INDIVIDUAL

Role of the non-executive director

A non-executive director is one who is not employed by the organisation. This is not the same as an *independent director*, who is not only not employed by the organisation (non-executive director), but also has no relationship with the organisation other than as a member of the board.

The UK's Higgs Review describes non-executive directors as "custodians of the governance process".[1] In Australia, it is considered good practice from a governance perspective for a majority of directors on a board to be non-executive and independent, especially in listed companies. For listed entities, the ASX Listing Rules and the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*[2] contain relevant requirements in relation to the composition of the board and certain board committees. Proxy advisers are increasingly rating companies on the independence of the board as a sign of their adherence to principles of good governance.

All directors, whether executive or non-executive, must comply with basic legal requirements under the *Corporations Act 2001* (Cth) (the Act). It must be emphasised that there is no room for a *sleeping* director on a board – a person who is there just to make up the numbers and takes no active role in the board's work. The courts have emphasised that they will be liable for breaches of directors' duties.

Non-executive directors are not expected to have the same level of detailed operational knowledge about their organisation as executive directors. However, the core duties for both executive and non-executive directors are the same. As stated by Justice Middleton in the *Centro* case:[3]

> *Directors are required to take reasonable steps to place themselves in a position to guide and monitor the management of the company. A director must become familiar with the fundamentals of the business in which the corporation is engaged; a director is under a continuing obligation to keep informed about the activities of the corporation; directorial management requires a general monitoring of corporate affairs and policies, and a director should maintain familiarity with the financial position of the corporation… It is clear that an objective standard of care is applicable to both executive and non-executive directors.*

1. D Higgs, 2003, *Review of the Role and Effectiveness of Non-Executive Directors*, Department of Trade and Industry, paragraph 1.6, p 11.
2. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th edition, February, https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf, (accessed 5 September 2019).
3. *ASIC v Healey* (2011) FCA 717 at 166; 172.

What does the role entail?

A non-executive director's responsibilities will normally be outlined in the corporate governance charter and may also be touched on in a director's letter of appointment.[4] Specific terms will vary from organisation to organisation, but will usually cover a director's responsibility in relation to:

- effective governance of the organisation;
- involvement in the formulation of the organisation's strategic direction and the approval of strategic plans;
- recruitment and performance of the CEO;
- reviewing, approving and monitoring the business plan and annual budget;
- contribution to the development of board and organisational policies;
- compliance with the legal requirements of being a director;
- compliance with legal and regulatory requirements of running a business;
- monitoring risks facing the organisation;
- any specific requirements in relation to stakeholders and networking on behalf of the organisation;
- Involvement with board sub-committees; and
- Identifying skills required by the board and potential candidates.

The charter might also refer to minimum standards of behaviour expected of a non-executive director.

How does a non-executive director add value to a board?

The perceived advantage of non-executive directors is their independence and objectivity – their ability to act in the best interests of the company is not compromised. Other ways in which non-executive directors add value include:

- bringing an independent and fresh perspective to decision making;
- having a broader and more extensive experience base than that of executive managers, resulting in different insights and approaches to issues facing the organisation;
- for non-executive directors with extensive board experience, a knowledge as to how other boards approach corporate governance;
- demonstrating relevant competency, experience and ethical behaviour;
- challenging, questioning and monitoring the CEO and senior management;
- their external networks which are of use to the company; and
- supporting and mentoring the CEO.

It should be noted that having a majority of non-executive directors is no guarantee against corporate failure. Also, there are studies which question whether the presence of independent directors really improves company performance and board effectiveness.[5]

4. G Kiel, G Nicholson, J A Tunny and J Beck, 2012, *Directors at Work: A practical guide for boards*, Thomson Reuters Australia.

5. See, for example, D R Dalton, C M Daily, A E Elstrand and J LJohnson, 1998, "Meta-analytic reviews of board composition, leadership structure, and financial performance", *Strategic Management Journal*, vol 19, no 3, pp 269-290; S Bhagat and B Black, 1999, "The uncertain relationship between board composition and firm performance", *Business Lawyer*, vol 54, no 3, pp 921-963; D L Rhoades, P L Rechner and C Sundaramurthy, 2000, "Board composition and financial performance: A meta-analysis of the influence of outside directors", *Journal of Managerial Issues*, vol 12, no 1, pp 76-91; G C Kiel and G J Nicholson, 2003, "Board composition and corporate performance: How the Australian experience informs contrasting theories of corporate governance", *Corporate Governance: An International Review,* vol 11, no 3, pp 189-205; S G Johnson, K Schnatterly and A D Hill, 2013, "Board composition beyond independence: Social capital, human capital, and demographics", *Journal of Management*, vol 39, no 1, pp 232–262; C Volonté, 2015, "Boards: Independent and committed directors?", *International Review of Law and Economics*, vol 41, pp 25-37.

Are non-executive directors also independent directors?

An independent director is a non-executive director who is not a member of the organisation and who is free of any business or other relationship that could materially interfere with - or could reasonably be perceived to materially interfere with – the independent exercise of their judgment. The ASX Corporate Governance Council provides the following guidance on assessing director independence:

> *Examples of interests, positions and relationships that might raise issues about the independence of a director of an entity include if the director:*
>
> - *is, or has been, employed in an executive capacity by the entity and there has not been a period of at least three years between ceasing such employment and serving on the board;*
> - *receives performance-based remuneration (including options or performance rights) from, or participates in an employee incentive scheme of, the entity;*
> - *is, or has been within the last three years, in a material business relationship (e.g. as a supplier, professional adviser, consultant or customer) with the entity, or is an officer of, or otherwise associated with, someone with such a relationship;*
> - *is, represents, or has been within the last three years an officer or employee of, or professional adviser to, a substantial holder;*
> - *has close personal ties with any person who falls within any of the categories described above; or*
> - *has been a director of the entity for such a period that their independence from management and substantial holders may have been compromised.*
>
> *In each case, the materiality of the interest, position or relationship needs to be assessed by the board to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity as a whole rather than in the interests of an individual security holder or other party.*[6]

Rather than define independence in terms of commercial or stakeholder interests, the AICD and some notable commentators such as the late Sir Adrian Cadbury[7] believe that it is more helpful to base independence on behaviour and mindset. This requires a board culture where intelligent inquiry and independent opinion are encouraged and where the views of experts on the board or dominant board members are not automatically deferred to without investigation. The difficulty with this approach is that it is not possible for people outside the boardroom to know whether a director is exhibiting these behaviours.

What are particular challenges facing non-executive directors?

Non-executive directors face many challenges. Those challenges include:

- having the right information and challenging management;
- given their other responsibilities, not dedicating sufficient time to the role;
- not keeping current with contemporary thinking and latest approaches to governance and management;
- understanding the complexity of the organisation including customers and markets, competitors, compliance systems, financial and technical information and commercial risks well enough to make reasonable business judgments;
- adapting to the impact of information asymmetry where management have much greater access to information than non-executive directors; and
- acting in a timely manner to compliance breaches.

The greater the proportion of non-executive directors on a board, the greater their reliance on management for information about what is happening in the organisation and the issues arising. It is the board's responsibility to ensure it receives all necessary information to fulfil their obligations and it is management's responsibility to bring important issues to the board's attention.

6. ASX Corporate Governance Council, op cit, Box 2.3, p 14.
7. A Cadbury, 1992, *A Report of the Committee on The Financial Aspects of Corporate Governance*, Burgess Science Press, London, paragraph 5.26.

Typical shortcomings in information presented to directors include it being too detailed, operationally-focused, silo-based rather than whole-of-business-based. Information that non-executive directors need to allow them to properly discharge their duties should be governance, risk or issues-based, related to decision making, with major performance information to enable the board to monitor and evaluate success.[8]

Are there special roles for non-executive directors?

Aside from the general corporate governance preference for non-executive directors, there are some areas where there is a specific mandatory role for non-executive directors. For example, if a listed company is in the S & P/ASX 300 Index, Listing Rule 12.7 requires that for the company to comply with the Corporate Governance Council's recommendations as to the audit committee's composition, the audit committee should consist only of non-executive directors and a majority should be independent non-executive directors.

For APRA-regulated organisations (for example banks, credit unions, insurance companies) Prudential Standard CPS 510 Governance (September 2018) requires that a majority of directors present and eligible to vote at all board meetings must be non-executive directors.

> This research also suggests that an important role is played by directors who sit on multiple boards in disseminating good governance practices throughout boards.

Should a director's number of directorships be limited?

Some investor groups have called for a limit to the number of non-executive directorships that can be held by one person.[9] This is sometimes referred to as *overboarding*. However, other research suggests that it is not the absolute number of boards on which a person sits, but rather a complex interaction of a director's ability, other commitments, the challenges facing each organisation on whose board they sit and the specific competencies they bring to the board which determines how many boards are enough.[10] This research also suggests that an important role is played by directors who sit on multiple boards in disseminating good governance practices throughout boards.

Generally, each organisation and individual will vary in their needs and abilities. This highlights the importance of using evaluations of both boards and individual directors to measure performance.

An increasing commitment and personal liability?

A non-executive director in Australia is currently a part time role, with a time commitment considerably less than a senior management position. This is being affected by the fact that there are numerous state and territory laws which impose personal liability on individual directors for corporate misconduct. That is, directors are liable simply because they are a director, even where they may not have had any personal involvement in a breach. In some states, the onus of proof is reversed, removing the presumption of innocence, and there are very narrow legal defences and limited rights of appeal.

8. Numerous examples were provided by the 2017-2019 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. See **https://financialservices.royalcommission.gov.au/Pages/reports.aspx**.
9. Australian Shareholders' Association, 2018, *ASA Voting and Engagement Guidelines for ASX 200 Companies*, **https://www.australianshareholders.com.au/Public/Advocacy_monitoring/Voting_engagement_guidelines.aspx**.
10. For a discussion of the research and issues surrounding number of directorships, see T Featherston, 2018, "Are directors too busy?", *Company Director*, AICD, September, **https://aicd.companydirectors.com.au/membership/company-director-magazine/2018-back-editions/september/busy-directors**, (accessed 25 April 2019).

This has had an inevitable impact on the time required and the remuneration demanded. It has also altered the balance of the non-executive role more towards that of an executive one as non-executive directors attempt to meet their growing responsibilities.

This increasing time commitment is consistent with the position under the Act that there is no distinction between non-executive directors and executive directors in the application of the core aspects of the duty of care: that is, understanding company's financial position and being in a position to monitor the company's affairs. As a result, non-executive directors must largely rely upon the business judgment rule and 'delegation' defences in the Act in leaving the day-to-day management of the company to the company's executives. Nonetheless, a real time commitment from a non-executive director is required.

The Australian Institute of Company Directors believes that there is a need to extend the business judgment rule and have proposed the 'honest and reasonable director defence'.[11] However, other than an extension of the business judgment rule to be a defence under the insolvent trading provisions of the Act, there has been little to movement to reduce director liability.

11. Australian Institute of Company Directors, 2014, *The Honest and Reasonable Director Defence: A proposal for reform*, [Policy Paper], 7 August, **www.governanceinstitute.com.au/media/681519/the-honest-reasonable-director-defence-a-proposal-for-reform_august-2014_f.pdf**.

About us

The Australian Institute of Company Directors (AICD) is committed to strengthening society through world-class governance. We aim to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. Our membership includes directors and senior leaders from business, government and the not-for-profit (NFP) sectors.

For more information **t:** 1300 739 119 **w:** companydirectors.com.au

07236-5-6