our parliamentarians to give urgent attention to the recommendations of their own commissions and tribunals.

Governance of public companies is a lot about applying commonsense. Don’t over regulate. Use continuous disclosure to keep everyone informed. Shareholders can then decide themselves whether or not to invest.

Leigh Clifford
It remains unclear whether:

- the current relatively uniform formulation of the duties and responsibilities of directors, irrespective of the size, type, nature and circumstances of the corporation, which has served our society relatively well over the years, is still sound and will continue to serve our society well into the future.
- the currently relatively uniform formulation of the duties and responsibilities of directors, especially between EDs and NEDs, will serve a reasonable base for our society into the future, subject to some important material reforms and changes.
- the whole system of the role of the corporation, and the duties and responsibilities of directors, needs fundamental reform and restructuring to be multifaceted in its application, and more customised to the special needs and circumstances of the various different types and sizes of corporations that now proliferate in our society.

The answer to the above probably lies with the second option, although debate on the third option could also be useful.

**The case for a comprehensive “business judgment rule”**

The need to redress this “expectation gap” is beyond mere social justice reform. Without it, there is significant risk to society that the optimal performance of corporations, and the benefits they deliver to society, will be compromised. By reflecting back upon the commentary in Chapter 1 of this white paper, a core function of a limited liability corporation is facilitating enterprise through the assumption and management of risk. More successful corporations have a propensity to achieve this function better than less successful corporations.

“Risk Management – Principles and Guidelines – AS/NZS ISO 31000:2009” is a nationally and internationally endorsed standard premised on the principle that risk is inherent to the state of being, and that there are inherent risks, and consequences of those risks, in each and every action, or inaction, that a person or a corporation may take, or not take. Generally, the presence of risk is absolute, and cannot be eliminated, although some categories of risk can be treated, minimised or transferred, sometimes giving rise to exposure to other new categories of risk. Risk is therefore best viewed as a relative condition.

By extrapolation, the likelihood of occurrence of a future designated outcome (whether positive or negative) for a corporation, can rarely (if ever) be certain. Only later, with the benefit of hindsight, is it known whether the risks associated with the desired future outcome actually occur. This is so, even if the prospect of the risks were identified and considered by the directors before the relevant decision was taken.
Companies are a risk investment. Directors can make decisions in their best
efforts to generate future prosperity for shareholders. External influences
and/or honest errors in judgment may make their decisions seem poor in
HINDSIGHT. The ability to judge someone with the benefit of perfect
hindsight is not appropriate in assessing judgmental decisions at the time.35

Based on these principles of risk, the inherent uncertainty of future outcomes
(notwithstanding best efforts), and given that one of the core functions of a
limited liability corporation is to facilitate enterprise through the assumption and
management of risk, the business judgment rule (BJR) has long been an established
tenet of corporate and governance law.

Essentially the BJR was designed to facilitate proper business and entrepreneurship
activity by corporations by absolving a director or officer from liability for loss by
a corporation (and its stakeholders) where the director or officer:

- acted reasonably in the circumstances in making a decision (or business
  judgment) on behalf of the corporation to act or defer from acting in a
  particular manner
- the decision was made in good faith by the director
- the director rationally believed the decision was in the best interests of the
  corporation.

There are other ancillary qualifying requirements as well, but the above captures
the essence of the BJR defence.36

The BJR defence has also been expressed as a reluctance by the regulator or the
judiciary to second guess, with the benefit of hindsight, commercial decisions taken
by corporate officers in the proper line of business.

Regrettably in Australia, and despite the recommendations of various commissions,
tribunals and peak industry bodies referred to earlier in this chapter, the need for
a comprehensive and universal BJR has not been embraced by our parliamentarians.
As a consequence, it has not been common practice, where new laws and regulations
are introduced imposing liability on corporations and their officers, to incorporate
a comprehensive and consistent BJR defence. Even among respected legal identities
and commentators, there is disagreement as to the scope and real effect of the
current limited BJR defence in the Corporation Act (sections 180(2) and (3)) and

35 A Director’s perspective – Australian Institute of Company Directors “Impact of Legislation on Directors” – Nov 2010
36 Australian Securities and Investments Commission (ASIC) v Rich (2009) 75 ACSR 1 Chapter 23, paragraphs [7173]
at common law. The judgment of Justice Austin in ASIC v Rich\textsuperscript{37} (refer especially Chapter 23) is particularly instructive in analysing the BJR defence, and contrasts with the comments of Neil Young QC even though he may have subsequently qualified those comments.\textsuperscript{38}

In a global commercial environment, the absence of an effective and universal BJR defence for corporate directors and officers adversely impacts Australia’s international competitive advantage and attractiveness, to its economic and social disadvantage. The laws and judicial systems of many other countries, for example, the US and Canada, have a far broader and more deeply entrenched BJR defence designed to promote business enterprise and prudential commercial activity.

**The case for insolvency reform**

In addition to a comprehensive business judgement rule, including its application to directors’ duties at times of corporate solvency stress, there is also a compelling case for more fundamental solvency agenda reform.

At present the law in Australia is pernicious, and renders directors personally liable for insolvent trading by corporations, even though the corporation’s insolvent status might not be readily apparent at that time and only becomes apparent with the benefit of hindsight. This encourages the termination and liquidation of business enterprises at the earliest opportunity once solvency stress is encountered.

In regard to the economic and social benefits that flow from productive business activity, the termination and liquidation of a business enterprise can have profound impacts on the prosperity and social well being of the community in which the business enterprise operates.

Although Australia’s corporate insolvency laws are rigorous and disciplined, there are international examples of modified approaches which encourage a business enterprise on the brink of insolvency to be reconstructed and continue as a going concern. Adaptations of these examples should be considered for adoption by Australia in an endeavour to arrest the value destruction that otherwise is likely to result from the continued application of Australia’s current corporate insolvency regime.

Regrettably the outcome of various Parliamentary Joint Committee and Capital Markets Advisory Committee considerations over the last decade, and even recent governmental ministerial statements in regards to corporate insolvency reform in Australia, have not supported a reform agenda.

In the wake of the impact of the recent global financial crisis, the time is now right to promote corporate insolvency reform.

\textsuperscript{37} (2009) 75 ACSR 1.

\textsuperscript{38} Australian Securities and Investments Commission ASIC Summer School “Corporate Liability vs directors’ personal liability – have we gone too far or not far enough” February 2008 – www.asic.gov.au.
It is particularly noted that the need for corporate insolvency reform has broad support from relevant peak industry bodies, including the Australian Institute of Company Directors, the Insolvency Practitioners Association and the Law Council of Australia.

Closing the “expectation gap”

It would be wrong to suggest that corporations and their directors (including NEDs) should not be bound by proper and principled regulatory controls. Society has a legitimate need for protection from corporate abuse and the risk of irresponsible conduct by those with management and direction responsibility of corporations.

But equally there is a need for a balance of convenience to be found in the sometimes conflicting interests between different sectors of society and their expectations upon corporations and how their directors should act and respond. If this balance of convenience is not found, then the risks of unintended consequences to society are significant.

There is a need for all sectors of our society to work towards addressing the “expectation gap”.

Moving towards a better balance

It would be indefensible to suggest that directors, including NEDs, cannot improve their performance, enhance their behaviour and engage more meaningfully with the community to assist in narrowing the “expectation gap”.

Clearly more can be done to better explain the way well run boards work in practice. Improved understanding by those outside the boardroom, would be a good start.

Although there is drive towards greater transparency of process and engagement by boards and their directors with shareholders and broader stakeholders, directors are constrained in their ability to move in this direction by legal and commercial armoury designed to protect commercial confidentiality, to ensure equality of access and timing to price sensitive corporate information, and to minimise the exposure of directors to the risk of unwarranted personal liability and reputational damage. Much of this legal and commercial armoury is designed to ensure corporate integrity and probity of conduct in further protection of the public interest. The challenge is how to reduce the constraints which bind directors, without prejudicing the public protection purposes for which that armoury was designed.

Dianne Hill
Directors are now doing so much more in this area than ever before. For example:

- industry associations such as the Australian Institute of Company Directors have extensive education and information courses, programs and diplomas designed to improve the governance standards of their members and to educate those who deal with boards and directors to the proper role and reasonable performance expectations of directors
- corporations and their boards are now also taking a more active role in engaging with their shareholders which is leading to improvements in the understanding of roles and legitimate expectations, and greater trust and confidence between directors and their shareholders is developing
- numerous authoritative writings on directorship and governance practices are now available to the public
- there is an emerging trend for NEDs, especially through the lead of the board chairman, to be more visible at moments of crisis for the corporation, where solidarity of approach and demonstrable board support for the strategy being adopted by the corporation engenders confidence and trust amongst stakeholders generally.

The theatre of the annual general meeting (AGM) is a forum where boards can be open and responsive to their shareholders and broader stakeholders. However, perhaps the structure and the order of agenda of AGMs need to be modified to facilitate this end. In particular, AGMs should be structured so that the specific resolutions are dealt with first and then shareholders are given an opportunity to ask questions on miscellaneous matters relating to the company at the end of the meeting where “other operational issues” can be dealt with. Ideally, one would ask shareholders to provide advance notice of the questions they wish to ask at the AGM.

James Strong

And yes, more needs to be done. But, if the relatively exponential advances in the evolution of governance practices over the last 20 years are any guide, much more is and will continue to be done by, and on behalf of, directors over the coming years.

Two way street

Shareholders also have a vital role to play in helping improve governance standards and in getting the balance right.

The Australian Institute of Company Directors has recently taken a leadership role in the release of an informative and useful publication on shareholder engagement
in Australia.\textsuperscript{39} This is an important and emerging area of governance development. Britain’s Financial Reporting Council is also taking a lead role in this respect and with the publication of its “Stewardship Code” in July 2010\textsuperscript{40} for institutional investors. The code is designed to:

- improve communication between institutional shareholders and the boards of corporations in which they invest
- ensure that engagement between the institutional shareholder and the investee corporation is closely linked to the investment process within the institutional shareholder
- secure sufficient disclosure to enable investment manager’s clients to assess those manager’s actions in relation to the code so that this can be taken into account when awarding and monitoring investment management mandates.

In the US, governance rating watch lists and report cards such as Calpers Focus List\textsuperscript{41} are growing and becoming more influential. Although some such governance watch lists and report cards have been criticised as being too generic, too narrow, and insufficiently customised to meet the needs and circumstances of individual corporations, their utility and the quality of their service will continue to develop and their use will continue to grow. This is likely to lead to greater transparency and accountability of the governance practices of corporations and help to align expectations with reality.

Although enhanced shareholder activism is seductively appealing, it too has its risks. The greatest risk of shareholder activism, is unbridled “shareholder democracy” where dominant or influential shareholders, without accountability to the shareholders as a whole and without being constrained by the fiduciary duties owed by directors, might act with self interest paramount, and in relative disregard of, the interests of other shareholders, and the long term interests of the corporation and its other stakeholders.

\textsuperscript{41} Californian Public Employees Retirement System – www.calpers-governance.org/focu lists/home.
The importance of the role of the NED in the control and stewardship of corporations in our society cannot be overstated.

The effective performance of corporations is dependent upon the performance of its directors (including its NEDs) and the effectiveness of the corporation’s governance.

Yet despite the success of the limited liability corporation and the benefits it generates, there is a disparity of views about the proper role of directors, including NEDs, as the “hearts and minds” of those corporations. This disparity has been fuelled by trends in society and by the inappropriate behaviour and performance of a very small number of executives and directors who have damaged the reputation of the vast majority, and eroded the public trust and confidence in the integrity of the corporate sector.

The public has a limited understanding of the workings of corporations and of the evolving art and science of corporate governance. This lack of understanding is particularly acute in relation to the role of the non-executive director.

Certainly, the full extent of the role performed by a NED is opaque to most of the public, giving rise to an “expectation gap” between the public’s perception and the proper nature of that role in both law and in practice.

The causes of this “expectation gap” are many, but the gap is significant, and poses a real risk to Australia’s continued productivity and international competitiveness unless promptly addressed.

Despite the release of a series of important and authoritative reports for legislative reform recommending the refining, reforming and clarifying of the role and responsibility of directors, to date, our legislators and regulators have
failed to make meaningful changes to redress the concerns. There is material risk to our nation’s welfare if they continue to fail so to do.

There is a clear and compelling case for both education and reform to redress this “expectation gap”. There are also actions that both directors and investors can take to help work towards closing the gap.

This white paper is intended not only to raise the awareness of the importance of this issue but also to stimulate debate on the issue and encourage steps to be taken by which the “expectation gap” may close, better alignment might prevail, and corporate performance is not subjected to the risk of negative consequences arising from that expectation asymmetry.

Hopefully this white paper may also help the public gain greater appreciation of the valuable role played by NEDs as the “hearts and minds” at the centre of the limited liability corporation, and as important contributors to the delivery of corporate performance for the benefit of all stakeholders.
Appendices have been provided to give the reader insight into the board environment, including the scope, potential issues and common structures such as a typical board agenda and calendar, and remits for standing board committees.

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MIND THE EXPECTATION GAP
Suggested further reading

Those wishing to better understand the technical legal aspects of these duties and responsibilities, and to gain insight into the intricacies and challenges of the law as it relates to those duties and responsibilities, may wish to refer to the following sources of information:

- The Annual McPherson Lecture Series (refer to the Preface of this white paper)
Appendix B

Sample board agenda

[ COMPANY NAME ]
ABN [ ]
BOARD AGENDA

Time:
Date:
Place:

Tick/mark as ✓ means for presentation/discussion
    ■ means for noting and exception issues only
    ✗ means not on agenda

SECTION A: MEETING FORMALITIES (applies for all meetings)

✓ A.1 Welcome
✓ A.2 Apologies
✓ A.3 Agreeing Agenda
✓ A.4 Minutes from previous meeting(s)
  • approval
  • matters arising (not already on Agenda).
SECTION B: STRATEGIC MATTERS

B.1 Strategic Plan Matters
  (a) Development/Variation
  (b) Reporting against progress
B.2 Prospective New Projects/Acquisitions
B.3 Corporate Matters
  (a) Corporate Structure
  (b) Other (specify if any).
B.4 Subsidiary Companies
  (a) Items for Resolution
  (b) Other (specify if any).

SECTION C: FINANCIAL MATTERS

C.1 Financial Report
  • Statement of Financial Position
  • Statement of Financial Performance
  • Projected Cashflows
C.2 Budget/Performance against Budget
C.3 Adjustments/provisions
C.4 Tax Matters
C.5 Annual/Half Yearly Reports
C.6 Other (specify if any)

SECTION D: OPERATIONAL MATTERS

D.1 Divisional Activities Reports
D.2 Personnel Matters
D.3 Other (specify if any)
SECTION E: CORPORATE GOVERNANCE MATTERS

- E.1 Board Annual Calendar Scheduled Matters
- E.2 Board Sub-Committee Minutes/Reports
  - (a) Audit/Risk Management
    - audit
    - risk management
  - (b) Nominations/Remuneration
    - nominations/succession planning
    - remuneration
- E.3 Corporate Governance Charter Matters (if any)
- E.4 Share trading approvals by directors/officers (if any)
- E.5 Special Issues for reporting (if any)
  - (a) OH&S incidents;
  - (b) Trade Practices matters;
  - (c) Environmental incidents;
  - (d) Major legal proceedings;
  - (e) Insurance claims;
  - (d) Other (specify if any).

SECTION F: CAPITAL MARKETS MATTERS

- F.1 Continuous Disclosure (ASX)
- F.2 Broker/Analyst Reports/Briefings
- F.3 Media Reports/Contacts
- F.4 Shareholding movements
- F.5 Other (specify if any).

SECTION G: GENERAL

- G.1 Other specified matter (if any)
- G.2 Any other business

SECTION H: CLOSURE

- H.1 Next meeting:
  - (a) Board
  - (b) Board Committees
- H.2 Closure
Sample board annual calendar

Board Calendar (Strategic Governance Issues)

1. Strategy
   - planning
   - adoption
   - review/monitor

2. Board Review
   - composition/succession
   - evaluation of performance
   - remuneration

3. Corporate Governance Charter
   - compliance
   - review/monitor
   - report by Nomination and Remuneration Committee
   - report by Audit and Risk Management Committee

4. Strategic Governance Issues
   - Audit Report
   - OH&S Report
   - HR Report
   - Environmental Report
   - Risk Management Report
   - Legal Report
   - Diversity Report
5. Budget
   • adoption
   • review/monitor

6. Performance review/monitor
   • strategic
   • operational
   • financial

7. Operational Issues
   • Overall operations report
   • Significant project reports
   • Client relations report
   • Quality/complaints report
   • IT report

8. Financial Issues
   • financial performance (revenue/expenses/cashflow)
   • capital requirements
   • contingencies

9. Capital Markets Issues
   • investor relations
   • relative share price performance
   • shareholder communications
   • analyst/broker relations
   • substantial shareholder liaison

10. New Business Initiatives
    • strategic acquisition targets
    • corporate growth opportunities
Appendix D

Audit committee – scope of remit

(a) External Audit

• Assess and recommend selection and remuneration of external auditor.
• Monitor external auditor independence having regard to all regulatory requirements.
• Agree scope of audit and provide instructions to external auditor.
• Ensure availability of personnel and assistance as reasonably required by external auditor.
• Receive and review external auditor’s preliminary report including with and without executive management as appropriate.
• Oversee and monitor implementation of external auditor’s recommendations (as accepted).
• Monitor audit activities to ensure they are materially comprehensive and are carried out with effectiveness and efficiency.
• Reviewing auditor performance.

(b) Accounting Policies and Reporting

• Oversee, review and monitor application of accounting policies and reporting of financial information to shareholders, regulators and generally.
• Oversee that the organisation’s accounting policies and audit approach cover all material financial statement areas.
(c) Internal Audit

- Assess and review structure, responsibility and reporting framework of internal audit function (as appropriate).
- Overseeing that the organisation has appropriate and effective systems and processes to ensure integrity controls.
- Receiving internal audit reports and recommendations arising.
- Assuring adequate compliance with applicable laws, regulations, codes and internal protocols and processes so that the organisation is acting within the law and the bounds of the organisation’s ethical codes.

(d) Generally

- Reporting on these matters to the Board with recommendations.
- Consulting with independent professional advisors as appropriate on matters within the scope of remit.
- Performing such other tasks and functions as requested by the Board from time to time.
Appendix E

Risk committee – scope of remit

(a) Overview
• To review and make recommendations on actions specific to risk including exposure, identification and management and including without limitation organisational, strategic, financial, OS&H, reputational and material operational risks.

(b) Risk Management
• Approve policies for organisational risk appetite and management.
• Receive and review periodic ongoing risk management report.
• Monitor and review risk management policies and processes.

(c) Insurance
• Review and approve policies and practices concerning insurance requirements, needs and reporting.
• Without limiting the foregoing, review and monitor workers compensation and occupational health and safety cover.

(d) Generally
• Reporting on these matters to the Board with recommendations.
• Consulting with independent professional advisors as appropriate on matters within the scope of remit.
• Performing such other tasks and functions as requested by the Board from time to time.
Nomination committee – scope of remit

(a) Board Membership

• Board and board sub committee membership, succession planning and performance including:
  – assessing the skills and experience required on the board
  – assessing the extent to which the required skills and experience are represented on the board
  – establishing processes for the identification of suitable candidates for consideration of appointment to the board.
• Board committee terms of reference review and recommendations, including with respect to appointment of members.
• Evaluation of board, board sub committee and director performance;
• Board member induction, education and development.

(b) CEO and senior executives

• Periodic review of the job description and performance of the CEO according to agreed performance parameters.
• Succession planning for the CEO position and oversight of senior executive succession planning.
• Involvement in complaints, grievances and disciplinary processes of senior executives.
(c) Diversity

- Diversity policy development, monitoring and review.
- Development, monitoring and review of strategies and programs to promote diversity consistent with the policy.
- Monitoring the implementation of diversity strategies and programs consistent with the policy.

(d) Generally

- Reporting on these matters to the board with recommendations.
- Consulting with independent professional advisors as appropriate on matters within the scope of remit.
- Performing such other tasks and functions as requested by the board from time to time.
Remuneration committee – scope of remit

(a) **Policy Determination**

- Determine appropriate remuneration policies, levels and packaging options (as appropriate) for:
  - board members
  - CEO
  - senior executives
  - generally.
- Monitor implementation of such policies.
- Review such policies to ensure they:
  - motivate the pursuit of longer term growth and success of the corporation so as to add shareholder value
  - operate within an appropriate control framework
  - demonstrate a clear relationship between outcomes and reward
  - comply with legislation
  - are consistent with prevailing best practice.

(b) **CEO**

- Assess a suitable remuneration and reward package for the CEO in relation to prevailing market practices, internal affordability, performance against goals and KPI’s, and other relevant matters.
- Align the CEO’s goals and KPIs with desired corporate outcomes.
(c) Generally

- Reporting on these matters to the Board with recommendations.
- Consulting with independent professional advisors as appropriate on matters within the scope of remit.
- Performing such other tasks and functions as requested by the Board from time to time.
DIRECTORS have vested in them the management and direction of the many commercial, statutory, not-for-profit and community corporations that have been so instrumental in the delivery of profound benefits to mankind and its standard of living. Non-executive directors have a vital role to play in the prudential governance of these corporations in the interests of all stakeholders of the corporation. There is a disparity of views and expectations between various sections of society, including parliamentarians, regulators, judges, journalists and practicing directors, about the proper role and responsibility of non-executive directors. This publication seeks to identify the extent of that disparity, stimulate debate and encourage steps to help close the “expectation gap”.

For more information visit our website www.companydirectors.com.au