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Dear Sector Governance Branch

Review of the Legislative Framework that provides for the Governance and Accountability of State Owned Corporations: Issues Paper

Governance Institute of Australia is the only independent professional association with a sole focus on the practice of governance. We provide the best education and support for practising chartered secretaries, governance advisers and risk managers to drive responsible performance in their organisations.

Our Members are all involved in governance, corporate administration, company secretarial practice and compliance within their organisations, including public listed and public unlisted companies, private companies, public sector entities and not-for-profit organisations, with their primary responsibility being the development and implementation of governance frameworks.

Governance Institute of Australia welcomes the opportunity to comment on the Issues Paper, *Review of the Legislative Framework that provides for the Governance and Accountability of State Owned Corporations* (the issues paper) and draws upon the experience of our Members in providing our response.

Executive Summary

Under the *State Owned Corporations Act 1989* (NSW) (the SOC Act) government entities are commercialised and asked to exist in an environment that closely resembles the private sector. The SOC Act provides the legal and governance framework for state owned corporations (SOCs) and pursues, as far as appropriate, private sector objectives while maintaining public ownership.

Governance Institute recognises that the issues paper seeks to review the current governance structures of SOCs with a view to proposing amendments to the framework to:

- enable better commercial performance of SOCs
- improve the oversight of SOCs, and
- streamline and strengthen the accountability and governance framework of SOCs

Governance Institute understands that the policy intent is to improve the efficiency and accountability of government business, and we believe that this can be achieved through:

- centralising the governance provisions relating to SOCs and providing a principles-based governance framework for SOCs to operate within
- rationalising and providing one set of principal objectives spelt out in the SOC Act

- ensuring that the functions are also rationalised, detailing the responsibilities and activities of SOCs, and ensuring that these are included in either the SOC's enabling legislation or company constitution, as relevant
- providing a limited menu of pre-defined categories of legal forms from which to choose when creating a SOC, and ensuring that a clear rationale is provided for the maintenance of a particular system, and/or the decision of a Minister to adopt a particular model
- requiring a clearly established framework for the roles and responsibilities of SOCs and their Shareholding and Portfolio Ministers in a central piece of legislation, preferably the SOC Act, which is applicable to all SOCs
- strengthening the model for ministerial directions by providing for consultation with the entity on matters subject to a ministerial direction, and ensuring that reimbursement or appropriate funding is available for the direction to be carried out
- enhancing the SOC's reporting requirements in relation to ministerial directions, by requiring that SOCs report in the Statement of Corporate Intent (SCI) half-yearly and annual financial reporting requirements on the achievement and financial imposition of non-commercial objectives or ministerial directives
- providing a clear and consistent framework for the operations of boards and executive officers of SOCs which is principles-based and allows for the autonomy of the SOC to decide on its own internal governance framework without the interference of the government, and
- harmonising the duties of directors of SOCs with the duties outlined in the *Corporations Act 2001*, but also retaining specific defences in the SOC Act for directors who have acted in good faith, in accordance with a ministerial direction.

Governance Institute is cognisant that an immediate disclosure framework has also been proposed in the issues paper as a way of improving the proactive disclosure of information between the SOC and the Shareholding or Portfolio Minister. In its current form, Governance Institute opposes such a measure, on the basis that there is not enough detail on the proposed scope, extent and operation of such a regime. However, if further details were to be forthcoming, we would consider those accordingly before providing our recommendation.

Providing clarity and certainty with respect to the governance structures of SOCs

Governance Institute notes that given the current legal and governance framework for SOCs, there is:

- a lack of clarity about the role and powers of the governing boards of commercialised government entities which has implications for the understanding by directors and Ministers about their accountabilities, responsibilities and obligations
- a myriad of legal structures which has implications for the governance frameworks in place. For example, Governance Institute's (produced under our former name, Chartered Secretaries Australia) *Benchmarking Governance Practice in Commercialised Government Entities* Survey (the Benchmarking Survey) published in November 2009, reveals that more than half of Commonwealth government-owned corporations (GOCs) are established under statute, more than one-third operate under the *Commonwealth Authorities and Companies Act 1997* (CAC Act) and less than one-third operate under the *Corporations Act 2001*
- uncertainty about differing funding and reporting obligations, and
- the potential for increased costs for entities required to seek advice about their reporting, audit and other accountability requirement where arrangements are unclear.

It is important, therefore, to ensure that there is a clear and consistent governance framework in place for SOCs. While Governance Institute broadly supports many of the measures put forward in the issues paper to address the current inefficiencies and lack of clarity that exist, we note that transparency and accountability for SOCs is a broader issue than simply ensuring that the Shareholding or Portfolio Minister is informed of the objectives, functions and performance of SOCs. Instead, SOCs, through a robust governance framework, must also be able to

demonstrate that they are acting in, and achieving, the goals of creating and maintaining shareholder value, and the long-term goals for the well-being of the community.

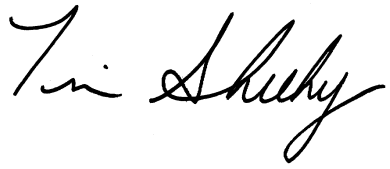
For this to occur, however, the SOC must be able to understand the context in which they are being asked to operate, including the regulations, policies and relevant rules and directives of public administration. This can only be achieved through an integrated governance framework that will enable them to achieve their goals efficiently and effectively. This integrated governance framework includes ensuring that SOCs are able to design their internal governance to match their objectives to operate commercially, and to operate within an external governance framework which is clear, transparent, consistent and not burdensome.

Conclusion

Governance Institute commends the review panel for providing a considered issues paper which seeks to canvas many of the framework issues currently impeding SOCs from operating at their most efficient level. Our responses to the questions posed in the issues paper are set out on the following pages; however, you should note that we have not attempted to answer all the questions put forward. Instead, our responses are limited to those issues of most interest to our Members.

Governance Institute looks forward to seeing the outcome of the consultation process, and the final proposals which will arise as a result of these discussions. We would welcome the opportunity to discuss any of our views in greater detail.

Yours sincerely



Tim Sheehy
Chief Executive

Feedback on list of proposals and questions put forward in the issues paper

Chapter 2: Policy Intent of the Legislative Framework

Policy Framework & the centralisation of governance provisions
The policy intent of the legislative framework, to improve the efficiency and accountability of government business for the benefit of consumers and taxpayers, while operating under similar conditions as private sector companies, remains valid. Governance Institute believes the lack of consistency and commonality in governance arrangements (various responsibilities are bundled up in multiple pieces of legislation) creates uncertainty and, at times, conflicting objectives, functions and accountabilities for SOCs to achieve. While we recognise that the nature of SOCs can vary in terms of activities, achieving an efficient accountability framework for SOCs requires the imposition of a clear and consistent governance structure. Governance Institute believes that a clear statement is warranted establishing the governance arrangements for SOCs in a central place rather than in separate constituting legislation.

Accordingly, **Governance Institute recommends** that the governance provisions relating to SOCs be centralised in the SOC Act. We note that the Lambert Report[1] recommended that the SOC Act should be the sole vehicle for governance and shareholder provisions. Such an arrangement will require the SOC Act to effectively spell out many of the issues discussed elsewhere in this paper, such as the roles and responsibilities of the Shareholding Minister; however, it is important that these provisions are not drafted in a prescriptive manner. Instead, the provisions should aim to provide certainty and clarity, and spell out the minimum requirements for processes to occur.

A principles-based approach to governance for SOCs
Governance Institute believes that an integrated governance structure requires a broader principles-based governance framework for SOC reporting which is not captured in the SOC Act. There is no 'one-size-fits-all' approach to governance in either the private or public sectors and a principles-based approach allows entities to assess each situation and consider the most appropriate governance model and framework for each organisation.

Governance Institute advocates a principles-based approach to governance, rather than a rules-based approach, as there is often no one 'right answer' to many governance issues facing SOCs. A principles-based approach provides insight into the decision-making of the board of the SOC and allows the board of the SOC to determine how they will meet the spirit of the principles. The Shareholding Ministers can then play a role in holding the board of the SOC accountable for their decisions.

We note that a model for governance could include the SOC Act providing the overarching governance framework, but also requiring SOCs to act in accordance with a principled governance framework which is separately drafted and implemented, for example in regulations or a Treasury policy statement. We note that there are already a number of SOCs and more broadly commercialised government entities that have voluntarily adopted and implemented the Australian Securities Exchange (ASX) Corporate Governance Council's *Corporate Governance Principles and Recommendations* (the Principles and Recommendations) as their governance model adapted to the public sector. Our Benchmarking Survey in 2009 revealed that many of the governance practices of commercialised government entities were closely aligned with those of ASX listed entities. However, we also believe that there needs to be further discussion about the most appropriate principles-based governance model for the public sector. Governance principles in addition to the legislative requirements are preferred, and reporting on an 'if not, why not' basis is also recommended as a more robust approach to governance.

[1] NSW Treasury, *NSW Financial Audit* (September 2011) Vol 2, 19-7

The 'if not, why not' approach is such that if an entity considers a governance recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it — a flexibility tempered by the requirement to explain why. This approach is key both to the success of the Principles and Recommendations being adopted by listed entities as the primary governance document in Australia and in meeting the needs of both institutional investors and organisations representing retail investors, as the disclosures provide a useful trigger for constructive engagement with company representatives about governance practices. The corporate governance disclosures, particularly the disclosures of why a company has not adopted a particular recommendation, have provided useful insight to investors concerning the management of the company. We believe that the 'if not, why not' model applied to SOCs would create equally useful triggers for constructive engagement between SOCs and Ministers, as well as other stakeholders, and also provide useful insight concerning the management of the SOC.

As highlighted in our opening letter the most important feature of a governance framework, apart from promoting transparency and accountability, is for there to be consistency and clarity in the governance relationships, and appropriate reporting and oversight of governance frameworks to all stakeholders. We strongly believe that a principles-based governance approach allows for this to occur.

Periodic review of all legislation governing SOCs
Governance Institute supports the regular review of any legislation and/or regulations governing SOCs. We note that a review of governance principles may not need to be carried out as often as a review of the rest of the framework. Governance Institute notes that such reviews may occur on a cycle which the review panel deems appropriate.

Chapter 3: Principal objectives and functions of a SOC

Objectives & Functions
Governance Institute notes that the current framework provides a mixed model within which the objectives and functions of SOCs are expressed. We note that the current arrangement sees principal objectives captured in both the SOC Act and various enabling acts, relevant to specific SOCs, with some other more general objectives also contained in the enabling acts. We note that this approach causes confusion for SOCs as some of the other objectives expressed in the enabling legislation are non-commercial in nature, thereby conflicting with the usual primary objective of operating as a commercial entity. We are also aware that some of the objectives contained in the enabling acts are framed to resemble functions, thereby, creating further inconsistencies and confusion for SOCs.

It is important that the objectives and functions of SOCs be appropriately rationalised. We believe that the current framework requires SOCs to navigate and compare differing and sometimes competing objectives and functions in order to operate.

Governance Institute recommends, therefore, that there be one set of principal objectives contained in the SOC Act. The principal objectives should be clear, consistent and broadly applicable to all SOCs. For example, a principal objective might be for SOCs to operate as commercial entities. In this regard, Governance Institute concurs with the findings of the Lambert Audit Report[2] which recommended that the objectives be clarified and centralised in the provisions of the SOC Act.

The functions of the SOC should then be limited to expressing the activities and responsibilities of the SOC only. The functions should be contained in either the enabling legislation for the SOC, or the SOC's constitution, as is appropriate for the particular SOC. For example, a function might be expressed as protecting public health by supplying safe drinking water to customers and public in compliance with an operating licence. We note that the functions of SOCs should not be contained in the SOC Act, and that there should be a clear distinction

[2] NSW Financial Audit 2011, Report Part C: Policy, Financial and Economic Reform, September 2011

between the functions of the SOC and its principal objectives. **Governance Institute recommends** that the statements of functions for SOCs, currently located within each of the enabling acts, also be rationalised and updated.

Chapter 4: Corporatisation models

Corporatisation models
Governance Institute notes that there are a wide range of corporate models available to the government to utilise when constituting a government owned commercial entity, such as a SOC. Governance Institute believes that a clear policy framework is needed in which there are a limited menu of pre-defined categories of commercial forms from which to choose when creating a SOC to ensure that clarity is achieved as to the governance framework that is being established, including the accountability and responsibilities of the board, and Shareholding and Portfolio Ministers. As highlighted above, the central governance features of this arrangement should be contained within the SOC Act to ensure that clear and consistent advice is provided.

Governance Institute prefers that only one model of SOC is adopted. However, we recognise that the framework can still accommodate both company SOCs and statutory SOCs within its structure. Importantly, there needs to be a clear rationale for the maintenance of a dual model system, if deemed appropriate, and/or the decision of a Minister to adopt a particular model.

It is good governance for a Shareholding or Portfolio Minister to outline the business case and detail the value proposition which sets out the criteria for creating the SOC in the first place. The business case for establishing a SOC should be premised on the value that professional directorship, and the commercial form may bring to the public sector. In deciding which commercial form is appropriate, the government should consider the oversight, advice and guidance of the organisation to be formed, in relation to the:

- strategy to improve performance and contribute to the creation of shareholder value
- capability and culture of the organisation to implement the strategies and deliver services effectively, efficiently, ethically, and legally
- business risks, their mitigation and effectiveness of controls, and
- integrity of financial statements and compliance.

Clarity as to which form of SOC is the most fit for purpose is central to outlining the business case and detailing the value proposition, and will need to reflect:

- why the SOC was established in the first place
- its legislative requirements, and
- any other relevant circumstances, including why a particular governance structure might differ from that put forward as part of this framework.

The roles and responsibilities of each of the parties to the framework should be clearly spelt out and Governance Institute notes that this can only occur where there is a consistent and clear governance framework in place. The government should also consider regularly reviewing whether or not the corporate form and business model remain relevant. This might include inquiring as to whether:

- the ongoing structure and form of the SOC remains fit for purpose, and
- the same objectives might be achieved by changing the organisational form.

As noted above, we recognise that there may be very good reasons to retain both company SOCs and statutory SOCs; however, it should be noted that Governance Institute is strongly opposed to the introduction and/or perpetuation of other additional SOC models above those that already exist.

Chapter 5: Roles and responsibilities

One of the key findings of Governance Institute's 2009 Benchmarking Survey was that the adoption of the corporate form has not resulted in the clarity this form is intended to provide as

to the roles of the various parties in the governance framework, that is, the shareholder (government); the board of directors (governing body); and management. We believe that this issue is ongoing.

Role of Ministers, boards and management
A fundamental question which has arisen in the context of the relationship between the SOC and its Shareholding and Portfolio Ministers is whether there is sufficient distance between government and the entity it creates. The findings of the Benchmarking Survey suggest that corporatised bodies owned by the government cannot be termed optimal from a corporate governance perspective, while such lack of clarity as to role definition exists.

Governance Institute notes that government owned corporations also reported in the Benchmarking Survey that where the government is the sole voting shareholder, the board is accountable to the Shareholder Minister(s) who may also act as directors in terms of exercising decision-making powers, setting the strategic and operational direction of the business, appointing the chairman of the board, and/or appointing the chief executive or managing director. This is not considered good governance practice.

To address this situation, **Governance Institute recommends** that the roles and responsibilities of the board, executive, Shareholding and Portfolio Ministers be clearly spelt out and documented for each SOC, specifying the authority of the board and its accountability to the Shareholder and Portfolio Ministers.

This means ensuring clarity with respect to:

- the identities and roles of the key stakeholders (for example, Minister, chair, directors, chief executive (or equivalent) etc)
- the powers vested in each stakeholder and the basis on which such powers rest (for example, do the power arise from legislation? — this would be clarified if those powers were in the SOC Act)
- the reporting responsibilities of each stakeholder and the identity of the stakeholder to whom those reporting obligations are owed (for example does the chief executive only report to the board?)
- whether the relationships between stakeholders are formally based in a performance agreement, and the nature of the performance agreement, for example, the SCI which outlines the objectives, major activities and performance targets for the financial year consistent with the government's policy and budgetary requirements
- the frequency of review of any performance agreement or SCI
- the functions reserved for the board
- the extent of the board's decision-making powers, including powers of delegation
- clarity of roles as between the board and the shareholding or relevant Ministers as to who
    - sets the strategic direction the business
    - appoints the chair of the board and its members
    - appoints the chief executive or managing director
    - determines the remuneration of the board and CEO, and
- the recruitment and selection of the board members.

While some of these concerns are dealt with elsewhere in the issues paper, Governance Institute believes that they are all important matters that need to be documented. We recognise that it would be impractical and inflexible for all these matters to be included in the principal legislation, because the roles and responsibilities may vary. Nonetheless, we do believe that there are certain roles which will be consistent, for example, the role of the Minister. We note that the review panel might consider requiring that these roles and responsibilities be documented as a part of a good governance framework.

Shareholder objectives
Governance Institute notes that the strategic direction and goals for a SOC will be influenced by the government's key policy and service delivery priorities.

We note that currently there can be confusion over the role of the Shareholding Ministers, and the Portfolio Ministers and the various accountabilities of each in relation to SOCs. We are of the view that the interest of the Shareholding Ministers should lie with the commercial direction and performance of the SOC, while the Portfolio Minister concentrates on industry policy and regulation. Governance Institute believes that it is important that the separation of roles is properly formalised and reflected in the governance framework. Such matters might be put into the SOC Act to ensure that they are clear and consistent.

Ministerial directions and approvals
Given the social and regulatory responsibilities of the government, occasions may arise where the government requests (informally) or directs (formally) the SOC to act in a manner which may not be in the best commercial interests of the organisation. This may be contrary to what the board believes it must do to meet its primary legislative objectives or functions of the SOC.

Currently, ministerial directions powers may vary between organisations depending on how they were established. Some require board consultation, some allow for reimbursement, and others require approvals before the SOC can be directed. SOCs often have to grapple with the processes for ministerial directions, and then juggle with how they incorporate the directions into their operations without incurring significant cost or non-compliance.

Governance Institute notes again that the primary issue is the clarity of the framework and ensuring that there is transparency and accountability in the process of issuing and acting in accordance with ministerial directions.

Governance Institute recommends, therefore, that there be one consistent model for the giving of ministerial directions which is clearly entrenched with either the Shareholding Minister, or the Portfolio Minister, or both, but provides clear legislative requirements with respect to the reasonable consultation with the SOC, and ensuring that appropriate funding or reimbursement is available where the ministerial direction is likely to require the SOC to incur costs.

Governance Institute notes that should a non-commercial requirement be planned for a SOC by government, the effects on the SOC should be transparent to all stakeholders and the public. The ability for the Shareholding Ministers to give directions to a commercial SOC should be limited and spelled out, where the direction is made outside of the annual SCI process.

The current provisions appear to allow for both formal and informal directions to be administered, and creates significant uncertainty for SOCs. While we recognise that the SOC Act requires ministerial directions to be in writing and tabled in parliament, Governance Institute Members note that there may be media or political reasons why a Shareholding Minister does not utilise the formal process. We note that in NSW it is also the Portfolio Minister who is often the most likely to utilise the powers granted through ministerial directions.

Governance Institute notes that an alternative approach, which allows the SOC to be responsible for the achievement of non-commercial requirements where warranted by a ministerial direction, might be to require that the SOC report on its financial performance, including reporting where it performs non-commercial activities. Governance Institute believes that reporting on non-commercial activities and objectives, whether the subject of a formal or informal ministerial direction, provides transparency and accountability of the costs of the SOC. The requirement that half-yearly and annual reports be laid before parliament also means that these costs are made public. **Governance Institute recommends** that the SCI, half-yearly and annual reporting obligations include reference to costs associated with the achievement of non-commercial goals, as required by the SOC.

Chapter 6: Accountability and Reporting

As noted above, the problems with accountability and reporting for SOCs can lie in the reporting of financial performance that has been coupled with a responsibility to also attain non-commercial objectives imposed by the government (over and above their competitors), such as environmental protection goals, or social responsibility requirements.

Such measures may be provided by ministerial direction or otherwise imposed on the SOC, and Governance Institute reiterates that reporting on these matters through the SCI, half-yearly and annual reports provides a mechanism whereby the accountability for the costs associated with implementing non-commercial measures can be properly seen and costed in the preparation of future budgets for the SOC.

SOC reporting and auditing
Governance Institute supports the retention of the Auditor-General as the appropriate body to audit SOCs given that public moneys are involved.

Shareholders' ability to rectify poor performance
Governance Institute notes that the poor performance of a SOC is an issue for the Shareholding Minister, as they are required to hold a board to account for financial performance. This means that Shareholding Ministers require quality, relevant and timely reporting of performance.

We note that one proposal put forward in the paper concerns the introduction of an immediate disclosure arrangement which mirrors the continuous disclosure obligations of publicly listed companies. The proposed outline suggests that the SOC will be responsible for informing the Shareholding and Portfolio Ministers when changes which may materially impact upon the SOC's service provision or its financial performance, position or prospects occurs.

Governance Institute recognises that there may be several benefits to implementing an immediate disclosure regime, such as:

- clarity of purpose, including the strengthening of decision making and government processes, and provides the capacity to defend decisions
- clarity on whether disclosure is required for legislative purposes or as a matter of good governance
- opportunities to assess if decisions alone may be made public, or also the discussion behind the decision, bearing in mind that some decisions are appealable
- opportunities for agencies to become familiar with their stakeholders, as part of ensuring they meet stakeholder requirements and expectations.

However, we also recognise that at this stage of consideration there are still questions about the reasons for requiring the disclosure, including whether it:

- is in the interests of good governance
- is to match the increasing interests of broader stakeholders
- assists the public to better understand how decisions are made in government and how those decisions will affect them
- is an evaluative tool to measure the success of government activities
- contributes to maintaining the public's confidence in the integrity of government and meeting the obligations of stakeholders.

Further, in the public sector context, there are also broader policy questions to be addressed, including:

- What information should be disclosed, and should this information be restricted to the outcomes and results of the entity, as distinct from the activities and plans of the agencies?
- Are we asking for disclosure about the decision-making structures within the organisation? If so, is it appropriate for the Minister to interfere in this process?

- Are we asking for quantitative disclosure on performance? Is this information already available?
- Are we talking about disclosure about information already available under Open Government Access provisions?
- What is the materiality threshold for disclosure? For listed companies, it is clear that materiality relates to the share price of a company, but what is the equivalent for a SOC?
- When should this information be disclosed?
- Is the information required to be reported against the financial targets or other objectives of the SOC, or both?

Currently, the SOC Act framework allows for Ministers to request information from a SOC, but does not otherwise require the SOC to be forthcoming with information outside of its reporting obligations. We note that in its current form, the proposed immediate disclosure obligation might require that the SOC notify promptly and without delay and disclose information on matters that may lead to a material change in the SOC's service delivery, and/or its financial performance, position or prospects.

Governance Institute notes that in its current form, **we oppose** the introduction of an immediate disclosure regime. In the first instance we believe that the there are too many questions still to be answered about the intended purpose and scope of such an obligation, and how it will operate in practice.

We note that continuous disclosure obligations for publicly listed companies require that the company inform the market immediately of any information that is likely to have a material impact on the price or value of the entity's securities. A central feature of the continuous disclosure regime is materiality, and another is equality of access to information by all investors. We note that the proposed immediate disclosure model suggests that the immediacy of information is required for the Minister's benefit. This does not support enhanced transparency and accountability when disclosure of information is selective. Importantly, continuous disclosure is for the benefit of the entire market. In the public sector context, this includes the public, and so thought needs to be given as to how, or even if it is possible, for information required by the Minister can be made available to the public.

Chapter 7: Boards and Executive Officers of SOCs

As a matter of good governance, the board of the SOC should be independent of management or political influence and resilient to changes in the machinery of government. As noted above, however, such a structure or process only exists where there are consistent and transparent processes detailing the extent to which Ministers may exercise powers, who may exercise powers, and in what circumstances these powers may be exercised.

Ultimately, Governance Institute notes that the interaction of the Shareholding Ministers and Portfolio Minister and the board of the SOC should have a shared understanding that the operation of the board will be for a duration that best serves the interest of the company (unless specifically appointed for a short-term project), and that the board is best placed to:

- recognise the longer-term value drivers of the SOC
- take on the feedback from its stakeholders, including the community
- actively oversee and understand the board strategy and regularly monitor, along with management, the implementation and effectiveness of strategic plans or SCIs, and
- manage risk, including strategic risks and the relationship of those with the board strategy and key objectives.

Governance Institute believes, therefore, that the boards and executive officers of SOCs should be provided with the autonomy to effectively govern the manner in which the organisation performs and achieves its objectives. While the final responsibility sits with the Minister, the

board should be empowered to control and monitor management. Governance Institute supports the notion that the board of the SOC should:

- be able to appoint the CEO and set policies to meet its objectives
- have a clear commercial focus
- control its resources, either by employing them directly or having a formal contract with the provider of those resources
- have a clear process for the nomination, and appointment of other directors, and
- have a clear process for identifying skills required to sit on the board.

The operations of the board and executive of SOCs is of particular concern to Governance Institute as our Benchmarking Survey revealed that there are several issues which threaten the independence, transparency and accountability of SOCs. For example, our Benchmarking Survey noted that in the majority of commercialised government entities, non-executive directors do not meet separately from executive directors. This is markedly different from the top 200 listed companies, where the majority report that their non-executive directors meet separately from executive directors.

The capacity of non-executive directors to meet separately from executive directors is a central governance issue, as it goes to the heart of whether the independent, part-time directors are able to discuss issues separately from management. Indeed, the Principles and Recommendations specifically note that: 'Non-executive directors should consider the benefits of conferring regularly without management present, including at scheduled sessions'. In commercialised government entities, the lack of a separate forum for non-executive director discussion could give rise to a perception that the board could be controlled by internal management, or lacks independence from the Shareholding or Portfolio Ministers.

This lack of separation is also evident in the board appointment and removal processes by which directors are appointed or removed from the board of the SOC.

Appointment and removal of directors

Governance Institute notes that the current arrangements concerning the appointment and removal of directors remain the responsibility of the Shareholding Ministers.

In 2011, the NSW Government adopted a new policy and process for the appointment of directors to the board of SOCs which relies on:

- the board identifying the skills gaps on the board and the board's nomination committee (where it exists) suggesting potential candidates to fill the gaps
- the voting Shareholding Ministers, Portfolio Ministers, and Treasury identifying further potential candidates
- a committee assessing the merit of shortlisted candidates through interviews and/or a review of their experience, and
- making an appointment on the basis of the work of the committee.

In practice, however, Governance Institute notes that this process still lacks clarity, accountability and transparency. As our Benchmarking Survey also revealed, nomination committees are largely absent from the commercialised government entity environment. Even when taking into account joint committees, very few commercialised government entities have specified nomination as the focus of a board committee. The absence of this committee raises the possibility that the key responsibilities of deciding director competencies necessary for the company, board succession plans and processes for board evaluation may not rest with the governing bodies of commercialised government entities, but instead continue to rest with the relevant Shareholding Ministers.

We also note that despite alignment with the Principles and Recommendations in order to try and assert an arms' length relationship with government, directors of SOCs, and indeed all types of commercialised government entities, are still appointed by the government, suggesting that independence is hard to achieve in this context.

Nonetheless, Governance Institute believes that transparency and accountability should underpin the processes associated with the appointment and removal of directors. In this regard, we support greater professionalism being promoted in the public sector, including that the boards of SOCs should be responsible for:

- implementing an induction program for all new directors and providing for access to continuing education to update and enhance directors' skills and knowledge, recognising any legislative requirements in relation to skill sets which may relate to specific sectors within which the board operates
- implementing a plan for evaluating and identifying the relevant competencies, skills, experience and expertise required by the board in order to discharge its responsibilities
- evaluating the range of skills, experience and expertise it requires to discharge its responsibilities
- developing an internal governance framework based on the relevant legislation, regulations and standards applicable to the SOC
- appropriately integrating board committees and detailing the board committees' responsibilities
- designing the relevant delegations policy required to support the board structure
- implementing a process for the regular review of board performance — it may be an internal or externally-facilitated review process
- ensuring a risk management policy is developed for the oversight and management of risk and requiring management to design and implement the risk management framework and internal control system, including reporting to the board on whether risks are being appropriately managed
- ensuring that a policy for managing conflicts of interest and related party transactions is developed (consideration can be given to whether this policy needs to include reference to political affiliations), including a process for managing perceived, actual and potential conflicts of interest
- providing input to and final approval of management's development of the strategic plan and performance objectives
- ensuring it can provide strategic guidance to the public sector entity and effective oversight of management.

In light of the findings of the Benchmarking Survey and the points above which highlight the important functions which should be reserved for the board, **Governance Institute recommends** that SOCs establish a nominations committee (or a similar mechanism) which makes recommendations about the necessary and desirable skills required for the board. Further **we recommend** that clarity be provided on the ability of the board to recommend its own appointments, or whether suggestions for board appointments should be provided to the shareholding or relevant Ministers for consideration.

Governance Institute notes that the SOC Act currently makes no provisions for the removal of a director, and that this process should be contemplated and set out, in at least minimum requirements alongside those concerning the minimum conditions for the appointment of a director. **Governance Institute recommends** that the minimum requirements for the appointment and removal process be encapsulated in the SOC Act.

In relation to other matters concerning board governance, we note the following:

- Evidence from the private sector suggests that the larger the board, the greater the difficulty in achieving consensus when making decisions. Notwithstanding this, diversity of opinion is essential to the proper function of a board. In the private sector, the majority of companies permit a maximum of up to ten directors on the board. **Governance Institute recommends** that a maximum requirement for board size be set.
- There is no consensus on what, if any, is an appropriate length of time for a director to serve on a board. Limits on tenure have previously been stipulated on the proviso that a director is no longer independent the longer that they have been on the board; however,

this assumption fails to account for the fact that the board member is required to undertake ongoing education and training to ensure that their skills remain up-to-date and improve the longer they are on the board. **Governance Institute recommends** that no limit on tenure be set, but that boards ensure that a director of the entity is appointed for a period until his or her independence may have been compromised.

- It is good governance for the board to put in place a policy and mechanism for annual evaluations of the board. Assessment of the board's performance should be undertaken in relation to the value proposition. It is good governance for an externally-facilitated evaluation to take place every two to three years with an annual internal evaluation in the intervening period. **Governance Institute recommends** that the SOC be required to disclose if a board evaluation has taken place in the previous 12 months.
- The role of the chair of the board is to encourage independence and diversity of thought in the boardroom and establish a culture that is not captive to groupthink. The chair can face different challenges in relation to the acting in the best interests of the SOC while also taking into account the government's policy objectives, and the Shareholding and Portfolio Ministers contribution to government outcomes. **Governance Institute** recommends that the board charter or other board governance document, a position description or similar, or a corporate governance page on the website or in the annual report set out the role of the chair.

Chief Executive Officers

Governance Institute supports the recommendations of the Lambert Report[3] which were that the board of the SOC be entrusted with the responsibility of selecting and appointing the CEO. Further, we support the retention of the provision in the SOC Act which notes that the CEO may be appointed to the board. **We recommend**, however, that a further clarification be added noting that it is the responsibility of the board to determine if the CEO should also sit on the board.

Chapter 8: Directors' Duties

Governance Institute strongly supports the harmonisation of directors' duties for directors of SOCs with the duties outlined in the *Corporations Act 2001*. We note that the supporting reasons are outlined in paragraph 8.5 of the issues paper. We would add that we believe that alignment is also appropriate in light of the diverse range of organisations that already operate under the Corporations Act, and the original drafting intention of the directors' duties in the SOC Act, to align with the directors' duties in the Corporations Act.

We recognise, however, that there are limits to which the Corporations Act can apply to the directors of SOCs. In the first instance, we note that the business judgement rule may not be fit for purpose for use by SOC directors who are, in effect ordered to act in a manner which may not always be in the best interests of the SOC.

We are cognisant that the SOC Act currently provides a liability defence in respect of particular obligations, including where the director acts in good faith in accordance with the direction of a minister. For example, Ministerial directions can require a SOC to take a particular action or cease to perform a particular action which is in contrast to their principal objectives or functions. While the SOC Act currently provides certain defences to a potential breach of duties if directors are acting in good faith in accordance with a request for information or written direction issued in accordance with the SOC Act, this type of defence is not directly available in the Corporations Act. We believe that a separate defence should continue to exist in the SOC Act with respect to actions made in good faith in response to a ministerial direction, which would mean that directors' duties in the SOC Act would differ in this respect from the Corporations Act.

We note that the insolvency requirements for directors provides another area of concern for directors. Governance Institute notes that a situation may arise where a director may be concerned where state funding is an issue in terms of amount, type and/or timing, and the

[3] NSW Treasury, *NSW Financial Audit* (September 2011) Vol 2, 19-7

Corporations Act requires a continuing declaration of solvency. Again, we note that such a consideration can be alleviated if a proper defence is provided for directors in the SOC Act.

Governance Institute recommends, therefore, that the Corporations Act provides the appropriate model for directors' duties and should be adopted subject to the required defences and/or amendments to the SOC Act framework being retained.