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## 6 Assessing the role of the board

### Key points

- Independent, well-informed decision-making, including on executive remuneration, is in the best interests of a company and its shareholders. Board members therefore require a mix of skills, knowledge and experience.
- While ultimately it is up to shareholders to elect the most suitable board candidates to represent their interests, the board plays the pivotal role in endorsing candidates and managing director performance.
- Accordingly, it is important that the processes for board selection and renewal work well.
  - The lack of diversity in the membership of Australia’s boards — particularly the very low (and declining) participation of women — suggests that many companies are not adequately utilising available talent.
  - The current use of the so-called ‘no vacancy’ rule by some boards makes it harder for shareholders to elect candidates not endorsed by boards.
- Increased liability of directors under various corporate and other laws may be reducing the pool of suitable candidates for directorships.
- Many boards establish remuneration committees to reduce the potential for conflicts of interest in setting executive remuneration and more effectively utilise board members with specialist skills and knowledge.
  - The current ‘if not, why not’ requirement is appropriate in encouraging boards to establish remuneration committees, accommodating the circumstances of smaller companies.
- Strengthening remuneration committee independence, including protocols for non-committee members attending meetings and the use of specialist advisers, could reduce potential conflicts of interest when setting executive remuneration.
- Many boards seek advice from remuneration consultants to inform decisions on executive remuneration. Consultants can usefully augment board skills and experience in this area.
  - However, potential for conflicts of interest can arise, particularly where consultants do not report directly to the board, or where they provide other services to the same company.
  - Improved disclosure could help shareholders assess the independence and value of external advice to boards and their remuneration committees.

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Given the board's central role in determining remuneration for the chief executive officer (CEO), senior executives and directors, a well-functioning board is fundamental to achieving the most appropriate remuneration outcomes for a company. In particular, as discussed in chapter 4, the independence from management of board decision-making, as well as the capacity of boards, is important for executive remuneration decisions.

## 6.1 The central role of the board

The *Corporations Act 2001* (Cwlth) specifies that the business of a company should be managed by, or under the direction of, the directors on behalf of shareholders (section 198A). It is the board's responsibility to identify an organisation's strategy and goals, and it is management's responsibility to decide how to implement these (AICD 2007d).

The board of a public company must have at least three directors. Generally, companies specify in their constitution a minimum and maximum number of board members. In 2008, for a sample of 87 ASX100 companies, average board size was 8.8 (ACSI 2009c). Further, Korn/Ferry International and Egan Associates (2008) found that for the top 300 companies in 2008, on average three-quarters of directors on the board were non-executive directors (NEDs), with the ratio of NEDs to executive directors decreasing the smaller the company.

Directors have a range of legal duties that are set out in the Corporations Act. They are required to exercise their powers in the best interests of the company, to take reasonable steps to comply with financial recording and reporting requirements, and to disclose any material personal interests or significant information under Australian Securities Exchange (ASX) listing rules.

A key role of the board is to appoint the CEO and determine remuneration packages for directors and the executive team (chapter 2).

According to the ASX Corporate Governance Council, the board should be structured in such a way that it:

- has a proper understanding of, and competence to deal with, the current and emerging issues of the business
- exercises independent judgment
- encourages enhanced performance of the company
- can effectively review and challenge the performance of management. (2007a, p. 16)

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## Independence of boards

Independent decision-making is a basic requirement for an effective board. All directors — including executive directors — should bring their own objective judgment to bear on board decisions (ASX Corporate Governance Council 2007a). The ‘independence’ of directors is not defined in the Corporations Act and boards generally adopt their own definition. The ASX Corporate Governance Council defines as independent a NED who is free of any business or other relationship that could materially interfere with the independent exercise of their judgment, or be perceived to do so (ASX Corporate Governance Council 2007a). Box 6.1 lists factors identified by the ASX Corporate Governance Council that can affect the independence of a director.

### Box 6.1 The independence of directors

When determining the independent status of a director the board should consider whether the director:

- is a substantial shareholder of the company (a person with a ‘substantial holding’ as defined in the Corporations Act) or an officer of, or otherwise associated directly with, a substantial shareholder of the company
- is employed, or has previously been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board
- has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
- is a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
- has a material contractual relationship with the company or another group member other than as a director.

*Source:* ASX Corporate Governance Council (2007a, p. 17).

In contrast, the Australian Prudential Regulation Authority (APRA) has adopted a stricter approach, and explicitly states that particular circumstances (adapted from the ASX Corporate Governance Council’s guidance, see box 6.1) will not meet its test of independence (APRA 2009e). Thus, under APRA’s standards a director who falls into one of these categories can not be independent.

Both APRA’s and the ASX Corporate Governance Council’s definitions and guidance relating to ‘independence’ have been criticised by the Australian Institute

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of Company Directors (AICD) for being too explicit and for conferring independent status according to ‘a relationship-based definition’ (AICD 2007a). The AICD argue that questions of independence should be concerned with independence of mind and a willingness to act and make a difference in the boardroom. They do not consider that this is properly addressed by governance rules about prior business associations (AICD 2008b). While this argument has merit in principle, relationship-based definitions are arguably a reasonable (and perhaps only) proxy for ‘independence of mind’.

The ASX Corporate Governance Council noted that its guidance is intended to provide an indication of areas boards should consider when determining a director’s independent status and not to definitively specify situations where independent judgment is impeded (ASX Corporate Governance Council 2007b). For this reason, boards are able to respond on a ‘comply or explain’ basis in relation to directors’ independence.

Andrew Murray (sub. DD112) submitted that the ASX Corporate Governance Council’s approach fails to fully address situations where a director is subject to the patronage of dominant shareholders or individuals. This is akin to APRA’s approach, where a direct association with a substantial shareholder of the company would mean the director could not be deemed independent. However, the Australian Securities Exchange (sub. DD142) noted that the important concept in relation to executive remuneration decisions is ‘independence of management’ and that this is a less restrictive concept than that necessary in other contexts, where independence from substantial shareholders may also be relevant.

In essence, when moving from a ‘comply or explain’ basis to ‘black letter’ law, complex definitional issues emerge. In this context, it becomes increasingly problematic to consider differing definitions of independence: for example, where ‘independence from management’ is applied for remuneration committee membership and a broader definition incorporating independence from major shareholders is used for the audit committee.

### *Current requirements*

To ensure that the board exercises independent judgment, the ASX Corporate Governance Council (2007a) recommends that:

- a majority of the board be independent directors
- the chair of the board be an independent director
- the chair and chief executive officer not be the same individual

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- directors considered by the board to be independent are identified in the annual report, with reasons why the board considers the director independent, along with any disclosure of relationships that may affect the director's independence.

In addition, APRA's governance standards require that APRA-regulated institutions' boards comprise a majority of independent directors and have independent chairs who have not been the CEO of the regulated institution at any time in the previous three years (APRA 2009e).

### *Current practice*

The 'independence' of boards in Australia compares favourably with other countries. For example, Australia has a much higher proportion of companies that separate the roles of chair and CEO than the United States (box 6.2). In 2008, around 80 per cent of all listed companies in Australia had a separate chair and CEO (ASX 2009a); this proportion increases for larger companies, with 92 per cent of the top 150 Australian companies having a separate chair and CEO (Mercer, sub. 41, p. 8).

Furthermore, on average, Australia also has a higher proportion of NEDs in large companies than the United Kingdom (box 6.2). In 2007-08, across top 300 companies (by market capitalisation), 74 per cent of directors were NEDs, increasing to 80 per cent for top 50 companies (Korn/Ferry International and Egan Associates 2008).

Guerdon Associates (2009b) observed that boards of ASX300 companies became both larger and more independent between 2007 and 2008. ASX300 company boards, on average, comprised just over half independent directors, with larger companies in this sample having a higher proportion of independent directors (figure 6.1).

Thus, the prevalence of a majority of independent directors on boards decreases the smaller the company. In 2008, only 45 per cent of all listed companies indicated that their boards comprised a majority of independent NEDs (ASX 2009a). Generally, companies that did not have a majority of independent NEDs reported that this was due to their relatively small size, lack of resources or that the experience and skills of non-independent directors were appropriate.

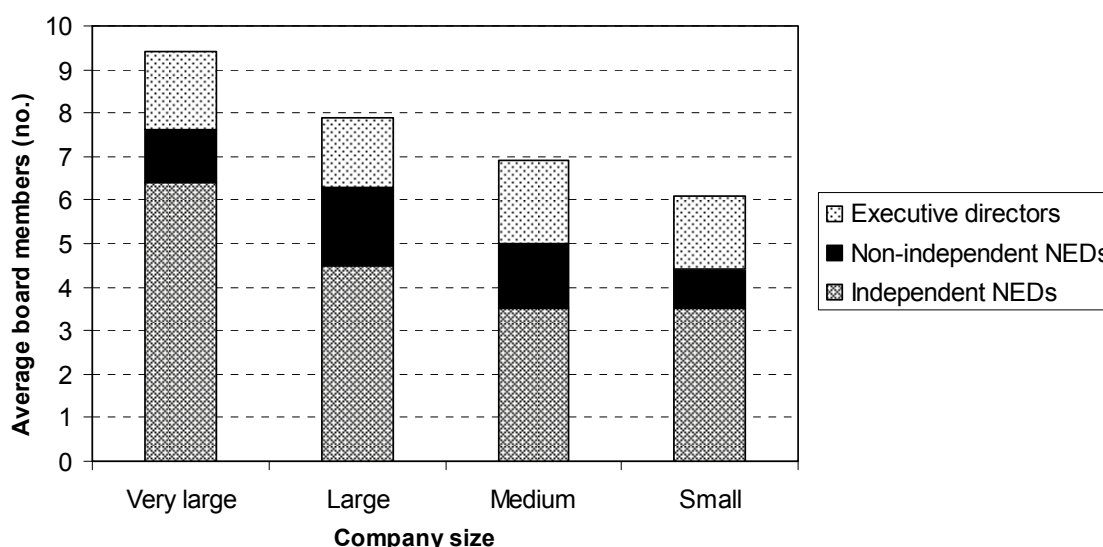
**Box 6.2 International regulation and practice on board structure**

In the United States, the practice of combining the role of CEO and chair is common, and is the case for almost three-quarters of top 200 companies in 2008 (NACD 2009).

In the United Kingdom, the Combined Code states there should be a strong presence of both executive and NEDs on the board, with at least half the board being independent directors. PricewaterhouseCoopers (2008) suggests that the boards of larger UK companies comprise about 60 per cent NEDs.

Some European companies, such as in France, the Netherlands and Germany, adopt a ‘dual board’ structure involving a ‘managing’ board, comprising executive directors and a separate ‘supervisory’ board, consisting of NEDs.

**Figure 6.1 Board structure by company size<sup>a</sup>, ASX300 companies, 2007–08**



<sup>a</sup> Company size determined using market capitalisation and sample split into quartiles. ‘Very large’ equates to market capitalisation over \$2 billion; ‘Large’ equates to between \$650 million and \$2 billion; ‘Medium’ equates to between \$240 million and \$650 million; and ‘Small’ equates to less than \$240 million.

Source: Guerdon Associates (2009b).

*Balancing inside knowledge and independence*

Executive directors are able to bring company-specific knowledge to board deliberations and their presence can enhance board effectiveness and company performance. This may also apply to NEDs who cannot be regarded as fully independent — for example, if they were previously employed by the company.

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However, the presence of executive directors on a board also poses challenges. Because they hold senior managerial positions within the company, executive directors may be too close to management to perform impartial monitoring. This could also apply for non-independent NEDs. However, on the whole, representation of executive directors, and non-independent NEDs on Australian boards, is relatively low. Figure 6.1 indicates that, irrespective of board size, there are on average two executive directors on ASX300 company boards and one to two NEDs who are not ‘independent’.

It is not always appropriate for a company to have a majority of independent directors on its board (box 6.3). In a small start-up company, for example, company-specific expertise may be a more valuable attribute than independent monitoring and advisory skills. However, in a larger, more mature company, a majority of independent directors on the board may be more appropriate, as the costs arising from insufficient monitoring and undesirable actions are likely to be much greater.

The heterogeneity of companies suggests that different tradeoffs will be made between the monitoring and advisory skills provided by independent directors and the company expertise afforded by executive (and possibly other non-independent) directors.

Similarly, from the perspective of enhancing company performance, it may not always be best to separate the role of chair and CEO. Separation may be less suited to highly entrepreneurial companies (likely to be small), where the equity market may view a dual CEO/chair as positive. Furthermore, if CEO/chairs have a major equity stake in the company, they are likely to pursue actions that are in its best interests. In this way, equity ownership and separation of the roles of CEO and chair may, to a certain extent, be substitutes in promoting desirable managerial actions. However, this is only likely to occur in exceptional circumstances in closely held companies. From the perspective of promoting good corporate governance, separation of the CEO and chair generally remains a desirable principle.

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### Box 6.3 Board independence and company performance

While it is commonly held that increasing the proportion of independent directors on a board will improve company performance, the evidence from academic research is equivocal.

Bhagat and Black (2002) assess whether greater board independence is correlated with long-term company performance. Analysing a sample of US companies over the 1980s and 1990s, they find that there is a *negative* correlation between recent company performance and board independence. They interpret this as providing evidence that poorly performing companies increase the share of independent directors on their board in an attempt to improve performance. However, they do not find that this actually improves subsequent company performance.

In Australia, similar research has also yielded conflicting results. For example, Lawrence and Stapledon (1999), using a sample of the top 100 companies (by market capitalisation) in 1995, found no strong evidence that the share of independent directors on a company board affects share price returns or accounting performance. On the implications for policy, they note that:

Each additional regulatory requirement imposed on companies adds to the compliance costs for those companies (and, indirectly, their shareholders). Therefore, even if the empirical evidence unequivocally indicated that board structure and composition improved corporate performance, it would still be necessary to ask whether the costs of imposing governance regulations on all listed companies would be outweighed by the benefits. (Lawrence and Stapledon 1999, p. 57)

In an analysis of the board characteristics of 348 of the ASX500 companies in 1996, Kiel and Nicholson (2003) find a negative relationship between Tobin's Q (a ratio comparing the market value of a company's stock with the value of a company's assets) and the proportion of outside directors serving on the company board. The authors concluded that, although boards do need to be aware of possible agency problems, no single theory provides a complete explanation of the relationship between corporate governance and corporate performance (Kiel and Nicholson 2003, p. 201).

## 6.2 Attracting talented and experienced candidates

It is important that Australian boards are able to attract a wide range of talented and experienced individuals to serve as company directors. However, some participants questioned whether this is happening in practice. In particular, participants raised concerns regarding nomination committee processes and whether boards are fully exploring the pool of potential candidates for directorships.

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### *Current practice*

Directors are appointed by resolution at a general meeting of the company, with the board and its chair playing an important role in the nomination of candidates. When a seat on the board becomes vacant, it is usual practice for directors to appoint someone to this role, pending approval by shareholders at the company's next annual general meeting (CAMAC 2009).

The ASX Corporate Governance Council (2007a) recommends that boards have a nomination committee, and suggests that the committee comprise predominantly independent directors and an independent chair. They also suggest that the nomination committee make recommendations about necessary competencies of directors, board succession plans, processes for evaluation of board performance and the appointment and re-election of directors. The Council notes, however, that for smaller boards such a committee may not be practical.

Around half of top 400 companies by market capitalisation reported they had a separately constituted nomination committee in 2008 (table 6.1). For mid-cap companies (those ranked 251–400 by market capitalisation), where nomination committees existed, independent representation was not high. For example, 47 per cent of reported nomination committees did not comprise a majority of independent members. Larger companies that had a nomination committee were more likely to have a majority of independent members and an independent chair (WHK Horwath 2009a, 2009b).

The Corporations Act and a company's constitution outline the ways in which a director can leave office. These include resigning, breaching provisions in the company's constitution, being automatically disqualified from managing a corporation, becoming bankrupt or being removed by resolution in a general meeting (AICD 2007b). Only shareholders appoint and remove directors of public companies.

The ASX listing rules specify that directors can hold office for no more than three years without re-election. The average tenure of NEDs from ASX100 companies in 2007 was around five years (and nearly seven years for executive directors) (ACSI 2008b). However, over one-third of all directors on ASX100 company boards had served for over nine years.

**Table 6.1 Nomination committees in top 400 companies in 2008 annual reports**

	<i>Top 250 companies</i>	<i>Companies ranked 251–400</i>
	% all companies	% all companies
Nomination committee	59	47
Independence <sup>a</sup> of nomination committee:	% companies with nomination committee	% companies with nomination committee
• Independent chair	83	76
• Only independent members	36	18
• Majority independent members	44	35
• No majority independent members	20	47

<sup>a</sup> WHK Horwath define an independent director as someone who is not a member of management and who: (1) is not, or is not associated with, a substantial shareholder; (2) has not been employed in an executive capacity by the company in the last decade; (3) is not an original founder of the company; (4) is not a professional adviser to the company or is not a principal of a professional adviser to the company; (5) is not, or is not associated with, a significant supplier or customer; (6) has no significant contractual relationship with the company; (7) is free from any interest or relationship, that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company; and (8) has been a director for ten years or less.

Sources: WHK Horwath (2009a, 2009b).

## Are boards 'clubby'?

Some participants suggested that representation on boards across Australia effectively involves a 'directors club', recruiting among itself or from the ranks of known executives. In particular, concerns were raised about the role that incumbent board members play in influencing the ability of new entrants to gain seats on boards (box 6.4).

### Box 6.4 A 'director's club'? — views from submissions

The Australian Council of Super Investors stated 'we also note there's a perception of clubbiness of boards, particularly given the propensity of boards to recruit from their ranks' (trans., p. 301).

The Australian Human Resources Institute noted that directorships should not be determined by 'a club operating in accordance with an informal and discriminatory entry system where chaps look after chaps' (sub. 49, attachment 3, p. 3).

Amongst other reasons, the Australian Shareholders' Association cited the concentration of directors on boards as a reason for high executive pay:

It is the view of the ASA that there is currently an imbalance in favour of executives when setting remuneration. The causes include ... The concentration and lack of diversity of non-executive directors. (sub. 54, p. 20)

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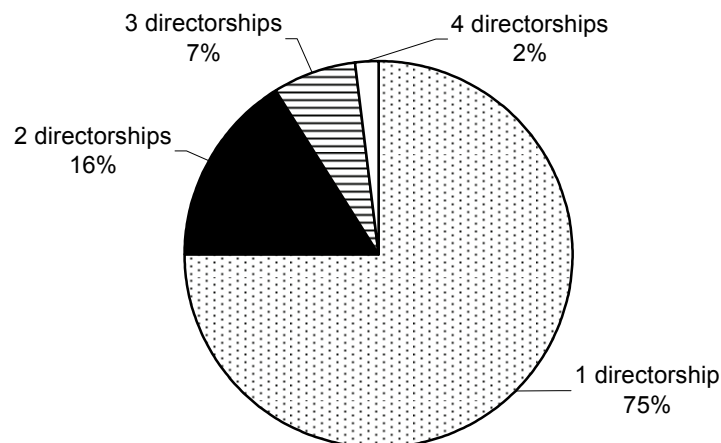
Perceptions of a ‘director’s club’, and a lack of diversity in board membership, was seen as limiting the scope to access talented and experienced individuals and resulting in directors spreading themselves too thinly across multiple appointments, as well as affecting the exercise of ‘independent’ judgment.

A key indicator of whether boards are ‘clubby’ is the extent to which directors hold multiple directorships. Evidence from Australian Council of Super Investors (ACSI) (2008b) indicates that in 2006-07, among ASX100 companies:

- of 106 new NEDs, 55 per cent already held, or once held, an ASX100 director position
- three-quarters of all NEDs in these companies sat on only one board (representing 56 per cent of all NED board seats), with 9 per cent holding three or four directorships on ASX100 boards (representing 17 per cent of all NED ASX100 company board seats) (figure 6.2).

Unsurprisingly, the incidence of executive directors holding multiple directorships is much lower than that for NEDs. Only 8.5 per cent of ASX100 company executive directors also held an additional non-executive directorship in an ASX100 company, with none holding two or more such executive directorships (ACSI 2008b).

**Figure 6.2 Percentage of NEDs in ASX100 companies by number of ASX100 board seats held, 2006-07**



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Sources: ACSI (2008b); RiskMetrics (pers. comm., 10 September 2009).

This suggests that multiple directorships among the boards of ASX100 companies are not widespread. However, many directors hold more than one directorship across a range of publicly-listed, private and not-for-profit companies. To illustrate

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the number and type of directorships held by NEDs, a brief profile of the directors of boards of three large Australian companies is provided (box 6.5).

Further, when all listed companies are considered, multiple directorships appear more common (table 6.2). However, some instances of high multiple directorships might be explained by corporate groups, where a director may sit on the boards of a number of companies within the group (for example, listed property trusts linked to a single company) (Kiel and Nicholson 2006).

**Box 6.5 Non-executive directors at three large public companies**

In 2008, **BHP Billiton** had a total of eleven NEDs and one executive on its board of directors. Only one of these directors held another directorship in an ASX100 company (of which he held two). No other BHP Billiton directors sat on ASX300 company boards, although several directors sat on boards of foreign or private companies. There was one female on the BHP Billiton board (BHP Billiton 2008).

**National Australia Bank** had a total of eight NEDs and two executives on its board. Three NEDs held one other directorship in an ASX100 company and two NEDs held two other directorships in ASX100 companies. One NED had four directorships in total in ASX300 companies (including with the National Australia Bank). Many of these directors also held directorships in private companies. There were two female directors on the board (National Australia Bank 2008).

In 2008, **Wesfarmers** had seven NEDs and two executive directors on its board. Of Wesfarmers' seven NEDs, two held two directorships in other ASX100 companies and two held one directorship in another ASX100 company. One of these NEDs held a total of four directorships in ASX300 companies (including Wesfarmers). Many of these directors also held directorships in private companies or not-for-profits. There was one female NED on the Wesfarmers board. This particular director also served on the National Australia Bank board of directors (Wesfarmers 2008).

To prevent any 'over-boarding', some participants suggested that regulatory limits on multiple directorships be imposed. For example, the Australian Shareholders' Association considered that NEDs should hold no more than five directorships (where a chair counts as two) (ASA 2005). However, figure 6.2 and table 6.2 indicate that only a small percentage of ASX100 directors would not pass this test, when considering only ASX100 companies, even when taking into account the greater working requirements for a chair and thus allocating double 'points' for such a role. However, this may change where a broader range of companies and organisations are considered.

**Table 6.2 Number of directorships in all listed companies held by directors in ASX100 companies, 2006-07**

<i>Number of directorships</i>	<i>Number of directors</i>		<i>Proportion of all directors</i>
		no.	%
1		333	55.8
2		129	21.6
3		76	12.7
4		43	7.2
5		10	1.7
6		3	0.5
7		2	0.3
8		1	0.2
<b>Total</b>		<b>597</b>	<b>100.0</b>

Source: ACSI (2008b).

There are some benefits as well as problems with ‘clubs’, particularly in a corporate context where board performance is crucially linked to directors working well together. For example, limiting entry to candidates known to share certain desired characteristics can reduce the risk of a recruit destabilising the board. Further, the experience from holding multiple directorships can be valuable to the companies concerned. According to Kiel and Nicholson (2006) such directors can use their networks to obtain support from key external stakeholders (resulting in say, access to capital at more attractive rates), can assist in disseminating innovation (including better corporate governance practice), and, particularly for new companies, can enhance reputation or credibility in the market.

However, there are concerns that as a result of their experiences and networks, members of the club may identify too closely with executives in deliberations about executive pay. One submission noted that:

... the problem with this is the perception of a self-interested ‘directors club’ of board members, fund managers, and executives past and present. ‘You vote for my pay rise and I’ll vote for yours’. This is an inherently conflicted plutocracy. (Michael Vanderlaan, sub. 9, p. 2).

Although restricting multiple directorships could increase the range of directors serving on boards, it might also prevent quality candidates who would be a better ‘fit’ from being chosen, and result in a loss of benefits that leveraging on a director’s experience and networks can provide. The point at which ‘over-boarding’ becomes problematic may be best left to boards, individual directors who face positional liability consequences from poor decision making and shareholders. As ultimately they vote on directors, it is incumbent on shareholders to assess the

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merits of each director, including their past and current roles, when voting on candidates.

### **A lack of diversity?**

A related concern is the lack of diversity among those who sit on boards, and, in particular, the significant under-representation of women. This raises questions regarding the comprehensiveness of nomination processes and whether boards are endorsing individuals who will most effectively represent shareholders.

Jillian Segal (sub. DD167) noted that seeking ‘board diversity’ is about seeking diversity of thought that results from diversity of background and experience, which can lead to improved decision making. Therefore, diversity can include observable and readily detectable attributes such as ethnic background, gender and age and also less visible underlying attributes such as education and personal views (Milliken and Martins 1996).

While the research is mixed on the impact of diversity on board and company performance (box 6.6), there is evidence that more diverse groups can foster creativity and be open to a greater range of perspectives (Milliken and Martins 1996; Anderson et al. 2009). However studies have also found that diversity in teams can lead to reduced integration of group members and higher levels of dissatisfaction and turnover (Lau and Murnighan 1998 and O’Reilly et al. 1989).

**Box 6.6      What is the impact of diversity on boards?**

Studies have shown that diverse boards can improve monitoring (of other board members and of the company) and can positively affect company performance for more complex companies or where CEO power is strong (Adams and Ferreira 2009; Anderson et al. 2009). Research has also shown that shareholders place a premium on more diverse boards (Westphal and Zajac 1995).

However, diversity is a ‘double-edged sword’ (Milliken and Martins 1996) and can have costs including reduced cohesiveness, communication breakdown or factions (Lau and Murnighan 1998; O’Reilly et al. 1989).

A number of participants regarded the lack of diversity as an important issue (Chartered Secretaries Australia, sub. DD147; Freehills, sub. DD130). The Australian Human Resources Institute (AHRI) argued that boards:

... have not kept in step with the rest of society, and on the evidence available, are most unlikely to do so of their own volition, which is to the potential detriment of both the community and shareholders. (sub. DD114, p. 3)

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In particular, participants focussed on the lack of gender balance on boards (ACTU, sub. 82; AHRI, sub. DD114; Jillian Segal, sub. DD167). ACSI observed that:

There is a strong perception that females have to jump through a higher skills ‘hoop’ than their male counterparts in order to grab the attention of prospective boards. There are situations that arise where boards look for new talent and the specificity of the skills required may potentially exclude female candidates. (sub. DD156, p. 4)

Guerdon Associates stated that ‘the low board representation of women indicates that current board demographics are not representative of the broader community, or even the executive community’ (sub. DD119, p 3).

The Business Council of Australia (BCA) noted that ‘the evidence does show that diversity in decision-making leads to better decisions’ (BCA, DD trans., p. 221) and welcomed a broadening of discussion on board diversity beyond issues of gender. Jillian Segal (sub. DD167) argued that an initial focus on improving gender diversity is the first and most important step in improving the diversity of the talent pool from which future directors can be drawn.

While the Commission obviously accepts that the diversity issue extends beyond gender, gender is a visible indicator and perhaps the most pervasive one. The fact that the representation of women on boards is so low strongly suggests that boards are not drawing sufficiently widely from the potential talent pool.

### **The gender imbalance**

A recent study by the Corporations and Markets Advisory Committee (CAMAC) examined the diversity of corporate board membership in Australia, noting a significant gender imbalance (CAMAC 2009). Research by the Equal Opportunity in the Workplace Agency indicates that female representation on Australian boards in 2008 fell below 2006 levels (table 6.3). Just over one-half of ASX200 companies do not have a woman on the board (EOWA 2008).

As table 6.3 shows, there is a similar imbalance in representation of women in executive management roles. A slightly higher proportion of women are reported as holding ‘executive management’ roles, with little increase in this proportion over the past six years. The Sex Discrimination Commissioner argued that this trend is likely to continue, with 5.9 per cent of women in executive ‘in line’ management positions in 2008 (down from 7.5 per cent in 2006) (Australian Human Rights Commission 2009).

There are some indications that it is common for non-executive directorship candidates to be sourced from the ranks of senior executive management; for

example, in 2000, 35 per cent of NEDs were retired CEOs (Sheridan 2001). In 2006, ACSI reported that 50 per cent of ASX200 NEDs comprised retired former corporate executives (ACSI 2007). Thus, since the ‘feeder group’ for board positions is likely to be dominated by people with senior management experience, the comparably low proportion of women on boards mirrors a wider phenomenon.

**Table 6.3 Representation of women on boards and in executive management, ASX200 companies, 2002–08**

<i>Year</i>	<i>Board seats held by women as a proportion of all directorships</i>	<i>Female executives as a proportion of all executive positions</i>
	%	%
2002	8.2	8.4
2004	8.2	11.4
2006	8.7	12.0
2008	8.3	10.7

*Sources:* EOWA (2002a, 2002b, 2008).

## Improving female representation on boards

### *Quotas and ‘soft targets’*

It might be expected that heightened competitive market pressures would mitigate against (and significantly increase the costs of) boards not fully exploiting the pool of potential candidates for directorships. However, the significant under-representation of women on boards belies this. In the context of recent statistics indicating that the gender diversity of boards has actually worsened, some participants argued that a significant change in policy approach — or ‘circuit breaker’ — was required. Their views reflected elevation of the issue evident in the community more widely (box 6.7).

Measures commonly advocated to increase the representation of women on corporate boards are quotas and targets. These could be mandated or applied on a voluntary basis, or through some combination of the two. Recently, the Sex Discrimination Commissioner proposed that publicly listed companies be required to set three and five year targets for gender equality on company boards and at senior leadership levels, and to publicly report on progress in their annual reports (box 6.7 and Broderick 2009).

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### Box 6.7     **Getting more women ‘on board’**

Over recent months, there has been a more elevated public debate about the obstacles to female representation on the boards of Australian public companies. Two opinion pieces that have appeared in the Australian Financial Review are illustrative.

According to Claire Braund (Executive Director of Women on Boards), in her article ‘Women Losing the Board Game’:

If the board is responsible for hiring the chief executive, influencing the appointment and setting the strategic direction for the company, why has attention not been paid to the deficit of women in top ranks and the serious economic implications of this human capital loss over the past two decades? What has been the role of advisers such as executive search firms in alerting boards to the need to look beyond traditional sources (former CEO and male partners) to serve as board members?

... At the 2<sup>nd</sup> Diversity on Boards Conference, two stories emerged that highlight different approaches to improving opportunities for women at senior levels. The first was told by the 40-something chairman of a large Australian engineering and construction firm, who noticed that no women were participating in his company’s leadership program. When he asked why, he was told women were not applying as they felt there was little point in such a male-dominated organisation. The result — the chairman and his board set a target for gender participation in the leadership program and women are now visible.

The second story was told by five Women on Boards members (including a former CEO) about their application for a vacancy for a well-paid board gig in a mid-sized company. None could believe she had not even been spoken to by the recruitment firm handling the appointment. But one told how she had emailed the chair, a former colleague who had said she would be great for the role. When she received the rejection notice, she forwarded it to the chair. The result — the chair ensured she was placed on the shortlist and, in time, appointed to the board as the best candidate. (Braund 2009)

Elizabeth Broderick (Sex Discrimination Commissioner), in her article ‘Make Room at the Table for Women’ also expressed concern about the productivity impacts of ignoring talented women and argued for targets or quotas to remedy the deficit:

... the 2009 Global Gender Gap report reveals that ... Australia sits in a group of countries that are number one in the world for women’s educational attainment. But, in terms of women’s labour market participation, we have dropped 10 rankings ... We are now ranked 50<sup>th</sup> in the world ...

Let’s be clear about the low female participation rates, the absence of women on boards and in senior levels of endeavour across the country. It is just not smart. There is no nation or government, industry or sector which can afford this kind of loss. I keep saying that without significant intervention — by government, by business — the number of women participating and progressing in the workplace will shrink even more and our ability to build the strong economy we want will be severely diminished.

It has become imperative that we implement special measures to accelerate the progression of women. It is becoming clearer and clearer that if we are to secure increased participation by women, it will be necessary to set numerical goals such as targets and quotas ... Publicly listed companies should set their own three and five year gender diversity targets at both Board and executive level ... If there is no significant progress over the next five years, then the Government may find that it has no other choice than to consider the imposition of quotas. (Broderick 2009)

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Some countries have introduced quotas mandated in legislation for gender representation on corporate boards. Norway recently introduced a gender quota for all publicly listed companies, requiring that women make up at least 40 per cent of the membership of company boards (box 6.8). Spain also enacted legislation requiring female representation on boards for any company tendering for public contracts. Further, Spain has introduced legislation, to come into effect in 2015, which follows Norway's approach. Media reports indicate that the French parliament is also considering a bill (submitted in December 2009) to require all companies listed on the Paris stock exchange to ensure 50 per cent representation of women on their boards by 2015 (Davies 2009).

**Box 6.8 Norway's quota for female directors of public companies**

In December 2003, Norway enacted legislation imposing a quota of 40 per cent females on boards of public sector entities. At the same time, the government announced that quotas would also be applied to private companies if improved gender representation was not achieved voluntarily by July 2005. Due to insufficient progress in meeting voluntary targets, the law was extended to all new public limited liability companies in 2006 and to public limited liability companies incorporated prior to 2006 from 2008 (Norwegian Ministry of Children and Equality 2009). Penalties for non-compliance with this law include de-listing or even liquidation.

There are around 500 public limited liability companies registered in Norway, incorporating some of the largest companies in oil, manufacturing and financial sectors (Nergaard 2008). In January 2008, 93 per cent of Norway's public limited liability companies complied with the legislation (Norwegian Ministry of Children and Equality 2009) and by January 2009 female representation on public limited liability company boards was 40.2 per cent (Statistics Norway 2009).

CAMAC highlighted several problems with the Norwegian approach, noting that 'it appears that PLCs [public limited liability companies] have encountered difficulty in finding a sufficient number of women with requisite experience or knowledge of the relevant industry for board appointment' and that this has resulted in significant multiple directorships by some women (CAMAC 2009, p. 48). While there is some evidence that the Norwegian quota may have imposed costs on firms' performance, it is too soon to determine the extent of this. Several 'supply-side' programs have subsequently been introduced and recent data from Statistics Norway suggests that multiple directorships by women are not greater than for men (Statistics Norway 2009).

Victoria, South Australia and the ACT have set voluntary targets to achieve greater representation of women on state government boards. In the case of South Australia, the target was 50 per cent female representation by 2008 and 50 per cent representation of female chairs by 2012 on state government boards and committees. In 2009, South Australia was still short of its first target, with

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45 per cent female representation, while 35 per cent of chairs on state government boards were female (Government of South Australia 2009).

In its report on board diversity, CAMAC noted that voluntary targets may be a useful tool for a company. However, it did not support the imposition of ‘a particular model of board diversity’ through gender or other quotas (CAMAC 2009, p. 48). In reference to quotas for boards of government bodies, CAMAC noted that there is a fundamental difference between public sector and private sector entities — with the government, in effect, being the sole shareholder in the first case. By imposing quotas on private entities the government would ‘cut across the powers of shareholders to choose the directors who will be accountable to them’ (CAMAC 2009, p. 49).

The Commission acknowledges that ultimately a company’s shareholders should determine who sits on the board, but this choice is inherently influenced by the board and its nomination processes. While shareholders may nominate their own representatives, it is the board that has the resources and the mandate to select nominees from a pool of candidates, as well as more detailed knowledge about the skill-sets needed by the company. Encouraging boards to seek qualified female candidates and put forward more women for nomination would not impinge on shareholders’ abilities to vote against these candidates where they do not consider them suitable.

One lesson that appears to have emerged from the Norwegian experience is that any efforts to improve representation of women on boards must take into account the supply-side or ‘pipeline’. Although the educational levels for women are high in Australia (for example, in 2007 women accounted for 56 per cent of all higher education students (DEEWR 2008)), many women are not getting crucial executive experience. This poses a dilemma for boards attempting to identify potential female directors. Research by Catalyst (2008) indicates a clear positive correlation between the proportion of women board directors in the past and the proportion of women corporate officers in the future. This could be because companies with women on their boards tend to have more inclusive workplace cultures and policies that support women’s advancement. Further, women board directors can be role models and mentors to women in the ‘pipeline’. This suggests scope for measures that address gender diversity at the board level to lead to improvements in the ‘supply-side’ within companies.

Some research indicates that only one woman on a board may not be sufficient to enhance capabilities and drive cultural change (Chief Executive Women 2009). In an informal roundtable held by the Commission, participants agreed that more than one woman on a board was required to move beyond tokenism. It was noted that

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when there is only one woman on a board, her perspective and views might not be afforded equal weight, and that attainment of a critical mass was required for effective change to occur.

However, historically there has been significant ‘push-back’ on gender quotas, chiefly as they are seen as undermining women’s professionalism and credibility and implying that their selection is not based solely on merit. Moreover, the imposition of mandatory quotas could prevent candidates who would be a better ‘fit’ from being chosen, leading to less experienced boards and negative impacts on company performance. While there is evidence that increased representation of women on boards can be good for the bottom line, it is not clear that this would be the case for all companies at all times and not under externally-imposed timeframes (box 6.9).

**Box 6.9 Does female representation matter?**

A range of reports find a positive relationship between company performance and the representation of women on boards (Catalyst 2007; Desvaux et al. 2008). One complication is the direction of causality — is positive performance due to more women on boards or are successful companies more likely to have more diverse boards? Smith et al. (2005) address the issue of causality and still find a positive relationship between company performance and female representation on boards in Danish companies. However, Adams and Ferreira (2009) found that the impact on board performance of gender diversity is likely to be positive for some companies and negative for others. Anderson et al. (2009) find that company performance is more sensitive to occupational diversity than social diversity (gender, ethnicity and age).

There is evidence to suggest that women directors are more likely to be independent from management and as such improve board monitoring capabilities. However, Adams and Ferreira (2009) find that a focus on monitoring at the expense of other strategic issues can be detrimental for some companies.

Many studies find little correlation between the representation of women on boards and CEO pay (Kaplan et al. 2008; Doucougliagos et al. 2007). However, Adams and Ferreira (2009) found CEO turnover is more sensitive to stock performance and that directors receive more equity-based remuneration in companies with gender diverse boards.

In reference to Norway’s quotas for corporate boards, ACSI noted that:

They say it’s worked extremely well but Norway has a very different culture I think about all sorts of matters to ours, and whether such a proposition would be acceptable here, we doubt, so we’re not at present advocating quota systems. But certainly there is need for some kind of a circuit-breaker. (DD trans., p. 235)

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While there was general resistance among participants to externally imposed quotas, there was considerable support for ‘soft’ or voluntary targets to improve the representation of women on Australian boards. ACSI submitted that ‘voluntary targets endorsed by boards may promote more concrete objectives with respect to skills and diversity without being perceived to be addressing these issues in a tokenistic manner’ (sub. DD156, p. 4). Jillian Segal (sub. DD167) proposed that all listed companies develop targets for female board representation and report against these on an ‘if not, why not’ basis. She suggested that targets could be determined by companies taking into account their own particular circumstances or could be benchmarked against a longer term goal of achieving, for example, 40 per cent representation within five years.

The AICD — while noting that companies should set measurable milestones towards achieving diversity goals — argued that any such goals and timeframes should be determined by individual companies according to their own circumstances and not be imposed by government, the ASX, or any other body, on a ‘one size fits all’ basis (AICD 2009a, box 6.10).

In a significant recent initiative, the ASX Corporate Governance Council announced proposals to expand the Corporate Governance Principles and Recommendations to recommend that each listed entity establish and disclose a diversity policy with measurable objectives relating to gender, and disclose in the annual report achievements against the gender objectives set out in the policy — on an ‘if not, why not’ basis (ASX 2009g).

The Commission considers that the introduction of targets, determined by companies according to their particular circumstances and reported on an ‘if not, why not’ basis, would encourage greater board diversity, but in a way that promoted company performance and had few downside risks. Such an approach would ideally be complemented by a range of supply-side approaches, potentially industry-led, both to ensure that there were appropriately qualified candidates and that their existence was brought to boards’ attention in an effective way.

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**Box 6.10 AICD measures to improve diversity on boards**

In November 2009 the AICD introduced a range of measures to achieve a greater representation of women on boards and in senior executive positions. These measures include:

- recommendations for boards to voluntarily adopt, and report on, diversity policies and goals for the board and senior management
- recommendations for comprehensive board reporting to shareholders on board selection and nomination processes
- the establishment of a mentoring program involving mentors from senior listed company chairmen to work with senior executive and professional women
- providing new guidance for boards and search professionals for a structured selection process for board appointments that highlights the advantages of diversity
- enhancing AICDs database and information services for current and aspiring women directors
- advocating that boards develop explicit policies to enhance the career development and retention of women in management roles in the company, this would include ‘family-friendly’ staffing practices and flexible working arrangements
- establishing an AICD scholarship program and other educational initiatives.

*Source:* AICD (2009a).

## **Improved disclosure of nomination processes and diversity policies and objectives**

Some participants suggested that one way to enhance board diversity would be to place a greater emphasis on the board nomination process (Guerdon Associates, sub. DD119; Origin, sub. DD129; Perpetual, sub. DD128; UniSuper, sub. DD118). Guerdon Associates noted that ‘this ‘sleepy hollow’ of board function is arguably one of the most important’ (sub. DD119, p. 4) while UniSuper (sub. DD118) argued that the functions of the nomination committee should be raised to a level of importance equal to the remuneration committee.

Currently — under recommendation 2.6 — the ASX Corporate Governance Council suggests the following information be made publicly available:

- a description of the procedure for the selection and appointment of new directors and the re-election of incumbent directors
- the charter of the nomination committee or a summary of the role, rights, responsibilities and membership requirements for that committee

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- the board’s policy for the nomination and appointment of directors.

Perpetual (sub. DD128) recommended a greater focus on nomination committees in respect to:

- utilising external recruitment consultants to undertake searches based on skills and experience required on the board
- promoting a greater focus on the processes involved in board nominations
- raising standards to ensure that board accountability begins with the process of board nomination (p. 2).

Regnan suggested that the board prepare a report explaining the board’s nomination processes, required skill set, board education, board induction processes and policies which allow directors access to expert advice. This report would then be subject to a non-binding vote by shareholders in order to increase shareholder oversight of board composition (sub. DD169).

The Commission considers that the current ASX Corporate Governance Council’s guidance in relation to nomination committees and disclosure of nomination committee function is appropriate and that a greater focus on the nomination process could be accommodated within the current guidance.

There was also support from participants for enhanced reporting on company and board diversity objectives (AHRI, sub. DD114 and AICD, see box 6.10). AHRI recommended that leading ASX companies include statements within their Annual Report or Sustainability Reports as to their policies, targets and practices with respect to diversity at a whole-of-company level (that is, including management and board levels). The AICD was also supportive of such approaches and recommended that boards voluntarily adopt, and report on, diversity policies and goals for the board and senior management (box 6.10).

In its report on the diversity of boards, CAMAC made three proposals for changes to the ASX Corporate Governance Council’s commentary on board composition and effectiveness:

- the commentary could include references to board diversity and ways to achieve diversity goals
- the commentary could refer to the benefits of undertaking a structured approach to board nominations
- recommending that companies provide further information to shareholders on the board recruitment process.

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After considering CAMAC's recommendations, the ASX Corporate Governance Council has recently proposed changes to its governance standards, including recommendations that companies:

- establish a diversity policy
- disclose in the annual report the proportion of women employees in the organisation, in senior management and on the board
- include a requirement to continuously review the proportion of women at all levels of the company in the nomination committee charter
- disclose the skills and diversity criterion boards use when looking for new board appointments (ASX 2009g).

### **Enhancing scope for board renewal**

One possible barrier to more diverse board membership is the entrenchment of incumbent directors. The ASX Corporate Governance Council (2007a) notes that board renewal is critical to performance. However, it is not clear to what extent boards' performance management systems contend with under-performance. This is complicated by the difficulty faced by shareholders in assessing the performance of individual directors. As stated by RiskMetrics to the Parliamentary Joint Committee on Corporations and Financial Services:

From the outside, it is a very hard thing for an institutional shareholder to work out, for each individual director, the answer to the question, 'Is this individual director a great guy on a board that is a dud?'. (Parliamentary Joint Committee on Corporations and Financial Services 2008, p. 59).

### ***Contestable board seats***

AHRI (sub. DD114) recommended that boards hold 'contestable elections' which apply to directors who have served for five years or more, or stand for election for the second or subsequent time. These 'contestable' seats would be open for other nominations from shareholders. In addition, boards could recommend several candidates, including one 'board-endorsed candidate'. The elections could be held on a 'first past the post' basis.

While this would lead to shareholders being able to vote on a wider pool of possible candidates and provide a clear process for shareholders to nominate candidates, some practical difficulties arise. First, uncertainty may be created where the board nominates a number of candidates but only officially 'endorses' one. Further, due to reputational risks associated with not being elected, potential applicants may be

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unwilling to subject themselves to such a poll, particularly where they are the non-endorsed ‘additional’ candidates put forward by the board.

*The ‘no vacancy’ rule*

A potential impediment to the election of new directors is the so-called ‘no vacancy’ rule. This is based on a common clause in company constitutions that provides for boards to specify the maximum number of directors at any given time, within the limit set by the constitution. Some participants argued that this rule can be used to inhibit shareholders from successfully electing new directors from outside the ‘club’.

For example, RiskMetrics contended:

These clauses allow the board in a contested election — typically when a candidate has been nominated by shareholders — to declare that the maximum number of directors is the number of directors presently on the board and, accordingly, there are no vacancies. For the non-board endorsed candidate this means that in order to be elected they must receive not only a majority of the votes cast on their election but also more votes than the board-endorsed candidate seeking election at the same meeting. (sub. 58, p. 13)

Generally in Australia directors are elected by resolution, with shareholders casting a ‘yes’ or ‘no’ vote for each director. Where there are limited seats available on the board, the candidates with the highest number of ‘yes’ votes win the available seats. If there is only one candidate for one seat, a vote above 50 per cent will be sufficient to secure this position.

In an environment where the average (board-endorsed) incumbent typically receives a 96 per cent ‘yes’ vote (RiskMetrics 2008a) — non-endorsed candidates clearly face significant difficulties. Thus, some participants argued that the ‘no vacancy’ rule should be removed, allowing shareholders to choose the number of members to sit on the board (Stephen Mayne, trans., p. 236; RiskMetrics 2008a). Such an approach was also supported by Andrew Murray (sub. DD112), AHRI (sub. DD114), the Australian Shareholders’ Association (sub. DD121), the Finance Sector Union (sub. DD126), the Law Council of Australia (sub. DD150) and ACSI (sub. DD156).

The ‘no vacancy’ rule was examined by the Parliamentary Joint Committee on Corporations and Financial Services in 2008. It found that dominance of entrenched directors on company boards is contrary to good governance and shareholder interests. The committee concluded that the process for nominating and electing directors in Australia could be substantially improved in many companies to ensure better quality candidates are appointed to company boards. It recommended that the

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Australian Securities and Investments Commission develop a best practice guide to company constitutional recommendations and practices governing the nomination and election of directors (Parliamentary Joint Committee on Corporations and Financial Services 2008).

Providing shareholders with a say on the application of the ‘no vacancy’ rule would mean that boards could no longer arbitrarily determine the maximum number of board members within the range in the constitution. One way of achieving this is to require that boards table a resolution at general meetings in circumstances where they wish to invoke the ‘no vacancy rule’ and non-endorsed candidates have submitted for election. Where this resolution is rejected by shareholders, candidates would be able to run for board vacancies up to the maximum number of seats stipulated in the company constitution. In situations where insufficient candidates receive a majority vote, the board would operate below the limit.

However, a question arises as to whether such a change would in practice make much difference. A significant number of participants considered that removing the ‘no vacancy’ rule would be unlikely to remove barriers to entry for appropriately qualified individuals to contest board elections and would have little impact on board diversity (AICD, sub. DD149; Boral, sub. DD123; Macquarie Group, sub. DD157; Westpac, sub. DD158). First, candidates must achieve a ‘yes’ vote of at least 50 per cent to successfully obtain a vacant seat. Given the importance of board stability and the confidence placed in board members by shareholders, it is highly likely that shareholders will continue to show strong support for board-endorsed candidates.

Second, participants have suggested that where an ‘outside’ candidate was a threat, boards may take pre-emptive action to fill any vacancies. Where this occurs the number of board members would tend over time to gravitate towards the maximum number allowed. If boards become too large this may affect the quality of their performance, while operating at the constitutional maximum would reduce the board’s flexibility to appoint additional directors when suitable candidates become available, and manage succession (AICD, sub. DD149; Australian Bankers’ Association, sub. DD135; BCA, sub. DD152; Boral, sub. DD123; Origin, sub. DD129; Perpetual, sub. DD128; Swan 2009; UniSuper, sub. DD118). Given the costs involved, boards would only take this approach where they considered the risk of a non-endorsed candidate being elected to be both high and detrimental to board performance.

An alternative response may be that the board seeks to reduce the maximum limit in the constitution in order to reduce the costs associated with a large board and minimise the number of non-endorsed candidates that could be elected. Once again, such an approach would have resulting costs in terms of reduced flexibility and is

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only likely to be pursued where the board considers there to be a real and significant threat of non-endorsed candidates being elected.

Boral (sub. DD123) argued that through voting on, and adopting, the company constitution, shareholders already determine the maximum size of the board. In addition, it was widely held by participants that the board is best placed to determine the most appropriate board size at any given time, within the constraints set by the shareholders in the constitution. In particular, it was argued that it can be beneficial for the size of a company's board to fluctuate from time to time — for example, in order to facilitate a transition of membership.

Nevertheless, it is important that the mechanism that enables shareholders to vote for and against directors works effectively — and is seen to be appropriate by shareholders themselves — as other aspects of the governance framework including remuneration practices, are based on this ultimate sanction. Strengthening the power of shareholders to replace directors who they feel are not effectively engaging with shareholders or responding to significant 'no' votes on remuneration reporting is likely to promote greater board accountability. Therefore, while boards are likely to be better situated to assess optimum operational and compositional requirements depending on the companies specific circumstances, it is important that in carrying out this role they do not inhibit shareholders from electing non-board endorsed candidates.

### *Supply-side approaches*

To attain the qualities required to be an accomplished director requires access to relevant opportunities to hone these skills. Thus, where experience in executive management is a highly valued background for directors, the diversity of those in executive management roles directly affects the diversity of boards. Consequently, when considering options to improve diversity of boards it is important to consider supply-side factors and measures that can enhance the development of relevant skills and experience by a wider range of potential recruits to boards. For example, CAMAC referred to mentoring programs and management practices that could assist more female candidates to emerge for board positions (CAMAC 2009).

The AICD has recently released a range of measures to improve board diversity, with several initiatives aimed at addressing supply-side issues (box 6.10). AHRI (sub. DD114) suggested that retail shareholder groups develop a registry of potential board candidates and work with educational institutions to provide a curriculum on board skills and governance practices.

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However, while an essential component of improving the number and range of qualified candidates wishing to hold board positions, it is not clear that supply-side approaches alone will be sufficient to address concerns that boards are not adequately utilising a diverse pool of talent.

#### *Other impediments to attracting suitable board candidates?*

The liability risks that directors face under corporate and other laws was also raised as a potential disincentive for qualified candidates to take up directorships (Guerdon Associates, sub. DD119). Directors can be personally liable under a range of laws (chapter 2). Under the Corporations Act, directors responsibilities include the duty to: act in good faith in the best interests of the company (s. 181); act with reasonable care and diligence (s. 180); and prevent insolvent trading (s. 588G). Directors can also be held liable under continuous disclosure laws (s. 674). A breach of any of these provisions can give rise to a civil penalty of up to \$200 000 (s. 1317G). The Corporations Act also sets out criminal offences where a director is reckless, or intentionally dishonest and fails to exercise their powers and discharge their duties in good faith and in the best interests of the corporation (s. 184). A director found guilty of a criminal offence under this section can face a penalty of up to \$200 000, imprisonment for up to five years or both.

A 2008 survey of around 100 directors of ASX200 companies conducted by Treasury in conjunction with the AICD, suggest that liability laws can have a significant impact on directors' decisions to accept or keep a directorship. Concerns regarding perceived personal liability had resulted in respondents declining an offer of directorship (71 per cent of respondents), retiring from a directorship (76 per cent) and resigning from a directorship (46 per cent) (Treasury 2008).

The Treasury survey found that half the respondents perceived there was a high level of risk that they would be found personally liable for decisions made in good faith by themselves or the board. Furthermore, over two-thirds indicated that on occasion this risk of personal liability had resulted in directors or boards taking an overly cautious approach to business decision-making (Treasury 2008).

In practice, however, it is rare for directors to receive civil penalties. In the decade to 2004, 25 civil penalty applications were issued by the Australian Securities and Investments Commission (Welsh 2004). The majority of civil penalty applications issued related to contraventions of the directors' duty and insolvent trading provisions. While the penalty regime enables a criminal prosecution to be instigated after a civil penalty action has been issued, this has only occurred in one case (Welsh 2004). Thus, while it appears that perception regarding liability laws can

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increase directors' risk aversion, the extent to which this is limiting the pool of quality directors is unclear.

The Australian Government requested the Ministerial Council on Corporations to review director liabilities and identify areas for reform of personal criminal liability for corporate fault, in areas other than occupational health and safety and environmental protection legislation, by mid-2009. This review is still underway (Emerson 2009).

Guerdon Associates observed:

... COAG is certainly looking at that issue but they appear to be dragging their feet and if that's resolved, at least all the states are bringing their laws into line. They all have laws addressing safety, for example, that impact on directors. Instead of having seven different sets of laws and liabilities, bringing it all into one set would certainly help the process. (DD trans., p. 86)

Recently, the Minister for Employment and Workplace Relations announced that the Workplace Relations Ministerial Council had agreed on a model Occupational Health and Safety Act to be enacted by all States and Territories (apart from Western Australia). These acts will replace the ten principal occupational health and safety statutes across Australia and over 400 regulations and codes of practice (Gillard 2009). These changes should not only reduce compliance costs for many public companies, but also reduce the potential liability of directors in some jurisdictions (notably New South Wales). Progress by COAG in implementing these and other reforms in the 27 'regulatory hotspot' areas should help alleviate disincentives for directors as well as reducing the time required for compliance issues.

### *Compulsory training for directors*

Some participants raised concerns regarding the capabilities of directors on Australian boards. For example, an AHRI member survey indicated that 73 per cent of respondents believe that members of boards often have difficulty understanding the technical complexity of advice they are given on executive remuneration (AHRI 2009, p. 12). The Institute proposed that directors be subject to compulsory education and regular independent assessment of competence in order to ensure that board members possess the appropriate knowledge and experience, with a licence to practice required for directors of large listed companies (sub. 49).

Performance management of directors is the responsibility of the board. The ASX Corporate Governance Council suggests that the nomination committee, where established, should develop and manage the board's performance management

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system and should ensure appropriate policies are in place to identify, assess and enhance director competencies (ASX Corporate Governance Council 2007a). Within this framework it is not clear that there is a need for independent assessment of director competence.

Board members should have a combination of relevant knowledge, business acumen, interpersonal skills, experience, good judgment, an interest in the business of the company and a commitment to apply themselves to the tasks of the board (CAMAC 2009). Increases in corporate governance regulation and compliance obligations faced by the board may lead to greater weight being placed on particular professional or business backgrounds, as may the nature of a company's operations. Thus, the skills required of a director will vary depending on the nature of the business and the mix of skills and experiences already represented on the board by other members. In addition, it would be very difficult to teach some of these skills through a course.

Currently, directors have access to various courses, such as those run by the AICD and Chartered Secretaries Australia. These, and other organisations, also issue a range of guidelines to assist directors. The Commission considers that it would be advantageous for board members to undertake regular training and development, but it is not clear that this needs to be mandated. Ultimately, shareholders should be able to pass judgment on the qualifications and qualities of each director when casting their vote.

### **6.3 How boards determine pay**

The processes a board follows in fulfilling its role to determine executive and director remuneration are influenced by a range of regulatory requirements (including the Corporations Act and ASX listing rules) and non-regulatory guidelines. Furthermore, the processes and rules applicable to determining remuneration differ for NEDs.

#### **How boards determine executive pay**

Under the Corporations Act, the board is responsible for determining the remuneration of the CEO. It is common for the board also to determine remuneration for other senior executives (such as those who report directly to the CEO). A typical process for setting CEO and senior executive pay is illustrated in figure 6.3. Examples of how individual companies determine their remuneration levels and structures are presented in box 6.11.

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While the board of directors is responsible for determining executive and director remuneration, most major companies establish a remuneration committee. Directors may also seek guidance from consultants — chiefly specialist remuneration consultants, but also taxation and legal advisers.

Details regarding remuneration arrangements must be disclosed in the remuneration report and shareholders are given the opportunity to cast a non-binding vote on this report. In certain circumstances, shareholders are also provided an opportunity to cast a binding vote on termination payments and equity grants to directors and executives. Shareholder engagement in the remuneration process, including disclosure and voting, is discussed in chapters 8 and 9.

**Box 6.11 Remuneration practices at three companies**

Woolworths stated:

The Board of Directors, assisted by a sub committee of the Board, review all remuneration relative to the rest of the Australian workforce and on appropriate international benchmarks. Information is gathered from a range of sources to assist the decision making process, such as remuneration consultants, publicly available annual reports, benchmarking, macroeconomic indicators and the results of union negotiations. (sub. 91, p. 5)

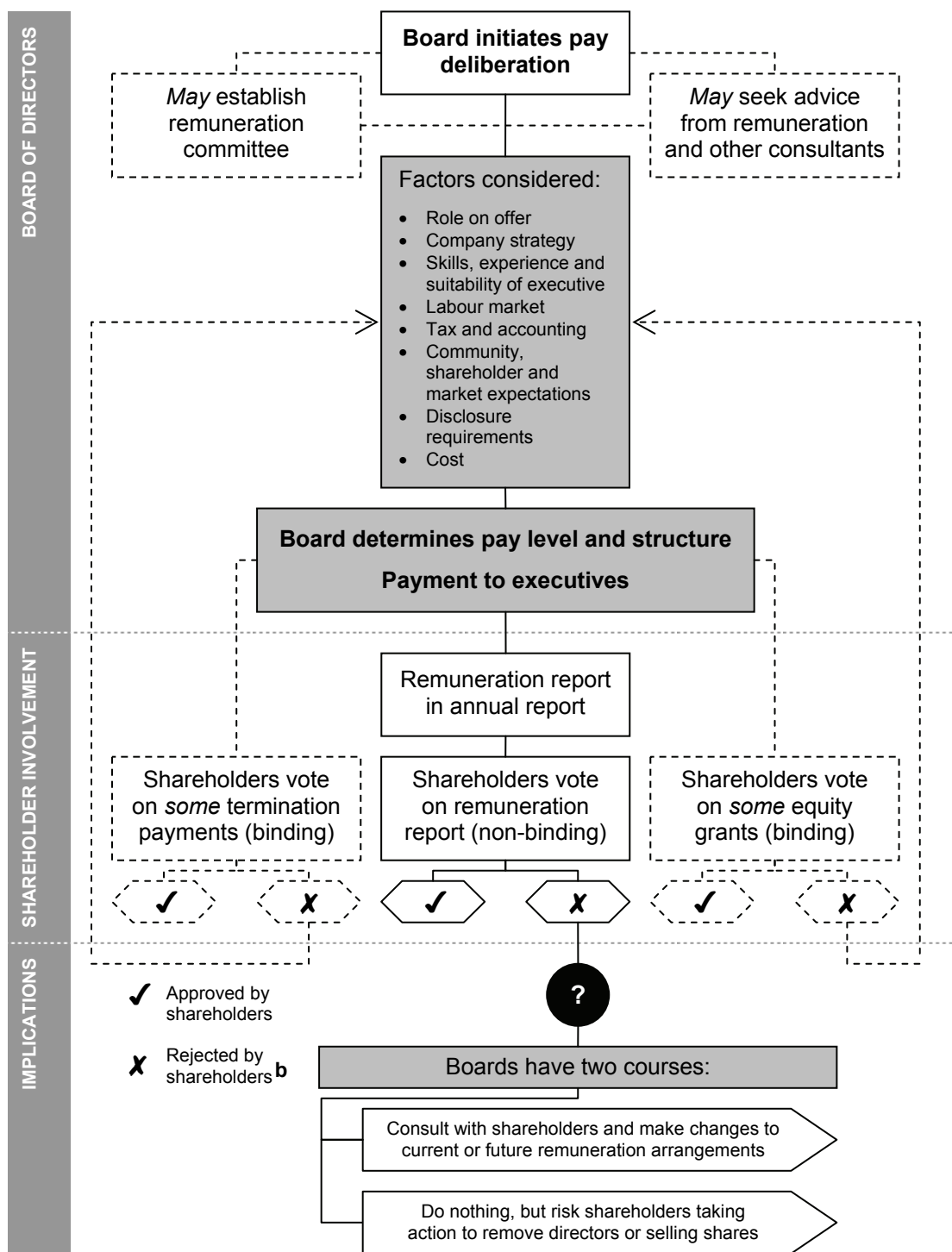
Bluescope Steel advised:

The Remuneration and Organisation Committee of the BlueScope board oversees executive remuneration policy and practice. This committee is comprised of independent directors only, and chaired by an independent director, being a director other than the Chairman of the Board. (sub. 56, p. 4)

Similarly, Origin Energy also has a remuneration committee, which:

... comprises three members who are Chair or are members of other major listed company Remuneration Committees who bring considerable knowledge of remuneration levels in other companies. (sub. 93, p. 11)

Figure 6.3 Processes for setting CEO and senior executives' pay<sup>a</sup>



<sup>a</sup> The board decides which executives' pay should be under its authority. This is generally the CEO and their direct subordinates. For other executives, this process tends to be simpler, with management having authority to negotiate appropriate remuneration levels. <sup>b</sup> The terms 'approved' and 'rejected' in this context do not necessarily refer to a simple majority of votes. In some cases where the 'no' vote is significant (but does not constitute a majority), boards might still choose to make changes to remuneration policy.

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## How boards determine NED pay

The board is also responsible for setting the pay of NEDs. In doing so, it draws on the advice and policies developed by the remuneration committee (if established), and also the advice of remuneration or other consultants as necessary (figure 6.4).

As the remuneration committee comprises mainly, or entirely, independent NEDs, committee members essentially determine their own pay. Consequently, companies are required to seek shareholder approval on the maximum fee pool for NEDs (box 6.12). Shareholders are not required to vote each year — a new vote is held only when the board wishes to pay NEDs more than the fee pool allows. The Hay Group indicated that ‘increases [in the fee pool] usually only occur every 2 to 3 years’ (sub. 84, p. 17).

Once a fee pool is approved, the board (or remuneration committee) then determines how much individual NEDs should be paid. PricewaterhouseCoopers observed:

NED’s individual skills and experience do not generally influence their fee, instead the fee tends to be based on the company’s characteristics. Characteristics that are typically considered by the Board when setting NED pay are:

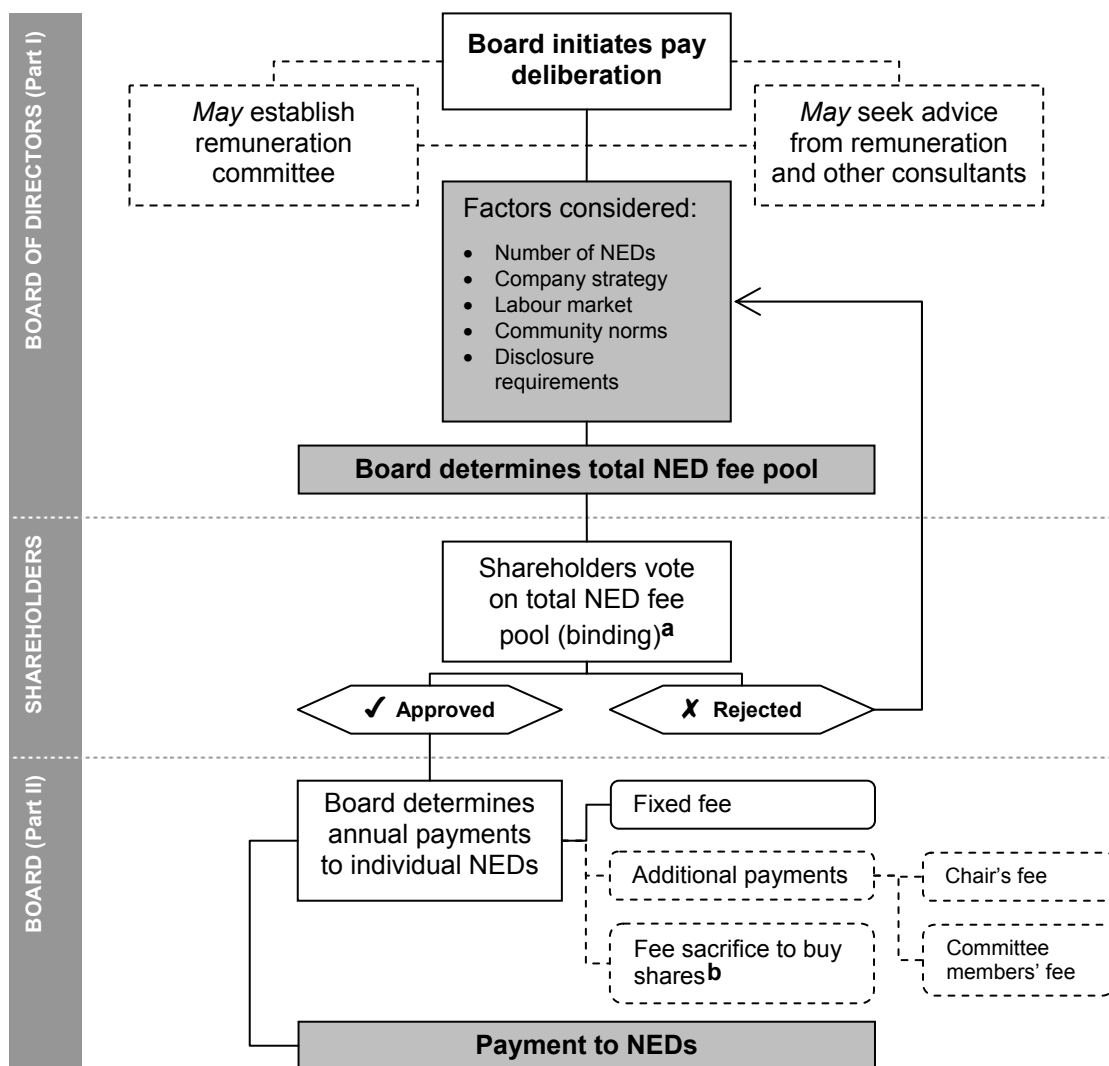
- the geographical diversity of the organisation
- the complexity of the company’s operations
- the market capitalisation/size of the organisation and
- the number of directors on the board and the impact that this has on time commitment. (sub. 85, p. 5)

Additional payments are sometimes made to those NEDs who serve on board committees, including higher fees for those who chair those committees.

Many companies also offer the opportunity for (or may require) NEDs to sacrifice part of their fees to purchase equity in the company, and may apply holding restrictions to these shares, in order to promote alignment with shareholder interests. According to Ernst and Young (2009), 36 per cent of ASX200 companies operate plans under which NEDs salary sacrifice fees to acquire shares. NEDs’ shares do not usually have performance requirements attached, as is the case for executives, in order to distinguish NED incentives from those of executive management and maintain NEDs’ independent oversight role of management.

Payments made to NEDs are reported on an individual basis in annual remuneration reports. Although not depicted in figure 6.4, if shareholders object to any individual payment (even after approving the fee pool ceiling), they could vote against the remuneration report.

Figure 6.4 Process for setting NEDs' pay



<sup>a</sup> This is not typically an annual vote, but rather a fixed ceiling set by shareholders that can last for a period of years. In this case, a new vote will only be called when this ceiling is to be exceeded. <sup>b</sup> While boards are required by ASX listing rules to pay NEDs by way of a fixed fee, some companies require NEDs to sacrifice at least a portion of this fee into buying company shares.

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**Box 6.12 Regulation of NED remuneration**

Under the ASX listing rules, NEDs must be paid a fixed sum and a company must not increase the total amount of director fees — the ‘fee pool’ — without shareholder approval by ordinary resolution (rule 10.17). This rule does not apply to the salary of an executive director. The board does not need to put the ‘fee pool’ to a vote each year. A vote is only required where the board wishes to pay NEDs more than the ‘fee pool’ allows.

This approach is similar to that adopted in the United Kingdom, where the board itself, or where required by the articles of association, the shareholders, determine the remuneration of NEDs within limits imposed by the company’s articles of association (the constitution of the company). The articles of association can only be changed by way of a resolution of shareholders.

### **The structure of the remuneration committee**

The process of determining the level and structure of remuneration for the CEO, senior executives and NEDs can be complex and require specialised knowledge. Remuneration committees can allow boards to deal more effectively with complex, specialised remuneration issues and to use directors’ time more efficiently (AICD 2007d). There is also an inherent conflict of interest where executives — who are also board members — are able to make decisions regarding their own pay. Remuneration committees are generally composed of independent NEDs, to form an arm’s length expert group and thus enhance the integrity of the decision-making process.

The ASX Corporate Governance Council notes that a remuneration committee ‘is an efficient mechanism for focusing the company on appropriate remuneration policies’, although it acknowledges that ‘ultimate responsibility for a company’s remuneration policy rests with the full board, whether or not a separate remuneration committee exists’ (2007a, p. 35).

The ASX Corporate Governance Council suggests that remuneration committees review and make recommendations to the board on:

- the company’s remuneration, recruitment, retention and termination policies and procedures for senior executives
- senior executives’ remuneration and incentives
- superannuation arrangements
- the remuneration framework for directors. (2007a, p. 35)

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### *What are the 'rules'?*

The ASX Corporate Governance Council (2007a) formally recommends that boards establish remuneration committees. It also 'suggests' (but does not formally recommend, so that 'if not, why not' requirements do not apply) that remuneration committees consist of at least a majority of independent directors, chaired by an independent director and with a minimum of three members. Similar recommendations are contained in the ACSI guidelines (ACSI 2009a).

The AICD considers that boards should establish remuneration committees comprising only NEDs, where the size of the company warrants this (AICD 2009b). However, it notes that for smaller companies, with smaller boards, it may not be practical to have a remuneration committee, suggesting that in these circumstances the entire board may undertake this role directly (sub. 59).

In November, APRA released its final governance standards, which would require APRA-regulated institutions to establish a remuneration committee and to have a written remuneration policy in place by 1 April 2010. APRA may grant an institution approval not to have a remuneration committee in exceptional circumstances and on condition that the board has 'alternative arrangements in place that achieve an equivalent outcome' (APRA 2009c, p. 5). In addition, these standards would require remuneration committees to comprise only NEDs, with a majority of independent directors and an independent chair.

### *Current practice*

According to the ASX (2009a), remuneration committees were in place at 55 per cent of all listed companies in 2007-08, a level virtually unchanged over the previous four years (table 6.4). The main reasons why some listed companies did not establish a remuneration committee included size of entity and resource constraints.

Larger companies are more likely to establish remuneration committees (table 6.4).

- 98 per cent of top 50 companies (by market capitalisation) have remuneration committees (Korn/Ferry International and Egan Associates 2008).
- 85 per cent of the top 250 companies and 72 per cent of mid-cap companies (those ranked 251–400) had a remuneration committee in 2008 (table 6.5).

Of the ASX300 companies that do have remuneration committees, 77 per cent have only NEDs (but not necessarily independent NEDs) as members of the committee (CGI Glass Lewis and Guerdon Associates, sub. 80). Another study (WHK

Horwath 2009a, 2009b) examines the composition of remuneration committees using a rigorous definition of ‘independent director’. It finds that the majority of top 400 companies (that have remuneration committees) have a majority of independent NEDs, with remuneration committees in larger companies more independent than remuneration committees in smaller companies (table 6.5). In addition, most top 400 companies that had a remuneration committee had an independent NED chair.

**Table 6.4 Listed companies with a remuneration committee<sup>a</sup>, 2003-04 to 2007-08**

	2003-04	2004-05	2005-06	2006-07	2007-08 <sup>b</sup>
	%	%	%	%	%
All listed companies	55	56	60	58	55
ASX500 entities	na	na	83	84	85

<sup>a</sup> This represents listed companies that report that they have adopted ASX Corporate Governance Council recommendation 9.2 — that boards should establish a remuneration committee. <sup>b</sup> The ASX Corporate Governance Council changed its interpretation of reporting in 2007-08. Prior to 2007-08, where a company reported the entire board considered remuneration matters, it might have been interpreted as the company having a remuneration committee. In 2008, this is treated as not having a remuneration committee. **na** Not available.

Sources: ASX (2005, 2006, 2007, 2008b, 2009a, pers. comm., 31 July 2009).

**Table 6.5 Remuneration committees in top 400 companies in 2008 annual reports**

	Top 250 companies	Companies ranked 251–400
	% all companies	% all companies
Remuneration committee	85	72
Independence <sup>a</sup> of remuneration committee:	% companies with remuneration committee	% companies with remuneration committee
• Independent chair	80	70
• Only independent members	39	22
• Majority independent members	35	32
• No majority independent members	26	46

<sup>a</sup> WHK Horwath define an independent director as someone who is not a member of management and who: (1) is not, or is not associated with, a substantial shareholder; (2) has not been employed in an executive capacity by the company in the last decade; (3) is not an original founder of the company; (4) is not a professional adviser to the company or is not a principal of a professional adviser to the company; (5) is not, or is not associated with, a significant supplier or customer; (6) has no significant contractual relationship with the company; (7) is free from any interest or relationship, that could, or could reasonably be perceived to, materially interfere with the director’s ability to act in the best interests of the company; and (8) has been a director for ten years or less.

Sources: WHK Horwath (2009a, 2009b).

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### *What are the benefits of remuneration committees?*

As pointed out by CGI Glass Lewis and Guerdon Associates, while remuneration committees are generally considered desirable to improve remuneration processes and outcomes, this is more likely to occur in larger companies:

... well staffed remuneration committees usually result in superior remuneration disclosure and structures, including remuneration levels consistent with market cap peers, and those often, but not always, occur in well performing companies. Generally, the standards are higher in the bigger companies. (sub. 80, p. 77)

Establishing and maintaining a remuneration committee is not costless. Moreover, boards of smaller companies might have an insufficient number of independents and NEDs to serve on a separate committee. Indeed, for smaller companies, the costs of requiring a separate remuneration committee might outweigh the benefits.

APRA's governance standards — including requiring remuneration committees be established unless special approval is sought — only apply to those entities it regulates. While one possible approach is to extend these requirements to all companies, this could impose significant costs on smaller companies. However, a strengthening of governance arrangements regarding remuneration committees, in line with the course set by APRA, could be achieved through a mix of 'soft' and 'hard' law approaches. For example, given that only 2 per cent of top 50 companies (by market capitalisation) and 15 per cent of top 250 companies do not have remuneration committees (Korn/Ferry International and Egan Associates 2008; WHK Horwath 2009a), one option would be to apply this rule to a sub-section of larger companies through the ASX listing rules.

### *Should remuneration committees be made more independent?*

A remuneration committee comprising only independent NEDs was seen by some participants as an important signal that executives do not have the ability to influence their own pay. Perpetual (sub. DD128) argued that remuneration committees comprising only independent members 'remove actual and perceived conflicts of interest' and promote shareholder confidence. The Australian Manufacturers Workers' Union stated that the independence of those setting remuneration from those receiving remuneration 'is integral to credibility being restored to levels of executive remuneration in Australia' (sub. 127, p. 9).

However, there was also support in submissions for the ASX Corporate Governance Council's suggestion that remuneration committees be chaired by an independent director and comprise a *majority* of independent members (ACSI, sub. 71; BCA, sub. 101; Chartered Secretaries Australia, sub. 57). This approach is also consistent

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with regulation in some other OECD countries, including the United States and the United Kingdom (box 6.13).

**Box 6.13 Remuneration committees in other countries**

In the United States, the New York Stock Exchange and NASDAQ listing rules require a compensation (remuneration) committee consisting solely of independent NEDs.

The UK Combined Code states that the board should establish a remuneration committee of at least three, or for smaller companies two, independent NEDs.

In Canada, listed companies must report on an 'if not, why not' basis whether they have established a remuneration committee composing all independent directors and with procedures to ensure that no individual is directly involved in deciding his or her remuneration. These rules are currently under review.

The European Commission recommends that remuneration committees should be set up within the supervisory board (and thus constitute exclusively NEDs) and that the majority of these directors should be independent.

In addition, some participants argued that while the remuneration committee should be responsible for remuneration decisions, it is important that the CEO has a voice in company remuneration strategies, policies, plan designs and actual levels for subordinate employees. Hay Group (sub. DD132) argued this could be achieved by management having an input into committee deliberations but ensuring that decisions were made by independent directors. Regnan (sub. DD159) highlighted the fact that, in its Corporate Governance Guidelines, the ASX Corporate Governance Council suggests that the remuneration committee have a charter which, among other things, sets out procedures relating to non-committee members attending meetings (box 6.14). In the Commission's view, Telstra's requirement that employees (including executives) should not be present at remuneration committee meetings when they have a material personal interest in a matter being considered, seems to be an example of good practice.

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#### Box 6.14 Remuneration Committee Charters

The commentary associated with the ASX Corporate Governance Council's Principle 8.1 states that:

The remuneration committee should have a charter that clearly sets out its role and responsibilities, composition, structure and membership requirements and the procedures for non-committee members to attend meetings (ASX Corporate Governance Council 2007a, p. 35).

Examples of sections in remuneration committee charters that address attendance of non-members:

**Qantas** — 'Directors who are not Committee Members may attend Meetings' ... 'The Chief Executive Officer and the Executive General Manager People are to attend such portion of each Meeting as requested by the Committee Chairman. (The Chief Executive Officer is not to be present when the Committee discusses issues relating to the Chief Executive Officer)' (Qantas 2008, p. 1).

**Macquarie** — 'All voting Directors of Macquarie may attend Committee meetings. The Managing Director of Macquarie shall normally be invited to attend Committee meetings at the invitation of the Committee but will have no voting rights. Members of management and/or parties external to the Group may be invited to attend any meeting of the Committee or part thereof, however, they may be asked to withdraw from all or any part of a meeting' (Macquarie 2009, p. 3).

**Telstra** — 'The Group Managing Director, Human Resources, Executive Director Remuneration and Workforce Planning and the Company Secretary attend all Remuneration Committee meetings by standing invitation, but may be asked to leave at any time. The Remuneration Committee may invite other people including any employee of Telstra to attend all or part of its meetings, as it deems necessary or appropriate. If an employee, including an executive director, has a material personal interest in a matter that is being considered at a meeting, he/she must not be present for consideration of that matter' (Telstra 2009, p. 2).

Currently 39 per cent of the top 250 companies and 22 per cent of mid-cap companies (the top 251 to 400 companies by market capitalisation) have only independent members on their remuneration committees (table 6.5). While a requirement for remuneration committees to comprise only independent NEDs puts in place a higher test of independence that could help address the potential for conflicts of interest surrounding remuneration decisions, such a threshold could impose significant costs and would affect most listed companies.

One option to increase the independence of remuneration committees is to elevate the ASX Corporate Governance Council's 'suggestion' on remuneration committee composition to a 'recommendation'. This would mean that companies would need to respond on an 'if not, why not' basis in regard to remuneration committees having a majority of independent directors, being chaired by an independent

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director and consisting of at least three members (the ASX Corporate Governance Council has indicated support for this approach (ASX 2009g)). An additional ‘soft’ law option could be to elevate the ASX Corporate Governance Council’s suggestion regarding remuneration committee charters from a suggestion to a recommendation (box 6.14).

Encouraging greater independence of remuneration committees through ‘soft’ law would avoid imposing such arrangements on companies where the benefits are unlikely to outweigh costs. Further, the application of ‘soft’ law avoids the need for prescriptive requirements regarding independence. Significant complexities arise in determining a ‘black letter’ law for ‘independence of mind’. While the Commission considers that relationship-based definitions are a reasonable proxy for ‘independence of mind’, they are still only a proxy, and as such some flexibility in determining independence status is necessary. Furthermore, while independence from a major shareholder is less of a concern for remuneration purposes, it is an important element of independence in other contexts. However, it may not be practical to institute differing definitions of independence, defined by particular relationships, for different board functions.

Additionally, mandatory requirements for larger companies — and on an ‘if not, why not’ basis for all companies — could be considered such that only NEDs (whether or not independent) be appointed to the remuneration committee. A requirement for remuneration committees to comprise only NEDs would affect fewer companies than requiring that remuneration committees comprise only independent NEDs. For example, around 23 per cent of ASX300 companies that have a remuneration committee have executives on it. Introducing this as a recommendation through the ASX Corporate Governance Council in conjunction with a listing rule for ASX300 companies, would provide greater flexibility for smaller companies where such arrangements may not be feasible.

Applying similar requirements to all companies, albeit with differing levels of stringency (according to company size) avoids conceptually inconsistent approaches, and potential problems created by arbitrary company size cut-off points (ASX, sub. DD142). Chapter 11 discusses these options further and provides recommendations.

### **The role of remuneration consultants**

Given the complexity and technical nature of remuneration structures, even remuneration committee members may lack the time, access to market-wide data and depth of knowledge required to develop the most appropriate remuneration

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packages for senior management. Specialist consultants can provide the board and remuneration committee with useful information and advice.

The AICD observed:

Remuneration arrangements for executives have become increasingly complex. Boards cannot be expected, in isolation, to be completely across the legal, financial modelling, accounting and tax aspects of many of today's executive remuneration packages, the intricacies of incentive plan design, market trends, and so on. Furthermore, many boards, particularly of modest scale companies, do not engage in this type of activity frequently and may in fact only seek to appoint a CEO every five-to-ten years. It may be the case that no member of the board including its chairman has the experience or skill to undertake these employment negotiations alone. (2009b, p. 10)

Remuneration consultants provide market data (from their own sources as well as remuneration reports) and insights on remuneration trends. They assist boards and/or remuneration committees to determine appropriate pay structures and performance hurdles (Mercer, sub. 41; PricewaterhouseCoopers, sub. 85) and provide insight on taxation, legal and accounting matters relating to remuneration (Egan Associates, sub. 105). The Commission has heard that it is rare for remuneration consultants to make recommendations about the quantum of remuneration. Rather, their role is generally to advise how remuneration can be structured.

### *Current arrangements*

Companies are not required to disclose their use of remuneration consultants, although some choose to do so. These include, for example, BHP Billiton, Iluka Resources and Woodside Petroleum (ACSI, sub. 71, p. 7).

The AICD guidelines on remuneration committees strongly endorse boards obtaining independent advice (AICD 2004). Its guidelines for listed company boards also provide examples of 'good practice' processes, including:

- having in place remuneration processes that incorporate independent opinion, expertise and transparency
- ensuring the board maintains control of negotiations with CEO candidates, and where appropriate, other executives
- obtaining appropriate expert advice, independent of management, when entering into employment contracts with executives and setting their remuneration (AICD 2009b).

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In practice, seeking external advice on remuneration matters appears fairly common. Boards, especially from larger companies, generally seek information from a range of consultants when determining remuneration packages. According to a survey by ProNed, a corporate governance adviser, 67 per cent of boards seek independent advice on CEO remuneration (ProNed 2009). Another survey, conducted by AHRI in 2009 (sub. 49), indicated that 83 per cent of boards seek independent advice when negotiating contracts with CEOs.

Some remuneration consultants provide a range of services to both the board and to management. Further, consultants can be contracted by the board directly, by the human resources department on the board's behalf, or by management (box 6.15).

Recently, APRA announced that for financial services businesses, if a remuneration committee (or the board, for companies with approval not to have a remuneration committee) makes use of expert advisers, they should have the power to do so in a manner that ensures that the engagement, including any advice received, is independent (APRA 2009c). Its Prudential Practice Guide notes that 'the board remuneration committee will need to exercise its own judgement and not rely solely on the judgement or opinions of others' and that the committee should not engage 'an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution' (APRA 2009c, p 7).

**Box 6.15 Remuneration consultants — working with the board and management?**

While some companies specialise in providing remuneration advice to boards (such as Guerdon Associates and Egan Associates), others provide advice to both boards and management.

Some advisers are drawn from management and governance advisory companies (for example, Hay Group and Mercer) or major accounting businesses (in particular, the 'big four': Deloitte, Ernst and Young, KPMG and PricewaterhouseCoopers).

Origin submitted that services of independent consultants are retained and instructed by the chair of their remuneration committee. Consultants report directly to the remuneration committee, 'independently of management' (sub. 93, p. 11).

BHP Billiton's remuneration committee receives specialist advice from an external company. They noted that the adviser is directly accountable to the remuneration committee, and does not provide any other services to the company (sub. 45, p. 8).

Woolworths stated that they use different consultants for non-executive directors and senior executives. They reported that there is a rigorous review process to determine the appropriateness of consultants used for providing this type of information (sub. 91, p. 10).

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### *Conflicts of interest?*

Many inquiry participants acknowledged the usefulness of the information and expertise from remuneration consultants. However, it was noted that potential conflicts of interest might arise in two ways:

- through lines of reporting, such as when a CEO hires a remuneration consultant to advise the board on the CEO's remuneration
- where a consultant also provides other services to the same company.

In the Commission's public hearings, Mercer reported that the lines of reporting for remuneration consultants can easily be blurred:

... we do find in a number of cases the board would say to the HR department to find a remuneration consultant, get them to provide us with data, and it actually flows through the management, even though it was a request from the board. (trans., pp. 333–4)

On the second issue, Bebchuk and Fried (2003) have argued that remuneration consultants have strong incentives to use their discretion to benefit the CEO, even where they are not contracted directly by the CEO:

Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future by this firm or, indeed, by any other firms. (2003, p. 79)

It is apparent that, in Australia, companies and remuneration consultants are mindful of the potential for conflicts of interest and employ a number of strategies to reduce this risk.

- Some remuneration committees or boards employ the consultant directly, and companies may also limit any other services they receive from the consultant (for example, BHP Billiton, sub. 45).
- Some consultants provide remuneration advice to boards only (CGI Glass Lewis and Guerdon Associates, sub. 80; Egan Associates, sub. 105).
- Others, such as the Hay Group, provide a range of services to boards and management but 'only provide advice to the Board when it comes to executive and/or director remuneration' (sub. 84, p. 26). Further, individual consultants responsible for this advice are not responsible for other services provided to a company.
- Mercer reported that where they provide services to both management and the board, and the board indicates that they need an independent adviser, Mercer will discontinue their executive remuneration work for the board (trans., p. 334; sub. DD139).

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The Commission understands that it is likely that the top two companies (in terms of market share) providing remuneration advice to boards in Australia also provide advice to management on remuneration, and to both the board and management on other areas more broadly. While large consulting companies can use ‘Chinese walls’ (information barriers to separate employees who work on remuneration issues) the extent of these practices is not disclosed.

In order to address conflict of interest concerns, some participants suggested changes to the process of engaging remuneration consultants, including: requiring that they be engaged directly by the board (at least on an ‘if not, why not’ reporting basis) (Fidelity International, sub. 83; KPMG, sub. 95; Oppeus, sub. 61); advising the board or management, but not both, on an ‘if not, why not’ basis (CGI Glass Lewis and Guerdon Associates, sub. 80) and that boards should have clearly defined and disclosed systems and procedures to address any potential conflicts (Guerdon Associates, sub. DD119; KPMG, sub. 95; PricewaterhouseCoopers, sub. DD138; Regnan, sub. DD159).

Kym Sheehan also suggested that there may be merit in developing a set of professional standards for remuneration consultants (sub. 36). This is currently occurring in the United Kingdom on an industry-led basis (box 6.16) and could be helpful in Australia for addressing possible conflicts of interest. Ernst and Young (sub. DD136) and PricewaterhouseCoopers (sub. DD138) were also supportive of such an approach.

However, a strict delineation of responsibilities, particularly restrictions on the ability of advisers to boards to liaise with management, might miss potential benefits. PricewaterhouseCoopers argued that consultants working with boards and management can lead to better outcomes in designing performance-based remuneration:

The main area where there is commonly an overlap between consultants working with both the board and management is when incentive plan structures are being designed. This is necessary to produce optimal outcomes. Liaising with executives enables the adviser to gain a thorough understanding of the business drivers which subsequently enables determination of the most appropriate incentive metrics. In addition, this enables strategic and performance alignment as management can then appropriately cascade metrics down to lower-level employees. (sub. 85, p. 8)

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**Box 6.16 International regulation on use of remuneration consultants**

**United States** — in the United States, the Securities and Exchange Commission requires listed companies to disclose all compensation (remuneration) consultants with any role in determining or recommending the amount or form of executive or director remuneration, stating whether such consultants are engaged directly by the committee and describing the nature and scope of their task. Proposed amendments in July 2009 include requiring disclosure about the fees paid to such consultants if they also provide other services to the company along with a description of those other services (SEC 2009a).

**United Kingdom** — the UK Combined Code stipulates that where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company.

The Walker Review in the United Kingdom included a draft 'Voluntary Code of Conduct in relation to Executive Remuneration Consulting in the United Kingdom' (Walker 2009). As of August 2009, Deloitte, Hay Group, Hewitt New Bridge Street, Kepler, Mercer, Towers Perrin and Watson Wyatt had all signed up to the draft code. The Code focuses on five fundamental principles: transparency, integrity, competence and due care, objectivity and confidentiality. The draft code also includes good practice guidelines on the ways in which these principles should apply.

However, the Association of British Insurers argues that the Code does not go far enough in acknowledging potential conflicts of interest. They contend that boards should disclose publicly how much they spend on pay consultancy each year, as well as how much management spend on other services from the same consultancy companies (Association of British Insurers 2009).

**European Union** — a 2004 European Commission recommendation stated that member policies should ensure that companies disclose the name of remuneration consultants whose services were used for determining remuneration policy (European Commission 2004). Subsequently, in April 2009 the European Commission released a further recommendation that stated that consultants who advise the remuneration committee should not advise the company as well (European Commission 2009a).

Ernst and Young similarly considered that it is more efficient and effective if a consultant reports to the board, with a mandate to consult with management (sub. 92). The AICD argued that any requirements regarding the relationship between advisers and management should only apply to advisers on remuneration of directors and key management personnel. Otherwise such an approach has the potential to impose unreasonable regulatory burdens and present practical difficulties for companies that engage a range of advisers on different aspects of remuneration and at various levels of the company (sub. DD149).

Further, Guerdon Associates (sub. DD119) noted that there may be several levels of independence of advisers that may be acceptable to boards and shareholders, such

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as where advisers provide no advice to management or where services are provided directly to management with the board's knowledge and consent.

Given the potential for conflicts of interest, there would be merit in requiring that if boards engage external advisers, their advice should be commissioned by, and provided directly to, the remuneration committee or board. APRA initially proposed such an approach in its September consultation. However, its final position is that it expects remuneration committees not to engage an adviser who is acting concurrently or has acted recently on behalf of management or any executive of the regulated institution (APRA 2009c). APRA's recommendation makes this compulsory for all APRA-regulated institutions. This is a stronger requirement than that previously proposed and could impinge on the board's ability to seek advice from multiservice providers.

#### *Greater transparency would help*

Increasing disclosure on the use of remuneration consultants would help shareholders identify the extent to which the consultants provide advice to the board or remuneration committee, and assess whether the remuneration decisions that boards and remuneration committees make are based on 'independent' (that is, not conflicted) advice. This was supported by some inquiry participants (box 6.17) and is in line with requirements overseas (box 6.16).

Further, there could be benefits from also disclosing whether other services are provided and how potential conflicts of interest are addressed. As is already happening in many cases, it is important that the board and consultancy companies have clearly defined systems and procedures to address any conflicts of interest that may arise. Thus, disclosure requirements could include details of these arrangements.

Regnan (sub. DD159) and the Australian Shareholders' Association both advocated significantly increased disclosures, including about how much the adviser was paid (both for advice provided to the board and for any other services that may be provided to the company) and the board's role in approving such work. The Australian Shareholders' Association noted that 'all too often, listed company boards of all sizes shield themselves by stating that they took advice from 'independent expert remuneration advisers', without shareholders having any way to ascertain who the adviser was, who appointed them, who they reported to and whether they were truly independent' (sub. DD121, p. 6). In addition, Guerdon Associates (sub. DD119) suggested requiring disclosure of company policy (if any) in regard to management contracting its own external advice in relation to their own remuneration.

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PricewaterhouseCoopers (sub. DD138), Chartered Secretaries Australia (sub. DD147) and Mercer (sub. DD139) disagreed with such increased levels of disclosure. Mercer argued that requirements regarding disclosure of other work conducted implies that ‘the mere fact that other services are being performed indicates that the consulting advice provided was not objective’ (sub. DD139, p. 19). They also argued that such disclosure may result in competitive or proprietary information being revealed and favours single service providers.

As noted by several participants, boards might not have accepted or followed the advice provided by remuneration consultants. Also requiring disclosure on this aspect was proposed by some, but mandating this may not be workable. Instead, where a consultant has concerns regarding this issue they could include specifications regarding the nature of disclosure in the contractual agreement with the company.

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### Box 6.17 Participant's views on disclosure of remuneration consultants

RiskMetrics argued:

... the Corporations Act should be amended to require that if a board, in the remuneration report, explicitly notes that it has relied on external advice in setting an aspect of executive remuneration, then the identity of that adviser should be disclosed. (sub. 58, p. 8)

Similarly, ACSI recommended that annual reports should contain information about any remuneration consultants, who appointed them and the services they provided (sub. 71, p. 7). The Australian Shareholders' Association said that disclosure of 'the consultant along with the disclosure of what other services the consultant has provided other than consulting to the board may be of some assistance' (sub. 54, p. 15). Oppeus made a similar suggestion (sub. 61).

CGI Glass Lewis and Guerdon Associates recommended disclosure of all advisers to the board with an opinion by the board on the adviser's independence and the reasons for that opinion (sub. 80). The Finance Sector Union (sub. 39) and Australian Manufacturers Workers' Union (sub. DD127) recommended remuneration consultants should be under similar disclosure requirements as auditors. The Finance Sector Union argued that the Corporations Act should require the consultant's independence be declared in the remuneration report, and the amounts paid to consultants for other services and a statement that (and reasons why) directors are satisfied that provision of these other services did not compromise the independence requirements.

Kym Sheehan argued that all advisers, not just remuneration advisers, to the remuneration committee be disclosed (sub. 36).

Ernst and Young cautioned that if disclosure is mandated, disclosure should only be required where the board 'relied' on the advice (sub. DD136).

The AICD observed that while it supported disclosure, it had:

... difficulty with this suggestion being mandated in all circumstances. We note that this position is different to that involving an auditor because the auditor prepares a report for shareholders, whereas a remuneration consultation provides advice to the board — advice which may or may not be taken up. Further, the ambit of a remuneration consultant's engagement can vary considerably from company to company, depending in part on the extent to which boards rely on other advisers (e.g. law firms for employment contracts, accountants for data analysis). (sub. 59, pp. 43–4)

Similarly, KPMG acknowledged the potential issues in mandated disclosure if a board chooses not to follow the advice of the remuneration consultant. It advised that standard wording should be developed indicating that the remuneration adviser may have been engaged to look at specific aspects of the report only, that the board may have adopted all, some or none of their advice and that the board remains responsible for the remuneration practices of the company (sub. DD145). Mercer noted that such disclosure is mandated in the United States, and noted:

We require our clients to run past whatever they're disclosing beforehand and we would push for the board acknowledging where we've provided advice but they've actually not adopted it or made a decision that was contrary to it. (trans., p. 335)