CENTRE FOR CORPORATE LAW AND SECURITIES REGULATION

THE UNIVERSITY OF MELBOURNE

INSTITUTIONAL ANALYSIS

CORPORATE GOVERNANCE RESEARCH AND ADVICE

CORPORATE GOVERNANCE: THE ROLE OF SUPERANNUATION TRUSTEES

A report prepared by Institutional Analysis and the Centre for Corporate Law and Securities Regulation, for the Australian Institute of Superannuation Trustees

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- Advising the UK government on corporate governance and company law reform.
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- Evaluating the corporate governance environment of an Eastern European country for a multilateral financial institution.

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1. Introduction

1.1. Background to the report

This report has been prepared for the members of the Australian Institute of Superannuation Trustees (AIST). AIST requested the authors to prepare a report covering a range of corporate governance issues relevant to the shareholding investments of trustees of Australian superannuation schemes. The Research Brief is set out in 1.2.

The report does not contain a set of "guidelines". Instead, it is designed to serve as a higher level document which could, for example, be used by trustees when formulating a set of voting guidelines tailored to the requirements of the superannuation fund in question.

The report does, however, refer to several sets of corporate governance guidelines. This is done to give a summary of generally accepted views, and sometimes to highlight differences in views. The main guidelines referred to are:

- **AFL-CIO Guidelines** – American Federation of Labor and Congress of Industrial Organizations, *Investing in Our Future: AFL-CIO Proxy Voting Guidelines* (1997).
- **ALI Principles** – American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994).
- **Bosch Report** – Working Party of the Australian Institute of Company Directors and others, *Corporate Practices and Conduct* (3rd edition, 1995).
- **Cadbury Code** – Committee on the Financial Aspects of Corporate Governance (Sir Adrian Cadbury, chair), *Code of Best Practice* (1992).
- **Cadbury Report –** Committee on the Financial Aspects of Corporate Governance (Sir Adrian Cadbury, chair), *The Financial Aspects of Corporate Governance* (1992).
- **CalPERS Guidelines –** California Public Employees' Retirement System, *US Corporate Governance Core Principles and Guidelines* (1998).
- **CISCO Guide** – The City Group for Smaller Companies, *The Financial Aspects of Corporate Governance: Guidance for Smaller Companies*.
- **Council of Institutional Investors' Policies** – Council of Institutional Investors, *Corporate Governance Policies*.

- **Hong Kong Code** – The Stock Exchange of Hong Kong, *Guide for Directors of Listed Companies*, Code of Best Practice (1995).

- **IFSA Guidelines** – Investment and Financial Services Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (1999).

- **Toronto Guidelines** – Toronto Stock Exchange, *The Toronto Stock Exchange Company Manual*, Part IV.M.

- **Toronto Report** – Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada*.

- **UK Combined Code** – Financial Services Authority, *The Listing Rules, Combined Code* (appendix).

- **US Business Roundtable Report** – Business Roundtable, *Corporate Governance and American Competitiveness*.

The report's structure is as follows. Section 2 outlines the meaning and importance of corporate governance. Section 3 discusses the role of superannuation fund trustees in corporate governance. The section includes a range of options as to how trustees can participate in corporate governance. And Section 4 gives an overview of some key corporate governance issues. These are issues which superannuation trustees should address when formulating a new corporate governance policy, or revising an existing policy.

1.2. Research brief

The Research Brief required the report to address these issues:

- The meaning, context and importance of "corporate governance".
- The role of superannuation fund trustees in corporate governance.
  - ⇒ Including a brief reference to the legal (equitable) obligation on trustees to "consider" whether to exercise their powers (including the voting right attached to shareholding investments).
- The relationship between superannuation fund trustees and investment managers hired by them.
  - ⇒ Including an outline of different options as to how a superannuation scheme's trustee may go about adopting and implementing a corporate governance policy.
- Corporate governance issues relating to companies in which shareholding investments are held. For example:
  - ⇒ Distinguishing the roles of board and management.
  - ⇒ Board composition (including role and importance / rationale for having a minimum proportion of independent non-executive directors on the board).
  - ⇒ Separation of the roles of CEO and chairperson.
  - ⇒ Board committees (including audit, remuneration and nomination).
  - ⇒ Appointments to the board, and re-election of directors.
  - ⇒ Directors' and executives' remuneration (covering both on-going remuneration issues and separation package issues).
  - ⇒ Disclosure (including financial reporting) and audit.

- ⇒ Share ownership by directors.
- ⇒ Dialogue with shareholders, particularly institutional shareholders.

♦ Environmental performance of company, and other issues concerning "socially responsible investing".

2. The meaning and importance of "corporate governance"

2.1. What is corporate governance?

Corporate governance is the system by which a company pursues the purpose for which it was established. For most Australian companies, the "purpose" referred to in this definition is to operate a business in the interests of shareholders. The interests of other stakeholders – e.g. employees, customers, suppliers and creditors – are also important. But the emphasis given to shareholders' interests reflects:

♦ The corporate law duty of directors and senior executives to act in good faith in the interests of the company – where the "interests of the company" are equated with the interests of the shareholders as a whole (at least while the company is solvent).

♦ The ownership status of shareholders – as discussed below.

2.1.1. To which companies is governance relevant?

Corporate governance is *relevant* to all companies – no matter how small or large – but it is particularly *important* to public companies listed on the stock exchange. This is because listed companies typically exhibit some separation of ownership and management – as illustrated in Figure 1. In a typical widely held listed company, the shareholders are not involved in the management of the company's business. Instead, the managerial function is carried out by the Chief Executive Officer (CEO) and other senior executives via a chain of delegation:

♦ The shareholders elect and delegate power to the board of directors.[1]

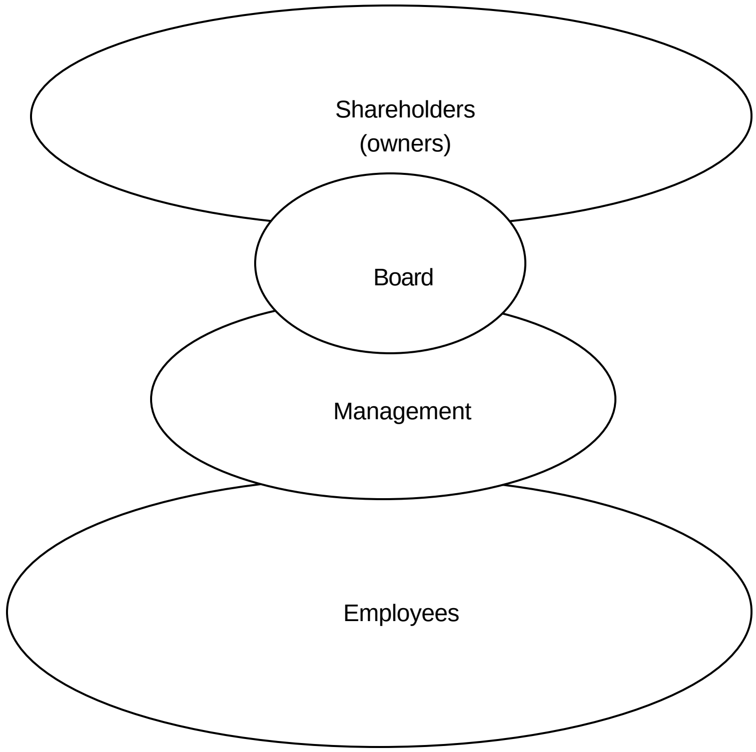
♦ The board of directors appoints and delegates power to the CEO.

♦ The CEO appoints and delegates power to other senior executives.

Superannuation funds' equity investments are predominantly in listed companies.

[1] As a matter of strict company law, it is in some circumstances technically incorrect to refer to the board of directors as a delegate of the shareholders in general meeting. However, as a matter of substance, it is accurate: The shareholders elect the directors and the shareholders also determine the content of the company's constitution – and the constitution typically grants to the board of directors the power to manage, or oversee the management of, the company's business (and then permits the board to delegate this power to the CEO). So, as a matter of substance the shareholders have – via their control over the content of the constitution – delegated powers to the board of directors.

Figure 1 Separation of ownership and management



2.1.2. What are corporate governance mechanisms?

One consequence of this chain of delegation is that day-to-day decision-making power – power to make decisions over use of the capital supplied by shareholders – rests with persons other than the shareholders themselves. And the interests of the CEO and senior managers will not always be aligned with the interests of shareholders. This is where corporate governance surfaces: several *corporate governance mechanisms* operate to minimise the divergence between the interests of senior executives and shareholders. Examples of corporate governance mechanisms are:

- **The "market for corporate control".** When a company is taken over by a hostile takeover bidder, the CEO and many senior managers usually lose their jobs. One way for a company's management team to protect the company from a hostile takeover bid is to run the company's business well and produce good returns for its shareholders. Therefore, the threat of a hostile takeover serves to decrease the divergence between managers' and shareholders' interests.

- **Executive incentive remuneration schemes.** An appropriately designed executive incentive remuneration scheme will tie the pay of senior management to the company's performance – so that managers stand to gain if shareholders gain. See 4.7.

- **Monitoring by the board and board committees, in particular non-executive directors.** See 4.3 to 4.6.

- **Disclosure and audit rules.** See 4.10.

- **Legal duties owed by directors and senior executives.**

- **Shareholder voting and other forms of shareholder "monitoring".** This is the governance mechanism that most directly impacts superannuation fund trustees. Shareholders[2] are in essence the "owners" of a company, because:

  ⇒ They supply equity capital for use in financing the company's business.

  ⇒ Under corporate law shareholders are the "residual claimants" – if the company is wound up the shareholders receive the proceeds of any assets left over after all creditors (including employees) and the costs of liquidation have been paid.

  ⇒ Reflecting their residual claimant status, they are given the rights of ultimate control: voting rights. Voting rights are decision-making rights. As discussed later, shareholders are entitled to vote on a range of issues, including election of directors and determining the content of the company's constitution.

  ⇒ While a company is operating profitably, shareholders have a right to share in distributions of profit (dividends).

2.2. Is corporate governance important?

2.2.1. Does governance affect performance?

Several US studies have found a positive relationship between corporate governance and corporate performance. That is, improved corporate governance is linked with improved corporate performance – either in terms of share price or profitability. However, it would be overstating the case to say that these studies are conclusive, because other research has either failed to find a link or found a negative link.

One difficulty in looking for statistical evidence of the value of good corporate governance is that governance is multi-dimensional. As indicated above, there are several different corporate governance mechanisms – which can interrelate with and, sometimes, substitute for one another.

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2 References to shareholders in this Report are to holders of ordinary shares.

2.2.2. Do investors value good governance?

A recent large-scale survey of institutional investors found that a majority of investors consider governance practices to be at least as important as financial performance when they are evaluating companies for potential investment.[3] Indeed, they would be prepared to pay a premium for shares in a well-governed company compared to a poorly governed company exhibiting similar financial performance. In the UK the premium was 18%. Another similar survey of institutional investors, globally, has also revealed governance to be an important factor in investment decision-making.[4]

2.2.3. International and Australian interest in corporate governance

There is extensive international interest in corporate governance. Many countries have issued major reports on the subject including Canada, Hong Kong, Japan, Korea, Malaysia, South Africa, the United Kingdom and the United States. In recent years, a number of international organisations have become active in the corporate governance movement. These include the OECD, APEC, the Basle Committee, the World Bank, the Asian Development Bank and the European Bank for Reconstruction and Development. At the international level, the World Bank has been active in strengthening corporate governance systems in its client countries. Currently, almost 100 World Bank projects contain corporate governance components.

A particularly prominent development has been the OECD corporate governance principles which were completed in May 1999. They are intended to reflect common elements that underlie good corporate governance. The principles address:

- The rights of shareholders.
- The equitable treatment of shareholders.
- The role of stakeholders in corporate governance.
- Disclosure and transparency.
- The responsibilities of the board.

In relation to Australia, major reports which deal with corporate governance are the Hilmer Report, *Strictly Boardroom* (1993) and the Bosch Report, *Corporate Practices and Conduct* (1995).

Another development has been the introduction, in mid 1996, of Australian Stock Exchange Listing Rule 4.10.3. The Listing Rule requires companies to include in their annual reports:

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3 McKinsey & Company, *Investor Opinion Survey* (2000).

4 Russell Reynolds Associates, *Corporate Governance in the New Economy: 2000 International Survey of Institutional Investors* (2000).

> "A statement of the main corporate governance practices that the entity had in place during the reporting period."

No benchmark standards are set and there are no areas of compulsory disclosure. However, an indicative list of corporate governance matters that an entity may take into account is contained in Appendix 4A of the Listing Rules. Issues covered in the Appendix include board composition, appointment and retirement of non-executive directors, remuneration policies, procedures for directors seeking independent advice, audit review, business risk strategy, and ethical standards.

3. The role of superannuation fund trustees in corporate governance

3.1. How large is institutional share ownership?

Superannuation funds are one type of institutional investor. Others include insurance companies, investment trusts and managed investment schemes. The aggregate shareholding of institutional investors in listed Australian companies has grown significantly in recent decades. Local and overseas institutions now hold around 45-50% of listed Australian equities. Australian superannuation funds account for approximately 20%.

3.2. Why is the growth in institutional share ownership significant?

3.2.1 Who owned the shares before the institutions?

Until at least the 1960s, individuals (private investors) owned a substantial proportion of listed Australian equities. This meant that the separation of ownership and management referred to earlier, and its consequences, were considerably more pronounced than today because:

- In most cases a private investor will hold only a very small percentage of a company's issued shares (a small fraction of 1%).
- A small shareholder in a large company stands to gain only a small reward for any efforts at monitoring the board and management, because the benefits from monitoring are shared among all the (many) shareholders. But monitoring is costly, and therefore most small shareholders are "rationally apathetic".

In their famous book published in 1932, Berle and Means expressed the concern that "Where ownership is sufficiently sub-divided, the management can … become a self-perpetuating body even though its share in ownership is negligible".

3.2.2. What is the significance of institutional investors overtaking private investors?

The rise in institutional share ownership has meant an increase in the concentration of shareholdings. Whereas no private investor would normally hold more than 1% of a company's shares, it is not uncommon for a large institution to hold 3-10%, and sometimes more, of a company's shares. The incentives for such a large shareholder to take an interest in the governance of the company are – at least in theory – far greater than for a tiny individual shareholder.

On the other hand, there are several disincentives to institutions playing an active role in corporate governance. These include the costs involved, conflicts of interest, lack of expertise and legal risks. The comparatively low level of proxy voting by Australian institutions[5] can probably be explained partly by these disincentives.

3.3. On which issues may shareholders vote?

In the vast majority of companies shareholders have no power to make decisions (by voting in general meeting) on matters concerning the management of the company's business. These matters are the domain of the board of directors and, where the board has delegated some of its powers, the senior executives and others to whom the board's management powers have been delegated.

However, that still leaves a considerable range of matters in respect of which the general meeting of shareholders is entitled – and, in many cases, is *required* – to make a decision. The Corporations Law, the ASX Listing Rules, companies' constitutions and general company law give public-company shareholders decision-making or veto rights in relation to issues like:

- Election and removal of directors.
- Appointment and removal of the auditor.
- Adoption and amendment of the constitution.
- Changing the company's type (e.g. from a no liability company to a company limited by shares).
- Changing the company's name.
- Certain share-capital transactions, including reductions of capital and selective buy-backs.
- Large placements of shares.
- Variation of the rights attached to a class of shares.
- Approval of certain related party transactions.
- Ratification of breaches of directors' duties.

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[5] See G Stapledon, S Easterbrook, P Bennett and I Ramsay, *Proxy Voting in Australia's Largest Companies* (Centre for Corporate Law and Securities Regulation, and Corporate Governance International, 2000).

3.4. How does voting actually take place?

3.4.1. What is the difference between voting on a show of hands and on a poll?

Most shareholder decisions in Australian listed companies are made on a show of hands of those shareholders attending the general meeting. On a show of hands, each shareholder present and voting has one vote – regardless of how many shares they hold.[6] Institutional investors rarely attend general meetings. If they wish to vote they ordinarily complete a proxy form appointing a proxy to attend the meeting and vote on their behalf. The chairperson of the meeting must have regard to the proxy votes lodged in deciding whether to accept the result on a show of hands as the decision of the meeting. It is a duty of the chairperson to determine "the will of the meeting" – and this requires the chairperson to call for a poll if it appears that a different decision could be obtained on a poll. On a poll, decisions are taken according to the number of shares voted (that is, one-share/one-vote), including those voted by proxy. But in practice, it is relatively rare for a poll to be conducted.

3.4.2. How do superannuation funds lodge their proxies?

For medium-sized and large superannuation schemes, exposure to Australian equities normally includes *direct* investment in shares as well as *indirect* investment through managed investment schemes (unit trusts) that themselves hold shares. The focus here is on direct investment.

Commonly, the task of "managing" a superannuation scheme's direct investments in shares will be delegated to an investment management firm. It is also standard practice for a custodian to be hired to hold legal title to the scheme's share investments. As the custodian is the registered owner of the shares, it is the party:

- To whom the company must send notices of meeting and proxy forms.
- From whom the company must accept completed proxy forms or votes at the meeting.

But, as the custodian holds the shares on a bare trust for its client (the trustee of the superannuation scheme),[7] the custodian must act according to its client's instructions in regard to forwarding of notices of meeting, and exercise of voting rights. In practice, these issues will be covered in the contract between the scheme trustee and the custodian, and the contract between the scheme trustee and the investment manager. An increasingly common arrangement (which is illustrated in Figure 2) involves:

- A clause like this in the contract between the scheme trustee and the investment manager:

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6 A proxy will also be able to vote on a show of hands unless the company's constitution disallows this.

7 The scheme trustee is itself in a trust relationship with the scheme beneficiaries, and so the custodian is really holding the shares indirectly on trust for the scheme beneficiaries collectively: *ASC v AS Nominees Ltd* (1995) 18 ACSR 459 at 472.

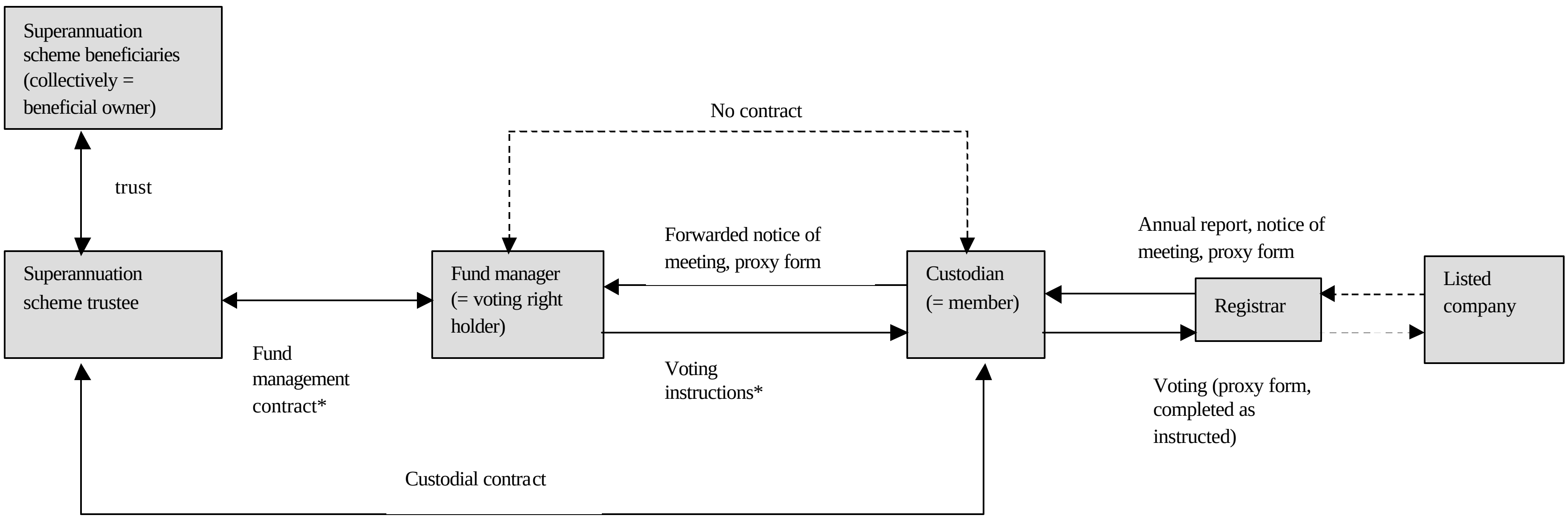
> "The Trustee authorises the Manager to exercise any right to vote attached to a share or unit forming part of the Portfolio *or to so direct the Custodian.* The Manager must use its best endeavours to implement any direction the Trustee gives on the appointment of a proxy and the way in which the proxy should vote but in the absence of any direction may exercise or not exercise the right to vote as it sees fit, having regard to any general direction contained in [the investment instructions set out by the Trustee in a schedule to the contract]." (Emphasis added.) (AIMA Standard Investment Management Agreement 1995, clause 12.1)

♦ Clauses in the contract between the scheme trustee and the custodian requiring the custodian:

  ⇒ To forward notices of meeting to the investment manager.

  ⇒ To complete proxy forms, and return them to the company's registrar, as instructed by the investment manager.

Figure 2 Typical investment arrangement for a large superannuation scheme



* Commonly the fund management contract gives the fund manager power to give voting instructions to the custodian. The fund management contract usually says that these voting instructions are subject to any instructions that the trustee(s) of the scheme may give from time to time. See G.P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford: Clarendon Press, 1996) 89.

3.5. Are superannuation trustees legally required to vote?

Under company law, voting is optional for any shareholder. But superannuation scheme trustees[8] are subject not only to company law rules, but also to:

- A range of rules arising under the Superannuation Industry (Supervision) Act 1993 ("SIS Act").
- Trust law rules – including fiduciary duties.

In the United States, in order to fulfil their fiduciary duties, the trustees of private-sector pension plans are obliged to vote their shareholdings, or ensure that they are voted. The latter requirement applies where the voting right has been delegated to an investment manager. The regulator responsible for private-sector pension schemes – the Department of Labor – has stated that voting rights must be exercised "on issues that may affect the value of the plan's investments" otherwise trustees will not be fulfilling their fiduciary duties.

It appears that the position under Australian law is different – at least where a superannuation fund has a non-controlling shareholding. Here, the scheme trustee's duties appear not to require that a vote be cast. Rather, the principal legal obligation is to *consider* whether or not to vote, and – if a decision is made to vote – to consider how the votes should be cast. This obligation arises each time a shareholder meeting is held. The obligation arises under the general law (trust law) duties owed by trustees, and also under the statutory duties contained in the SIS Act. Where the trustee has hired an external investment manager, and the investment management contract includes a clause under which voting authority is delegated to the investment manager:

- The obligation to consider whether to vote rests with the investment manager.
- The trustee has a duty to monitor and supervise the investment manager's exercise of its discretion in regard to voting. As discussed in 3.7, this monitoring role could be performed in-house by the scheme's administrator or it could be contracted out.

3.6. Should superannuation trustees take corporate governance seriously?

Many would regard the answer to this question as self-evidently "yes". However, the trustees of some large superannuation schemes have a deliberate policy of not voting. It is therefore important to set out the reasons why trustees should formulate a corporate governance policy, incorporating positive use of their voting rights:

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8 It is very common practice for an Australian superannuation scheme to have a single trustee, and for that trustee to be a company. The directors of the corporate trustee may be referred to loosely as the trustees of the scheme, but in law the company is the trustee and it owes the relevant legal duties. However, under the Superannuation Industry (Supervision) Act and also under the general law, the directors of a corporate trustee *effectively* owe substantially similar duties to those owed by the corporate trustee.

- **Legal obligation.** As mentioned in 3.5, superannuation trustees have a legal duty to consider whether to vote. This duty involves giving "real and genuine consideration" to this issue. Where the directors of a trustee board have a policy of not voting, there is a real risk that they are acting in breach of their general law and SIS Act duties.

- **Add value.** There is empirical evidence that institutional shareholder involvement in corporate governance is value-enhancing, at least in relation to certain issues. For example, US studies have found that institutional investor voting against takeover defences (e.g. poison pills) is associated with improved share price performance.

- **Avoid disproportionate influence of overseas investors.** Many overseas institutional investors that have shareholdings in Australian companies are strongly committed to exercising their voting rights, and playing an active role in corporate governance. Inactivity by Australian institutional investors will result in these overseas institutions having a disproportionate level of influence in Australian corporate governance.

- **Investment managers' interests are not identical to interests of scheme beneficiaries.** Where voting power is delegated to an external investment manager, it cannot be assumed that the investment manager will always exercise the voting right in the interests of the scheme beneficiaries. For example:

  ⇒ In some instances the costs of voting in an informed manner may outweigh the benefits *to the investment manager*. This may result in the manager either not voting or voting in a mechanical way – despite the fact that there would be benefits to the manager's clients from informed voting.

  ⇒ Many investment management firms are subsidiaries of financial conglomerates. This can lead to conflicts of interest. For example, an investment manager which holds shares in Company X might also be an investment manager for the superannuation fund of Company X, or another division of the investment manager's corporate group might provide – or hope to provide – insurance, banking or investment banking services to Company X. This may deter the investment manager from voting against a board-sponsored resolution at the AGM of Company X – even though voting against may be in the best interests of its clients.

  Therefore, a superannuation trustee has an important role to play in ensuring that delegated voting rights are being exercised in the interests of the scheme's beneficiaries. As discussed in 3.7, this monitoring role could be performed in-house by the scheme's administrator or it could be contracted out.

- **International best practice.** The UK Cadbury Report recommends that institutional shareholders should:

  ⇒ Maintain regular systematic contact with companies outside of general meetings.

⇒ Recognise their responsibilities as owners who should act in the interest of those whose money they are investing by influencing the standards of corporate governance and by bringing about changes in companies when necessary rather than by selling their shares.

⇒ Use their voting rights positively (i.e. not just always support management) and should disclose their policies on the use of their voting rights.

⇒ Take a positive interest in the composition of the board of directors of companies in which they invest.

There are similar recommendations in several other sets of overseas governance guidelines, and also in the IFSA Guidelines and the Bosch Report.

3.7. How can superannuation trustees participate?

There are several options for superannuation trustees who decide to devote attention to corporate governance. As voting is the most transparent way in which a shareholder can participate in the governance of an investee company, two key variables in these options are (i) who has day-to-day power over the voting right, and (ii) the manner in which the trustees are involved in monitoring the exercise of voting rights. Several different ways of addressing these two issues are outlined in Options A to F below.

3.7.1. Option A

The scheme's assets are managed by in-house fund managers, and voting is a matter for those internal managers. After the scheme's trustees adopt a corporate governance policy, they could monitor its implementation through:

♦ Internal reporting. For instance, the trustees could require the chief investment officer to report periodically on voting activity.

♦ Retention of an external governance adviser. The adviser could establish a system for monitoring the investment managers' compliance with the trustees' policy.

3.7.2. Option B

The scheme's assets are managed (either wholly or mostly) by several external investment management firms. However, in the investment management contract, the trustees expressly retain the voting right. In essence, voting instructions can come only from the scheme's trustees; not from the external fund managers. After the trustees adopt a corporate governance policy, they could either:

♦ Implement it wholly internally. That is, ensure that the scheme's administration includes sufficient staff to carry out the governance policy. This may prove too expensive for any scheme other than a very large one.

- ♦ Retain an external governance adviser to assist the scheme's administrators in implementing the policy.

3.7.3. Option C

The scheme's assets are managed (either wholly or mostly) by several external investment management firms. A clause in the investment management contract delegates voting power to the investment manager – but the same clause also says that the trustees are entitled to give voting instructions if they wish. In essence, the trustees have an override power.

Under this option, the trustees could require the investment manager to advise them, in advance, of any controversial resolution coming up at a shareholder meeting. When this information is provided by the investment manager, the trustees could either:

- ♦ Deal with it wholly internally. That is, ensure that the scheme's administration is able to knowledgeably process and deal with this sort of information whenever it arrives. Again, this may prove too expensive for any scheme other than a very large one.
- ♦ Rely on a retained governance adviser to assist the scheme's administrators in processing and dealing with the information.

3.7.4. Option D

This is the same as Option C except for one additional feature. Here, the trustees require the external investment managers to have – and act in accordance with – an "acceptable" corporate governance policy. As part of the investment management contract, the investment manager would be required to submit its corporate governance policy to the trustees for approval. The approval process could be dealt with either:

- ♦ Wholly internally. That is, ensure that the scheme's administration is able to knowledgeably assess each governance policy as it arrives. Again, this may prove too expensive for any scheme other than a very large one.
- ♦ With the assistance of an external governance adviser.

3.7.5. Option E

The scheme's assets are managed (either wholly or mostly) by several external investment management firms. A clause in the investment management contract delegates voting power to the investment manager – but the clause states that, in voting, the investment manager must follow the voting recommendations of a specific proxy voting adviser.

Under this option, the trustees still have a "monitoring" obligation under their general law and SIS Act duties. This would require the trustees to monitor the work of the proxy adviser. Again, the trustees could staff this monitoring responsibility internally or they could contract it out to a governance adviser.

This option has been adopted by some UK local authority (i.e. local council) pension schemes. Their investment management mandates with external fund managers require the managers to vote in accordance with the recommendations of Pensions and Investments Research Consultants (PIRC). PIRC was established in the 1980s by a group of local authority pension schemes whose trustees were concerned that their external investment managers were not always acting in their best interests when voting (or not voting). The Council of Institutional Investors is a somewhat similar proxy advisory organisation in the US.

In Australia there is currently no equivalent organisation to PIRC or the Council of Institutional Investors. Independent Shareholder Services (ISS Australia), based in Sydney, is a proxy voting adviser – but its client base is predominantly investment management firms. The key difference between it, on the one hand, and PIRC and the Council of Institutional Investors, on the other hand, is that the latter two organisations have been established primarily to serve the interests of investment managers' *clients*, rather than investment managers themselves.

3.7.6. Option F

The scheme's assets are managed (either wholly or mostly) by several external investment management firms. But the voting right is "carved out" and given to a third party retained by the trustees. The third party has marketed itself to the trustees as an activist investor, or "corporate governance specialist". The third party charges the scheme for exercising the voting right. This is a clear reflection of the value of the voting right to the trustees of the scheme.

This option has been adopted by some pension schemes in the UK. At least one high profile fund manager has marketed itself as a corporate governance activist, and has been prepared to bolster its voting clout by pitching for the voting rights attached to other large investors' shares.

3.7.7. Materiality

Some trustees who adopt Option A or B may decide that detailed voting analysis is unjustifiably expensive for some shareholdings. They may decide that a materiality test must be met before a shareholding will be voted. The materiality test might consist of several elements. For example:

- **The nature of the issue to be voted on.** For example, it may be decided that – subject to the size threshold discussed next – votes will be cast only on:
    - ⇒ All controversial resolutions.
    - ⇒ All other resolutions where the issue is likely to affect the value of the shareholding, or the rights of shareholders.

- **The size of the shareholding.** It may be decided that, above a certain size threshold, votes will be cast on all resolutions. The size threshold may be calculated in terms of the value of the shareholding as a percentage of the scheme's total assets, or as a percentage of the scheme's total equities portfolio. An additional element of the size threshold may require votes to be cast on all resolutions where the scheme's shareholding in the company concerned exceeds, say, 1% of the company's issued share capital (regardless of its value as a percentage of the scheme's assets).

4. Corporate governance issues relating to companies in which shareholding investments are held

This section gives an overview of some key corporate governance issues. These are issues which superannuation trustees should address when formulating a new corporate governance policy, or revising an existing policy.

4.1. What sort of dialogue should companies have with institutional shareholders?

4.1.1. Dialogue on operational and financial issues

Most sets of corporate governance guidelines support an on-going dialogue between company management and major shareholders, in relation to operational and financial issues. For example, the IFSA Guidelines point out that direct communication gives institutional investors a better appreciation of a company's objectives, its potential problems and the quality of its management; while at the same time making the company's management aware of the expectations and concerns of shareholders.

Many fund management firms used by Australian superannuation schemes maintain this type of regular dialogue with companies in which they have significant holdings. Typically, senior fund managers and analysts will have contact with a company's CEO or Chief Financial Officer or both. Depending on the size of the company, there may also be contact with divisional heads and investor relations executives.

A superannuation scheme that adopted Option A or B (see 3.7 above) could, as the day-to-day controller of the voting right, appropriately engage in dialogue of this kind. Occasional dialogue could also be appropriate under the other options – if the trustees felt that a particular issue warranted direct communication.

Communication between institutions and company management occurs in a variety of places, including one-on-one meetings (sometimes at the company's premises and sometimes at the fund manager's offices), plant or mine visits, brokers' presentations, "roadshows", etc.

If these meetings are held immediately after the release of the company's financial results this reduces the risk of "inside" information being given. Insider trading is illegal in all major jurisdictions and institutional investors must avoid acting on any information which is not yet "public". Also, in order to comply with Australia's continuous disclosure laws, companies must ensure that they do not release price sensitive information selectively in meetings with major investors. This has been a high profile issue with the Australian Securities and Investments Commission during 1999-2000.

4.1.2. Dialogue on governance issues

In addition to dialogue on operational and financial issues, many fund managers now also maintain a dialogue with company managements in relation to issues of corporate governance – for instance, board structure and composition, and executive remuneration.

Several UK fund management firms have appointed a "Corporate Governance Executive" to co-ordinate dialogue with investee companies on governance issues. In some cases this person has a separate line of communication with investee companies, and in other cases this person meets with companies at the same time as the equities managers and analysts (who are there principally to discuss operational and financial issues). Appointment of a specialist governance executive is not common in Australia at present.

4.2. What is the difference between the roles of board and management?

Some companies' constitutions state that the board of directors is responsible for managing the company's business. However, more modern clauses state that the business is to be managed "by or under the direction of" the board. This reflects commercial practice, under which the responsibility for managing the business is delegated by the board to the CEO – who in turn delegates to other senior executives.

Looking back at Figure 1, the board sits in a key position between the company's shareholders (owners) and the company's management (day-to-day controllers of the company's resources). Bearing this in mind, the board of a publicly listed company typically has these main functions:

1. Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the CEO.

2. Oversee the conduct of the company's business to evaluate whether it is being properly managed. As the ALI Principles point out, "oversee" means general observation and oversight; not active supervision or day-to-day scrutiny. This oversight function is *not* normally performed directly by actively supervising the CEO and other senior executives. Rather, it is normally performed indirectly by evaluating the performance of those executives and replacing any who are not meeting reasonable expectations concerning job performance.

3. Review and, where appropriate, approve the company's financial objectives and major corporate plans and actions. Examples of major corporate *plans* are long-term strategic and investment plans, annual capital and operating budgets, and targeted rates of return. Examples of major corporate *actions* are the creation or retirement of significant long-term debt, programs for issuing or buying back significant amounts of equity, significant capital

investments, major acquisitions and sales of significant businesses. These plans and actions will ordinarily have been initiated and formulated by senior management.

4. Provide advice and counsel to top management.

5. Select and recommend to shareholders for election candidates for the board of directors.

6. Review the adequacy of systems to comply with all applicable laws and regulations.

7. Any other functions required by law to be performed by the board (e.g. making an annual declaration about the company's solvency).[9]

4.3. How should a board be composed?

4.3.1. Background: What are the different types of directors?

Public company boards generally include two types of directors:

♦ **Executive directors.** An executive director is someone who has two separate roles: (i) an executive officer employed by the company; and (ii) a member of the board of directors. Virtually every listed company has at least one executive director – the CEO. Quite often the Chief Financial Officer is also on the board, carrying the additional title Finance Director. In large listed companies the heads of major divisions may also be on the board.

♦ **Non-executive directors.** A non-executive director has no separate employment relationship with the company. Their sole contribution is as a member of the board of directors. As Figure 3 illustrates, non-executive directors can be further classified as:

⇒ **Independent non-executive directors.** An independent director is a non-executive director who is free from any business or other relationship which could materially interfere with the exercise of their independent judgment.

⇒ **Affiliated non-executive directors.** An affiliated director is a non-executive director who has some kind of independence-impairing relationship with the company or the company's management. For example, the director may have links with a major supplier or customer of the company, may be a partner in a professional firm that supplies services to the company, or may be a retired CEO of the company.

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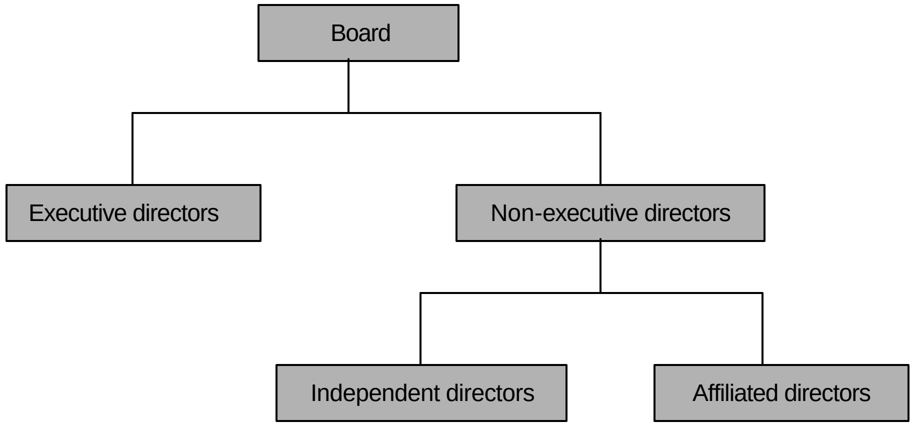
9 This list is derived from those in the ALI Principles and the US Business Roundtable Report.

Figure 3 Types of directors



IFSA and the Washington-based Council of Institutional Investors, among others, recommend that a company should disclose in its annual report which of the non-executive directors are independent, and the basis on which they are classified as independent. Where the company does not do this, the task of determining which of the non-executive directors are independent can be time-consuming – involving close analysis of related party transactions and other information in the Notes to the Financial Statements.

4.3.2. Why are non-executive directors important?

Some of the board functions outlined in 4.2 can appropriately be carried out by the board as a whole. For example, function 3 (reviewing the company's financial objectives and major corporate plans and actions). However, other functions are particularly suited to the non-executive directors. The Cadbury Report identifies two areas where non-executive directors – especially *independent* non-executive directors – can make an important contribution to the governance process as a consequence of their independence from executive responsibility. First, reviewing the performance of executive management (function 2). Second, taking the lead where potential conflicts of interest arise. For example, setting the CEO's pay (function 1) and dealing with boardroom succession (function 5).

4.3.3. How many independent non-executive directors are necessary?

Opinions vary on how many independent non-executive directors are necessary to achieve good corporate governance practice:

- The UK Combined Code recommends that non-executive directors should make up at least one-third of the board, and that a majority of these non-executives should be independent.

- The IFSA Guidelines and the Toronto Report recommend a higher standard – that a majority of directors should be independent non-executives. IFSA argues that a majority of directors should be genuinely independent in order to ensure that the board has the power to implement decisions contrary to the wishes of management or a major shareholder, if the need arises. IFSA contends that this creates a "more desirable board culture" and imposes a responsibility on the independent majority to be "especially competent and diligent" in carrying out their role.

- Several US sets of guidelines adopt an even tougher stance. For example, the CalPERS Guidelines recommend that "a substantial majority" of board members should be independent directors. And one of the Council of Institutional Investors' Policies is that at least two-thirds of a company's directors should be independent.

- The Bosch Report suggests a compromise in which the boards of listed companies should include a majority of non-executive directors, some of whom may have personal or professional associations with the company. The Report recommends that a majority of the non-executive directors should be independent, and that at least one-third of the board should be genuinely independent.

- The UK CISCO Guide for smaller listed companies suggests smaller companies should have at least two non-executive directors to ensure non-executive directors are not isolated or dominated.

4.4. Should the roles of CEO and chairperson be separated?

The role of the CEO is to lead the senior management team in running the company's business. In contrast, the role of the chairperson is to lead the board – one important function of which is to evaluate the performance of the senior executives (function 2).

It is therefore a widely accepted principle of good corporate governance in Australian and the United Kingdom that the CEO should not also be the chairperson. Combining the roles creates a considerable concentration of power and can remove a vital check on senior management's activities. Separating the roles with a clear division of responsibilities allows a balance of power and authority so that no one individual has unlimited powers. IFSA strongly recommends that the chairperson should be an independent director in order to "provide the appropriate counterbalance and check to the power of the CEO".

However, in the US it is quite common for a company's CEO also to be its chairperson. Justifications put forward include that the separation of board and management is achieved by having effective independent directors on the board, and the delegation of important decision functions to committees (such as remuneration and audit committees). Separating the roles introduces new costs, such as the "agency cost" of introducing an outside chairperson who may not behave in the best interests of the company and the "information cost" where the chairperson does not have the same knowledge or information about the company or industry as the CEO. There is also a concern about the potential for rivalry between the separate title holders, making it more difficult to pin the blame for bad corporate performance.

Despite this US practice, some US governance guidelines – including the AFL-CIO Guidelines – support a separation of roles.

In the event that the roles of chairperson and CEO are held by the one individual, it may be possible to achieve an acceptable balance of power. The UK Combined Code recommends that companies which combine the roles should have a strong and independent non-executive element on the board, with a recognised senior member to whom any non-executive directors' concerns about the CEO/chairman or other matters can be conveyed. The IFSA Guidelines and the CalPERS Guidelines contain a similar recommendation. However, the Bosch Report suggests that this approach makes board operations more complex and that separation of roles is "strongly preferred".

4.5. Should the board have committees?

The Bosch Report contends that the effectiveness of the board is likely to be enhanced by the establishment of appropriate board committees. Committees can distribute the board's workload and enable more detailed consideration to be given to important issues. And they are particularly useful when boards are large.

Many sets of guidelines recommend that committees should have written terms of reference, outlining the committee's authority and duties. As the Bosch Report states, committees should also have clear procedures for reporting back to the board, and agreed arrangements for staffing including access to relevant company executives and the ability to obtain external advice at the company's expense.

The three key committees from a corporate governance perspective are the nomination, remuneration and audit committees. These are considered in the following sections on appointments to the board, director and executive remuneration, and disclosure and audit.

4.6. How should directors be appointed?

4.6.1. Background

As a matter of corporate law, it is the shareholders who elect directors. In practice, however, it is in most instances the board (or a board committee) that selects and appoints the candidate for director, who is then formally "elected" by the shareholders at the next annual general meeting (AGM). When a new director is selected and appointed by the board (or a board committee), this is called "filling a casual vacancy". When the shareholders formally "elect" this person at the next AGM, the shareholders are in essence endorsing the board's choice of director. It is very rare for the shareholders to fail to elect the board's appointed candidates.

Under the ASX Listing Rules, directors other than the Managing Director (CEO) must "retire" by rotation every three years, and submit themselves for re-election by the shareholders if they wish to continue in office.

4.6.2. Should the terms of appointment be formal?

It is becoming widely accepted that non-executive directors should be appointed for specified terms, reappointment should not be automatic, and the term of the appointment should be disclosed in the annual report. The UK Cadbury Report recommends that directors should receive a letter of appointment which sets out a director's duties, terms of office, remuneration and review. The Cadbury Report also emphasises the importance of training for all directors and a proper introduction into the company's affairs.

4.6.3. Should there be a maximum term?

Some corporate governance guidelines, such as the CISCO Guide and the Hong Kong Code, recommend maximum terms for non-executive directors of about 5 years (longer for smaller companies). However others, such as the Toronto Report, reject the need for guidance on maximum terms. The AFL-CIO is opposed to term limits, on the basis that "they may result in prohibiting the service of directors who significantly contribute to the company's success and represent shareholders' interests effectively". The AFL-CIO prefers holding individual candidates to high standards when they seek election or re-election.

4.6.4. Should boards establish a nomination committee?

It is very common for a listed company's constitution to give the board as a whole the power to appoint a new director to fill a casual vacancy. However, it is now widely regarded as good practice to establish a nomination committee of the board – charged with making recommendations to the board on new executive and non-executive directors.

Nomination committees should have written terms of reference setting out their responsibilities, which typically include:

- Selecting and nominating candidates for board membership when necessary.
- assessing the performance of the CEO annually.
- Assessing the performance of the board as a whole.
- Assessing the contribution of individual directors.[10]

Recommendations differ as to the appropriate composition for a nomination committee. The Bosch Report and the IFSA Guidelines both recommend that at least a majority of the nomination committee's members – including the committee's chairperson – should be

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10 This list is taken from the Bosch Report.

independent non-executive directors. The UK Combined Code takes a softer line – suggesting that the committee should include a majority of non-executive directors (not necessarily independent). On the other hand, the Toronto Guidelines and the ALI Principles take a tougher line, recommending that the nomination committee should be composed exclusively of non-executive directors, and that a majority of them should be independent. The CalPERS Guidelines and the Council of Institutional Investors' Policies are tougher still, recommending that all members of the nomination committee be independent directors.

4.6.5. What if a director resigns?

The CISCO Guide recommends that any director who resigns from a listed company should be entitled to communicate (at the company's expense) with its shareholders, giving reasons for the director's resignation and any matters which should be brought to the shareholders' attention. This procedure could also apply where there is a fundamental disagreement at the board level falling short of resignation.

4.7. How should directors and executives be remunerated?

Directors' and executives' remuneration is one of the most visible and politically sensitive issues of corporate governance. However, while controversy often surrounds the size, or quantum, of remuneration, this is not necessarily an issue of corporate governance – a payment that may be excessive in one context may be reasonable in another. The key corporate governance issues are (i) transparency; (ii) pay for performance (whether the payment is justified); (iii) process for determination; (iv) severance payments; and (v) pensions for non-executive directors.

4.7.1. What does transparency entail?

According to the Cadbury Report, "the overriding principle in respect of board remuneration is that of openness. Shareholders are entitled to a full and clear statement of directors' present and future benefits, and of how they have been determined." A statement of benefits should cover all aspects of remuneration, including share options, bonuses, perks and pension contributions.

The IFSA Guidelines recommend that the board should disclose in the annual report:

- Its policies for remuneration of directors and executives.
- A justification for these policies and their relationship to the performance of the company.
- The size and breakdown of the remuneration of each director and each of the five highest paid executives.

The Bosch Report recommends that the disclosure should also include the existence and length of any service contract for the CEO.

In relation to remuneration in the form of share or option schemes (discussed in 4.7.2), the IFSA Guidelines urge that shareholders receive adequate disclosure to ensure they are receiving "due reward for the dilution that equity participation entails". IFSA contends that shareholders have a right to know "the costs of such schemes and the success of these elements of remuneration measured against the original reasons for their use".

Transparency is aided by the disclosure requirements in sections 300 and 300A of the Corporations Law. In particular section 300(1)(d) requires disclosure in the director's report (part of the annual report) of options granted to the company's five most highly remunerated officers. Section 300A requires that the directors' report for listed companies must include:

- Discussion of broad policy for determining the nature and amount of remuneration for board members and senior executives.
- Discussion of the relationship between this policy and the company's performance.
- Details of the nature and amount of each element of the remuneration of each director and each of the five most highly remunerated officers.

4.7.2. Why is pay-for-performance important?

There is considerable stigma associated with excessive remuneration. Therefore, remuneration schemes for executive directors and other senior executives below board level must be transparent and carefully structured to ensure that remuneration realistically reflects performance and the responsibilities and risks involved in being an effective executive officer.

What is the rationale for performance-related pay? Share and share option schemes can be an effective way to match remuneration with performance. Many sets of governance guidelines support the use of shares and options in remuneration packages. An appropriately designed share option scheme will help counter the economic problem of "agency costs", in which the interests of senior executives may diverge from the best interests of shareholders. When senior executives own shares they are encouraged to act in the bests interests of shareholders because the financial interests and risks of the executives are equated with the interests and risks of the shareholders. Furthermore, if executives' remuneration is directly linked to an increase in the share price (as with options), the benefit that the executives receive is proportional to the benefit received by all shareholders. This encourages executives to make decisions which will maximise shareholder wealth.

Share and option based remuneration can also counter the problem of directors and executives being too risk adverse. That is, in the absence of a share or share option pay-for-performance scheme, directors and senior executives take all the blame when the company under-performs, yet do not share in the upside when the company performs well. As a result they have no incentive to take appropriate risks (ones that would maximise shareholder wealth). But by structuring remuneration around company performance, these problems can be minimised.

Should non-executive directors participate in share and option schemes? It is common practice in the US for both executive directors and non-executive directors to receive share based remuneration. However the IFSA Guidelines endorse share or option schemes only for executive directors and other executives. According to IFSA, non-executive directors should be encouraged to invest their own capital in the company, but not receive shares as part of their remuneration. This is to avoid a conflict of interest which may arise from the fact that it is the non-executive directors who should be entrusted to design the remuneration schemes for the executives (see 4.7.3).

The traditional corporate governance view in Australia and the United Kingdom is that equity based remuneration for non-executive directors could cause management and independent directors to act in concert. Share and option based remuneration may be distinguished from each other, with some groups, including the Australian Shareholders Association, particularly opposed to option based remuneration. The rationale is that option based remuneration results in too close an alignment of non-executives and management (for example in the setting of hurdles), whereas share based remuneration need not do so.

However, there is growing acceptance internationally (particularly in the United States) that equity based remuneration (including options) can help to align board and shareholder interests. In Australia, Stan Wallis recently advocated a change towards equity based remuneration for non-executive directors. Acknowledging the concern that this could cause non-executive directors to act in concert with management, particularly in relation to the setting and achievement of performance hurdles, Wallis expressed the view that it is possible to "establish externally based and assessed hurdles which will align the interests of employees, management, directors and shareholders". Recent US studies have found evidence to support the case for share remuneration for independent directors. One study found, for example, that when directors of majority-independent boards receive incentive compensation, the likelihood of CEO turnover following poor performance increases.

Performance hurdles. As IFSA's Executive Share Scheme Guidelines emphasise, equity based remuneration should be properly structured so that the benefits reflect superior performance.

While it is common to link performance hurdles (particularly on options) to rises in the company's share price, this will reward management in a generally rising market, regardless of the actual company performance. Hurdles designed to reward superior performance may involve comparisons with similar companies in an industry or return on equity measures.

Where option schemes linked to the share price are used, the exercise price (the price at which the executive can buy the shares) should not represent a discount to the share price at the time the options are granted. For example if the share price is $2, an option giving the executive the right to buy shares (in three years' time) at $3, will provide strong incentives to perform, whereas an option at $1.90 will not. While an exercise price equal to the current market price for the company's shares is clearly preferable to an exercise price that is a discount to the current share price, using the current market price as the exercise price (a not uncommon practice) should often be a cause for concern. The reason is that this does not even take into account the effect of inflation.

As discussed above, transparency is a critical consideration and performance hurdles and option exercise prices must be fully disclosed to shareholders.

Repricing of options. The significance of appropriate performance hurdles is reinforced by the growing practice of repricing of options. This typically involves the lowering of an option's exercise price (perhaps in the context of a market-wide fall in share prices). Without the repricing executives may find a considerable proportion of their remuneration wiped-out. Executives would also lose any motivation associated with the performance hurdle.

However, repricing of options makes a nonsense of the claim that performance related pay gives managers incentives and risks similar to those of owners. When share prices are rising (even in the context of a rising market), executives are happy to take the credit (and reap the reward). However when the share price falls some executives expect a repricing.

The demand for repricing can be avoided through properly structured performance hurdles. If, as advocated above, hurdles are linked to comparisons with similar companies in the industry, or return on equity measures, there would be no basis to arguments for a repricing as poor performance could not be blamed on market conditions.

Taking your options with you. Recently in Australia, there have been some instances where a retiring executive has been permitted to retain options that would have otherwise have become worthless on retirement. This practice amounts to giving the executive an extra reward for *past* performance. The problem is that share option schemes are supposed to serve as an incentive device so that executives strive hard to achieve excellent performance in the *future*. It is therefore difficult to justify the practice of "taking your options with you".

4.7.3. What process should be adopted for determining pay?

Non-executive directors' remuneration. Under a typical constitution of an ASX listed company, shareholders must approve the aggregate amount of pay to non-executive directors. The constitution then typically makes it the responsibility of the board to determine the appropriate allocation of the aggregate remuneration between the different directors. In practice larger amounts normally go to those with extra responsibilities such as committee members and the chairperson.

Executive remuneration. Executive directors, as employees, receive a separate salary package which does not require shareholder approval.[11] The determination of executive remuneration is the responsibility of the board. However, to avoid conflict of interest, most sets of governance guidelines recommend that the determination is driven by the recommendations of a remuneration committee. The critical consideration is that executives' remuneration should not be determined by the executives themselves.

Remuneration committee. To avoid a potential or actual conflict of interest, it is almost universally regarded as good corporate governance practice to set up an appropriately composed remuneration committee to decide executive remuneration on the board's behalf. According to the UK Combined Code, the remuneration committee is responsible for designing remuneration packages to attract, retain and motivate executives of the quality required. The committee should judge where to position their company relative to other companies, and should take account of comparable remuneration and relative performance.

As to composition, several sets of overseas guidelines (including the UK Combined Code, the Council of Institutional Investors' Policies, and the CalPERS Guidelines) recommend that the remuneration committee should be made up exclusively of independent non-executive directors. The Australian guidelines take a softer stance – with the IFSA Guidelines and the Bosch Report both recommending a majority of independent directors. By implication, the Australian guidelines leave open the possibility of executive directors sitting on the remuneration committee – which is clearly undesirable.

Remuneration committees should have written terms of reference setting out their responsibilities, which often include:

- Remuneration arrangements and service contracts of the CEO and other senior executives.
- Remuneration arrangements for non-executive directors.
- Remuneration policies and practices for the company generally.
- Any company share schemes and other incentive schemes.
- Company superannuation arrangements.[12]

The remuneration committee may either make final decisions itself (if the board has delegated it sufficient power), or it may be a body which presents recommendations to the whole board. Many guidelines either expressly or implicitly prefer the committee to make recommendations, with the actual decisions being made by the whole board.

Recent UK reform proposals. The UK Department of Trade and Industry released a report in 1999 on directors' remuneration. The report suggested a range of reforms to the process for determination of remuneration, with a view to improving directors' accountability to shareholders. The report listed five possible options for reform, of which the government preferred two:

- Requiring listed companies to ask shareholders to vote on the board's remuneration report every year.

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11 But note that share option schemes require shareholder approval under the ASX Listing Rules.

12 This list is based on that in the Bosch Report.

- Creating special procedures under which shareholders could move a resolution on remuneration at the AGM.

There has not as yet been an equivalent push in Australia for greater shareholder involvement in the determination of executive remuneration.

4.7.4. Why are severance payments a concern?

Generous severance payments for senior executives raise issues of corporate governance. While large payments to executives are often mentioned in the media, large severance payments receive particular scrutiny. This is because of a particular concern that executives removed for poor performance should not be rewarded for failure.

Large severance payments often arise as a result of a company paying a departing executive the time remaining on their contract. It may in some cases be reasonable to pay out the remaining amount under the contract. But if the contract is a "rolling contract" this can be problematic. A three year rolling contract would *always* have three years left to run, and hence a departing executive is guaranteed three years pay if the contract is terminated by the company. These contracts have received considerable scrutiny in the UK, where the Combined Code recommends a maximum of one year for rolling service contracts. In Australia the issue of rolling contracts has not received much attention, though severance pay issues have been raised in high profile cases.

Rolling service contracts pose another potential corporate governance problem (apart from large severance payments) – automatic renewal of the contract means that performance may not be regularly reviewed by the nomination or remuneration committee.

Pressure from institutional investors in the UK has been successful in changing corporate conduct in relation to severance payments and rolling service contracts. Several institutions made it clear that they would not vote in favour of the re-election of directors whose contracts contained such clauses. Australia has yet to see comparable institutional activism on this issue.

4.7.5. Should non-executive directors receive pensions?

It is relatively standard practice in Australia for non-executive directors to receive a pension (or ongoing payment on retirement) as part their remuneration package. This situation gives rise to a potential problem for effective corporate governance.

Resignation is sometimes the non-executive director's most powerful tool in protesting against the board's (or the management's) activities. The act of resignation tends to attract media scrutiny and can also give the director the opportunity to communicate to shareholders his or her reasons for resigning. Anything that restricts a director's ability (or likeliness) to resign in such a situation is a threat to good corporate governance.

So, how can pensions for non-executive directors interfere with a director's likelihood of resigning in protest? The AFL-CIO Guidelines give the following example: "a director who is scheduled to receive a large pension contingent on a certain number of years of service is less likely to confront management if the director believes this may reduce the likelihood that the pension rights will vest." Recognition of this problem in the US led to shareholder activism (by institutions and shareholder activist groups), and subsequently a phasing out of pensions for non-executive directors.

However, Australian and UK corporate governance guidelines have not focussed on this issue and as a result pensions for non-executive directors are common.

There is a very strong policy case to be made against the granting of pensions to non-executive directors. Trustees may wish to reflect on this issue and consider following the US approach of actively discouraging these pensions.

4.8. Should directors be required to own shares?

Increasingly, Australian company constitutions require directors to hold at least a certain minimum number of shares. In some cases the required number of shares may be small, but some companies now require that directors hold a substantial number of shares.

Share ownership by directors is regarded fairly widely in the US as good corporate governance practice. The perceived benefit is that it brings the interests of directors into closer alignment with the best interests of the shareholders. However, even in the US there is no consensus in favour of requiring non-executive directors to own shares. Some US critics argue that a non-executive director must be truly independent, bringing their own experience to the boardroom, free from direct connection with the company. These critics argue that share ownership, while it would bring the non-executive director's interests into line with those of the company's shareholders, would also mean that the non-executive director was not independent.

One example of where significant share ownership by a non-executive director may be problematic is where the director becomes aware of a breach of law by the company (such as the recent case in Japan of Mitsubishi failing to disclose product defects). The non-executive director may be under an obligation to disclose this information, however it may have a serious effect on the share price and hence the director's wealth. This may cause the non-executive director to behave in a way which is certainly not independent of the company's management.

In some instances share ownership by directors can be achieved through appropriate remuneration schemes. However, as noted in 4.7.2, there are concerns about equity based remuneration for non-executive directors. So, even if substantial share ownership by non-executive directors is regarded as a good corporate governance practice, there may be significant practical issues as to how the shares can be acquired.

4.9. *Should share trading by directors and executives be restricted?*

Share trading by directors and executives is an increasingly public issue. The practice is regulated by the insider trading rules in the Corporations Law. In addition, some Australian companies have their own codes of conduct covering director share trading.

Where an Australian company has adopted a code, it is often summarised in the corporate governance section of their annual report. Some of these companies state that directors and executives must not buy or sell shares when in possession of price-sensitive confidential information. This type of guideline only repeats what is contained in the prohibition on insider trading in the Corporations Law. Other companies provide more specific guidelines and state that their directors are permitted to buy and sell shares only during specified periods of time. For example, a number of banks now have guidelines which state that directors and executives may only trade in the company's shares during a limited number of weeks following the release of quarterly, half-yearly and annual profit announcements. This reflects the position in the UK, where the Financial Services Authority Listing Rules contain a "Model Code" that restricts directors' share trading to certain post-results "windows". It also reflects the Bosch Report's recommendation that all listed Australian companies should have "a policy that regulates any allowable dealing on the part of individual directors and officers in the company's securities, including an agreed time frame in which buying and selling of the company's securities is permitted".

Some Australian companies require share trading by directors to be approved by the chairperson of the board and executives' share trading to be approved by the company secretary.

4.10. *What are the key governance issues in relation to financial reporting and audit?*

4.10.1. Background

As emphasised in the Cadbury Report and the Bosch Report, the board of directors has a duty to present to shareholders a balanced and understandable assessment of the company's financial position. One aspect of this duty is the provision of audited financial statements. Audits are a reassurance to everyone who has a financial interest in the company. The Cadbury Report describes the annual audit as "one of the cornerstones of corporate governance".

4.10.2. Should boards establish an audit committee?

The board has a duty to ensure that audits are objective and effective, and to that end it is universally regarded as good practice to establish an audit committee of the board.

The Bosch Report states that, in the absence of an audit committee, a board would need to go to considerable lengths to reassure shareholders and potential investors of the quality of the audit and the adequacy of the company's financial reports.

The ALI Principles explain that an audit committee provides a forum for regular, informal and private discussion between the external auditor and directors who have no significant relationships with management (assuming the committee is appropriately composed – see 4.9.3). In the absence of such a forum, an external auditor would probably be reluctant to call for a meeting at the board level unless a problem of great magnitude had arisen. In contrast, the provision of an institutionalised forum:

- Facilitates – and indeed encourages – the auditor to raise potentially troublesome issues at a relatively early stage.
- Allows the auditor to broach sensitive issues in an uninhibited fashion.
- Gives the auditor reassurance that it can readily obtain a hearing in the event of a disagreement with management.

In some jurisdictions, an audit committee is a regulatory requirement. This is not the case in Australia. Here, the ASX Listing Rules require each listed company to disclose in its annual report whether it had an audit committee, and if not, why not. This places considerable pressure on Australian listed companies to follow this approach to good corporate governance.

4.10.3. How should an audit committee be composed?

In terms of composition, the IFSA Guidelines and the Toronto Report recommend that the audit committee be composed entirely of non-executive directors (with a majority being independent). IFSA recommends that the committee's chairperson should be an independent director. The Bosch Report recommends that the committee chairperson should preferably not be the board chairperson.

Again, US guidelines are generally stricter in terms of committee composition. The CalPERS Guidelines and the Council of Institutional Investors' Policies both recommend that the audit committee be composed exclusively of independent non-executive directors.

4.10.4. What is the audit committee's role?

The audit committee should have written terms of reference setting out its responsibilities, which typically include:

- Nomination of the external auditor (the committee makes a recommendation to the board, which in turn makes a recommendation to the shareholders – because section 327(3) of the Corporations Law requires the shareholders to formally appoint the auditor).
- External audit engagements, including any audit tenders, with particular emphasis on the scope and quality of the audit.
- Coordination of audit approach between internal and external auditors.

- Effectiveness of arrangements to contain areas of significant financial risk.
- Changes made or contemplated to accounting policies.
- Significant transactions which are not a normal part of the company's business.
- Financial statements with both management and external auditors.
- Contracts, arrangements and undertakings involving related parties.[13]

The Cadbury Report and the IFSA Guidelines recommend that the audit committee should involve executive directors and other executives in its work where appropriate. For instance, the audit committee should have ready access to the Finance Director. However, time should be set aside for the audit committee members (all of whom should be non-executive directors – see 4.9.3) to meet the auditors separately to ensure independence and discussion of any unresolved or contentious issues.

4.10.5. How can auditor independence be impaired?

Auditors are appointed by a company's shareholders as their representative, and hence other dealings by the same accounting firm with the audited company can lead to a potential conflict of interest.

Audit independence has recently become a major issue, particularly in the United States. There are two particular areas in which auditor objectivity has been threatened (or at least questioned):

- Ownership of shares by audit partners in the client company.
- Provision of other services by audit firms.

Ownership of shares in client company. Audit standards internationally prohibit auditors having a significant interest in a firm they are auditing. However the exact standards may be loose, and do not necessarily prevent any shareholding. The Australian accounting industry codes of conduct states that an accounting practice may not audit a client company if any person in the practice, or a near relative, is the owner of shares forming a *material part* of the company's equity, or a *material part* of the assets of that person. However the reliance on a materiality test means that shareholdings in client companies are not ruled out. The industry's statement of best practice states that the auditor should dispose of any shares in a client after acceptance of an audit engagement. However this is simply a statement of best practice and not mandatory.

The laxity of these standards has become controversial after the recent finding by the US Securities and Exchange Commission (SEC) that partners of a leading audit firm had committed multiple violations of the independence rules, by owning shares in many audit

13 This list is based on that in the Bosch Report.

clients. The SEC subsequently devoted considerable attention to this issue, and in November 2000 issued revised rules dealing with auditor independence.

Provision of non-audit services. A related issue of auditor independence is the growing practice of large accounting firms receiving a large proportion of their income from consulting and other non-audit work. This creates the potential for a significant conflict of interest – in that an audit firm may be reluctant to challenge the company in order to protect its multi-million dollar consulting business. Australian audit firms have recently had to reject accusations that they have kept audit fees low in order to win consulting work.

This issue has also been addressed in the American SEC's rule revision mentioned above. France and Italy have gone so far as to prohibit an auditor from providing consultancy services for an audit client. In Australia consulting work going to auditors must be fully disclosed in the annual report. Several large accounting firms are now selling or floating their management consulting arms to demonstrate independence.

Audit committees should have regard to the value of non-audit business being given to the audit firm, and what effect this may have on the quality of the audit.

4.11. Should individual directors have access to independent resources?

The power of independent directors is severely curtailed if they are unable to investigate properly perceived irregularities. It is therefore widely regarded as good corporate governance practice for individual directors, in appropriate circumstances, to be able to obtain independent advice and information at the company's expense in order to fulfil their duties. Guidelines which recommend this include the UK Combined Code, the Toronto Guidelines, the Hong Kong Code and the IFSA Guidelines. The Bosch Report points out that "In the first instance, advice is likely to be requested from company officers or advisers but in some circumstances, advice from independent external sources may be appropriate. It is important that an agreed procedure be established which makes it clear under what circumstances, with what information and by what method board committees or individual directors can obtain such advice at the company's expense."

The practice of many Australian companies in this area is revealed in their annual reports. Some companies require a director to obtain the approval of the chairperson in order to seek independent advice at the company's expense. Others require the approval of the whole board. A requirement to obtain the approval of the rest of the board is inappropriate – particularly where the irregularities concern the board itself.

4.12. Should boards formalise performance standards?

Many sets of corporate governance guidelines recommend that the performance of (i) the board as a collective body, and (ii) individual directors, should be subjected to a formal process of review.

In relation to the board as a whole, the Council of Institutional Investors' Policies recommend that board evaluation should include an assessment of whether the board has the necessary diversity of skills, backgrounds, experiences, ages, races and genders appropriate to the company's ongoing needs.

In relation to individual directors, the CalPERS Guidelines recommend that performance criteria should address, at a minimum: attendance, preparedness, participation and candour. The IFSA Guidelines suggest that, when a director seeks re-election, "there should be a formal procedure approved by the board for evaluating the contribution of [the director] and for reporting to shareholders in the notice of meeting on the evaluation". The UK Combined Code recommends that every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary.

4.13. Protecting shareholder rights and reasonable expectations

There is a wide range of corporate practices and policies that have the potential adversely to affect shareholder rights and reasonable expectations. This section summarises a selection of these.

4.13.1. Should companies abide by the one-share-one-vote principle?

Many sets of corporate governance principles advocate the one-share-one-vote principle. In Australia, the ASX Listing Rules entrench the principle for ordinary shares. However, the ASX has power to waive any of its Listing Rules if it considers the circumstances appropriate. News Corporation sought a waiver of the one-share-one-vote rules in 1993 in order to issue "super-voting shares" – a separate class of ordinary shares with multiple voting rights per share. After a lengthy public debate and an inquiry into the issue, News Corp withdrew its application and the relevant Listing Rules were left unchanged.

If a company were to ask the ASX to waive the one-share-one-vote rules in the future, the company's shareholders would need to consider their position. Shareholder approval would probably be required even if the ASX agreed to a waiver. Arguments against non-voting shares and super-voting shares include:

- They may lead to entrenchment of senior management as a result of reducing the chance of a hostile takeover.

- They may increase the possibility of minority shareholders being disadvantaged.

On the other hand, arguments in favour of allowing non-voting shares and super-voting shares include:

- Provided they are restricted to newly issued shares, investors will have the choice whether or not to buy the shares. Any investor who disliked the securities could invest in the company's "normal" ordinary shares or in a different company.

- The capital raising options for a company with more than one class of ordinary shares are wider than for those with just the one class.

4.13.2. Should companies retain voting on a show of hands?

The manner in which voting takes place at a shareholder meeting is largely determined by the company's constitution. Almost invariably, the constitutions of listed Australian companies allow for voting on a show of hands and voting on a poll. On a show of hands, each shareholder attending the meeting has one vote – regardless of the number of shares they hold. In contrast, on a poll each shareholder has one vote for each share they own.

Commonly, the constitution will state that a vote must be taken on a show of hands unless a poll is demanded. In practice, most resolutions are decided on a show of hands. A recent study showed that only 7% of the Top 100 companies had a poll for director-election resolutions in 1999.[14]

The IFSA Guidelines recommend that each shareholder resolution should be decided on a poll. That is, that voting on a show of hands should be discarded. This could be achieved in two ways: (i) the company's chairperson could adopt a policy of always demanding a poll before a vote was taken on a show of hands;[15] or (ii) the company's constitution could be changed to require all resolutions to go automatically to a poll. Option (ii) would require special resolution approval of the company's shareholders.

The key reasons for IFSA's recommendation are that:

- As mentioned above, most resolutions are passed on a show of hands. But, for practical and legal reasons, most institutional investors are unable to vote on a show of hands. And in many companies institutional investors hold a majority of the shares. Therefore, resolutions are often passed by shareholders who collectively represent only a very small proportion of the total voting capital.

- For those institutional investors which go to the time and expense of lodging proxy forms, where a resolution is decided on a show of hands the institution's votes are – in a sense – never cast. This is because proxy votes are normally only taken into account on a poll. This is the case even for those companies that allow proxies to vote on a show of hands – because in practice the custodian holding the shares for the institution will also hold shares for many other clients who may have given different voting instructions. On the other hand, proxy instructions from institutions are never irrelevant because the chairperson of the shareholder meeting must take into account all proxy instructions validly lodged when deciding whether to exercise his or her power to demand a poll.

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14 G Stapledon, S Easterbrook, P Bennett and I Ramsay, *Proxy Voting in Australia's Largest Companies* (Centre for Corporate Law and Securities Regulation, and Corporate Governance International, 2000).

15 This assumes that the company's constitution does not require a vote to be taken on a show of hands before a poll can be demanded.

The Australian Shareholders' Association (ASA) – representing small shareholders – is vehemently opposed to IFSA's proposal. ASA believes that doing away with voting on a show of hands is a way of stifling debate at the shareholder meeting.

4.13.3. Why should shareholder resolutions not be "bundled"?

A "bundled resolution" is a motion, on which shareholders are asked to vote, which contains more than one discrete issue. The IFSA Guidelines refer to the "sugar coated pill" – where a company asks shareholders to approve a contentious matter by combining it in one resolution with an unconnected issue that is beneficial to shareholders. For example, combining the approval of a dividend with a proposed alteration of shareholder rights.

The IFSA Guidelines are strongly opposed to this practice. The Council of Institutional Investors' Policies also disapprove of bundled resolutions, particularly where one component involves amendment of the company's constitution or implementation of an anti-takeover device.

Bundling of resolutions is indefensible. Shareholders have a reasonable expectation that a controversial matter for which their approval is required can be voted on free of secondary considerations – like whether voting against the controversial matter also entails voting against a beneficial proposal.

4.13.4 Should shareholder approval be required for major transactions?

Under the ASX Listing Rules, a company is required to obtain shareholder approval where:

- The company proposes to sell its main undertaking. (A company's undertaking is the business or enterprise undertaken by the company.)
- The company proposes to make a "significant change" to the nature or scale of its activities, and the ASX informs the company that shareholder consent is required.

The second possibility involves an exercise of discretion by the ASX. This is in contrast to the UK, where the Financial Services Authority Listing Rules require shareholder approval for any "Class 1 transaction". A Class 1 transaction is one whose value represents 25% or more of the company's total value.

In the US, the Council of Institutional Investors' Policies recommend that shareholder approval should be required for "major corporate decisions concerning the sale or pledge of corporate assets which would have a material effect on shareholder value". The guideline states that a transaction involving assets worth 10% or more of the company's value is deemed to "have a material effect on shareholder value".

The IFSA Guidelines recommend that "major corporate changes, which in substance or effect may impact shareholder equity or erode share ownership rights, should be submitted to a vote of shareholders". The notes to this guideline make it clear that it is designed to catch not only a transaction where shareholder consent is required under the ASX Listing Rules (or other regulation), but also any other transaction that would have the indicated impact on shareholder equity or ownership rights.

Two issues for superannuation fund trustees to consider, in their capacity as major investors, are:

- Whether the existing form of regulation in Australia – involving ASX discretion as to whether "significant changes" to company activities need shareholder consent – is appropriate or whether it should be replaced by a more "certain" test (involving a percentage of company value).
- Whether they should lobby a company's board and management to put a major proposal to a shareholder vote where the ASX has not insisted on shareholder approval.

5. Can trustees engage in "socially responsible investing"?

Superannuation trustees should exercise caution in pursuing a socially responsible investment agenda. There is a significant legal hurdle which restricts (but does not prevent) such investment. Recent cases in the UK and USA have reaffirmed that the role of a trustee of a pension fund is to act in the best *financial* interests of the beneficiaries. This can be – but is certainly not always – inconsistent with acting in the best social or environmental manner. In cases such as *Cowan v Scargill* (commonly known as the "Mineworkers' Pension Scheme case") the union representative trustees on the pension fund board were found to be in breach of their fiduciary duties by attempting to enforce a policy of socially responsible investment.

The problem in the Mineworkers' case was that the trustees had no authorisation to act in the manner which they did, and it was not clear that their actions were of financial benefit to the beneficiaries. However there is nothing in that case (or other law) to prevent an investment fund being set up on the express basis of socially responsible investment. Indeed such funds are becoming more popular. The key proviso is that beneficiaries must be given the *choice* of investing in such a fund, and hence accepting the possibilities of lower economic returns.

Trustees should therefore not attempt to influence investment decisions based on their social or environmental views, where this could result in lower financial returns. Investment decisions must be made in accordance with the trust deed, trust law and the SIS Act. As indicated above, this will typically necessitate purely economic decisions. However there is certainly a growing demand for specially constituted investment funds to meet the growing concerns for socially responsible investment. If in any doubt trustees should seek legal advice as to the restrictions imposed by their trust deeds and legal duties.