The Embedded Regulator: The Independent Director in the Line of Fire*

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The independent director is promoted as a monitor of management in large publicly traded corporations. Their inclusion has become a feature of governance regimes in Australia, the UK and the US. This paper will briefly describe the reforms that have advocated the independent director as the solution to corporate governance problems and the methods used to promote them. The analysis reveals the independent director as an outsider inserted, like the embedded journalist, into a close knit structure. With echoes of the 'embed' program, the reforms which promote the independent director are redolent of governmental interference. As the limitations of 'command and control' regulation have become understood, the state has experimented with other forms of regulation in their quest to improve corporate governance. The independent director can be seen as part of this movement. The changes to the composition of the corporate board are an intervention in the structure and process within the corporation. The paper argues that this is a subtle form of enforced self-regulation implemented through soft law. It is undertaken by non-state or decentred means under pressure by the state. The second part of the paper considers the effectiveness of independent directors in their role as internal regulators of management. The role suggested for the independent director reveals the tension between two differing public interests. That is, the interest in a strong corporate sector and the interest in controlling the ability of corporations to adversely impact sections of the community. There is anecdotal evidence which casts doubt on the ability of the independent director to advance these interests and the empirical studies are mixed at best. The paper will canvas some of the difficulties independent directors may face and what contribution they can make to the governance of the corporation.

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Introduction

During the invasion of Iraq in 2003 the US government invited journalists to 'embed' with military units in order to provide coverage of the campaign. This program provided the journalists with unprecedented access to the soldiers and knowledge of the day to day operations. It was suggested that it would serve the public interest by providing more complete and current coverage of the war. It was, however, feared that the journalists could lose their objectivity in these circumstances and, as a result, the coverage would be slanted. In addition the provision for pre-publication security review of articles, in order to ensure national security was protected, heightened concerns. The program demonstrated the 'tension between free speech and security'.[1]

The features of the program were:

- The press outlet could apply to be allocated an embedded position;
- Vetted journalists would be selected from the pool and allocated to particular units;
- The journalists could live and travel with the military units;
- They had to agree to abide by rules which prohibited publication of sensitive material that could threaten national security.[2] In some cases their material would be subject to a 'security review' before publication.

Thus there was significant governmental control of the selection and allocation process. In addition there was potential for government interference in the output. This led some to question what effect the framework of the initiative had on the media coverage of the war by the embedded journalists.[3]

[1] Elana J Zeide, 'In Bed with the Military: First Amendment Implications of Embedded Journalism' (2005) 80(4) *New York University Law Review* 1309, 1310.
[2] Ibid., 1315.
[3] Michael Pfau, et al., 'Embedding Journalists in Military Combat Units: Impact on Newspaper Story Frames and Tone' (2004) 81(1) *Journalism and Mass Communication Quarterly* 74.

The parallels between the independent director and the embedded journalist are evident and encourage us to question how the regulatory framework which promotes the independent director affects their contribution. Since the 1970s corporate governance has become a fertile area for scholarship and law reform. [4] In this literature those who advocate changes in the composition of corporate boards to include independent directors are prominent.[5] The independent directors are seen as a way of providing a more effective check on management and improving the quality of corporate decision-making. Indeed the idea that independent directors are the 'silver bullet' for corporate governance problems has become the accepted wisdom.[6] Thus the independent director is seen as a way of dealing with two main issues. The first is the need to improve investor confidence. The second is the need to improve governance by improving the board process.

This paper analyses the independent director as an outsider inserted, like the journalist, into a close knit structure. As with the 'embed' program, the reforms which promote the independent director are redolent of governmental interference. This intervention occurs in an area, the corporate sector, where the hand of government is often considered to be suspect, as it generally is in the context of media control. The inclusion of the independent director on the corporate board also reveals a tension between two differing public interests. That is, the public interest in a strong, stable corporate sector and the public interest in controlling the ability of corporations to adversely impact sections of the community.

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[4] Some notable examples can be found as far back as the 1970s see, for example, H. Goldschmid, 'The Greening of the Boardroom: Reflections on Board Responsibility', 10 Columbia *Journal of Law and Social Problems* 17, Christopher D. Stone, *Where the Law Ends: the Social Control of Corporate Behavior* (1st ed, Harper & Row, New York, 1975) p. 272., R. Nader, M.Green and J.Seligman, *Taming the Giant Corporation*, Norton, 1976.

[5] B. Tricker, 'Corporate Governance--The Subject Whose Time Has Come' (2000) 8(4) *Corporate Governance* 289, 291.

[6] Editor, 'Beyond 'Independent' Directors: A Functional Approach to Board Independence' (2006) 119 *Harvard Law Review* 1553.

The format of the paper will be as follows: firstly, the independent director reforms in the UK, US and Australia will be examined and the degree of reliance on the reforms considered; secondly, the role of the government in the reforms will be described; and finally, the effect this framework has on the way the independent director operates will be considered.

The Impact of the Reforms

Reforms centring on the composition of corporate boards are seen as a way of improving the decision-making process on the corporate board as well as increasing the vigour of the board's monitoring of management. The key to many of these reforms is the independent director. Brought in from outside, the independent director has no direct or indirect connection with the corporation other than the position they hold on the board and a non-significant shareholding.[7] Therefore they are seen as having the ability to bring an independent judgement to bear on the performance of management. While these directors have been present on corporate boards since the nineteenth century,[8] this focus on them as monitors of board behaviour is relatively new.

The moves to enhance the position and increase the numbers of independent directors have gathered pace since the 1980s. Independent directors have been given additional responsibilities both on the board and often through the creation of committees controlling the audit, compensation and nomination functions once exercised by management. [9] These changes have been incorporated into

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[7] According to the Corporate Governance Council, *Principles of Good Governance and Best Practice Recommendations* to be classed as independent a director may not have a 'substantial holding' as defined in s. 9 Corporations Act 2001(Cth). A 'substantial holding' is 5% or more of the total number of votes attached to voting shares.

[8] See for example, *Re Denham* (1883) 25 Ch D 752 and *In Re Cardiff Savings Bank* (1892) 2 Ch 100.

[9] See for example Australian Stock Exchange's Corporate Governance Council, *Principles of Good Governance and Best Practice Recommendations*, Recommendation 2.1, 2003, UK *Review of the Role and Effectiveness of Non-Executive Directors* (Higgs Report), 2003. NYSE Listed Company Manual, s.303A.

governance regimes in Australia, the UK and the US.[10] As a result in Australia about 38% of the top 250 corporations claim to have a board with a majority of independent directors with all but 19 of the top 250 corporations having some independent directors.[11] The changes have been even more marked in the US where the majority of publicly listed corporations have boards dominated by independent directors.[12] In the UK the Higgs Review reported that in 2002 the average listed corporation had 2.7 executive directors and 3 non-executive directors in addition to a chairman.[13]

In addition to the changes in governance regimes the independent director has become increasingly important in investment decision-making. Perhaps because of the ease with which compliant and non-compliant corporations can be identified, the presence of independent directors has become a proxy for good corporate governance. One effect of this is that consumers and, importantly, investment professionals, are making decisions based on whether corporations have sufficient independent directors in place. The recent launch of a FTSE financial index[14] illustrates the current preoccupation with independent directors. This index is intended to provide international investors with more information upon which their investment decisions can be made. The index which scores corporations for their compliance with corporate governance requirements bases

[10] In Australia the requirement is incorporated into the Listing Rules by a 'comply or explain' mechanism effective from the 2004 Annual Report. In the UK the 'Combined Code' was incorporated into the Listing Rules in 1998. This required that at least 33% of directors be independent non-executive directors. A revised version of the Combined Code was made effective from November 1, 2003. These revisions took account of the Higgs Report Recommendations, which among other things strengthened the definition of independence and required that the largest companies had at least half of the board made up of independent directors. In the US the combined effect of changes to the NYSE Listing Rules and the *Sarbanes-Oxley Act 2002* means that all listed companies are required to have a majority of independent directors.

[11] J Psaros and M Seamer, *Horwarth 2004 Corporate Governance Report*, University of Newcastle (2004)

[12] See S. Bhagat and B. Black, 'The Non-Correlation Between Board Independence and Long-Term Firm Performance' (2002) 27 *Journal of Corporation Law* 231, 232.

[13] D. (Chair) Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, (2003)

[14] FTSE ISS Corporate Governance Index Series.

its ratings on 'the Five Global Themes of Corporate Governance'. Four of those themes relate to independent directors.[15]

A similar preoccupation can be seen in the 'Core Principles' of the California Public Employees' Retirement System (CalPERS). This fund has long been an active and influential player in the corporate governance debate. CalPERS asserts that '[i]ndependence is the cornerstone of accountability'.[16] Thus the first of its core principles, which are intended to provide a 'foundation' for good corporate governance, is that a 'substantial majority' of the board be independent.

In a parallel development, within corporations there is an understanding that compliance with corporate governance principles can add significant value to a corporation which goes above and beyond the inherent benefits of good corporate governance. A recent Australian report from KPMG highlighted the increase in share value in the oil and gas industry that can be achieved through improvements in governance.[17] They recommended that the corporation review the 'nature and design of control' within the corporation to allow management to understand and improve processes.[18] The improvements can provide share market and joint venture partner confidence in relation to very complex and demanding transactions.

In the Australian context many reports and inquiries into our large companies focus on the corporation's compliance or otherwise with the widely accepted principle that they should have a majority of independent directors.[19] These

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[15] These themes are 'Compensation systems for Executive and Non-executive Directors, Executive and Non-executive Stock ownership, Structure and Independence of the board, Independence and Integrity of the Audit Process'. The only other 'theme' is equity ownership.
[16] See the 'Core Principles' available at http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200603/item08c-01.pdf (accessed 16/8/06).
[17] KPMG, 'Can Governance Initiatives Deliver Value to the Oil and Gas Industry?' APPEA Journal 2005, 213.
[18] Ibid at p.215
[19] See, for example, the Horwarth Report, see above note 11.

reports have implications for the reputation of the corporation and consequently the share price it can attract. Interestingly, the FTSE's research indicates that those within the investment community expect that consideration of corporate governance issues by investors will increase over the next two years.

It is clear from the above that the reforms which promote the numbers and position of the independent director are increasingly important both within the corporate sector as well as in the minds of investors. Obviously this heightens the need for evaluation of their impact.

Content of the Reforms

In Australia the major changes were born out of efforts to improve corporate governance after the excesses of the 1980s. A number of industry initiatives led to the Bosch Report.[20] This recommended that corporate boards have a majority of non-executive directors, with at least one third being independent, a separation of the role of chairman and CEO and a majority independent audit committee. While this report began to set the scene for changes to the composition of Australian corporate boards it provided a weak definition of independence. The committee suggested that independence be defined with reference to the NED's current relationships except in relation to retired executives. Thus a person who had recently (but not currently) enjoyed a business relationship with the corporation could be classified as independent.

The ASX initially proposed a mandatory rule that listed companies have audit, compensation and nomination committees that were majority independent.[21] This proposal had a hostile reception and the ASX then focused on a 'comply or explain' regime.[22] The ASX cited industry's failure to respond to the Bosch

[20] Working group on Corporate Practices and Conduct (chaired by Henry Bosch), Corporate Practices and Conduct (1991). This included an early statement of Principles for directors and a recommendation that a board contain a majority of independent directors.
[21] ASX, Exposure Draft—proposed listing rule amendments and other Issues (October 1992)
[22] H. Bird, 'The Rise and Fall of the Independent Director' (1995) 5 *Australian Journal of Corporate Law* 9.

Report as a reason for adopting Listing Rule 4.10, which largely followed the recommendations of the Bosch Committee and required listed corporations to disclose their compliance.

A spate of corporate failures in Australia and overseas in 2001 heightened the demand for corporate governance reform.[23] The ASX convened the Corporate Governance Council in August 2002 to provide a practical guide to all parties involved in corporate governance. The result was further development of its earlier 'comply or explain' regime. Its report, *Principles of Good Governance and Best Practice Recommendations,* was released in March 2003. Again listed corporations must either comply with these or explain their reasons for non-compliance.[24] The focus of this document is on the general governance structure and the way that structure works is largely left to the individual corporation. So it states that the board should have a majority of independent directors but not what those directors should do (although the corporation should 'formalise and disclose' the functions of the board).[25] There should be a majority independent audit committee,[26] a nomination committee[27] and a remuneration committee.[28] Independence is defined but again the corporation is left to flesh out some of the detail. A non-executive director will be independent unless a substantial shareholder or they have been an executive, professional advisor or consultant to the corporation in the last three years. Business relationships will only preclude independence if they are 'material', a term that the corporation should define, or they 'materially interfere with, or could reasonably be perceived to interfere with, the director's ability to act in the best interests of the corporation.'[29]

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[23] For example, Enron --December 2001, World.Com,-- June 2002, HIH—March 2001, One.Tel-May 2001, Ansett-- September 2001.
[24] Listing rule 4.10
[25] Recommendations 1.1 and 2.1
[26] Recommendation 4.3
[27] Recommendation 2.4
[28] Recommendation 9.2
[29] Australian Stock Exchange's Corporate Governance Council, *Principles of Good Governance and Best Practice Recommendations*, Box 2.1, p. 23.

Interestingly, a recent survey of all Australian listed corporations has revealed that most corporations (83%) are complying with the disclosure requirements by either revealing that they have a majority of independent directors or explaining their non-compliance.[30] However, the numbers adopting the recommendation, that they have a majority of independent directors, remains quite low (36% down from 38% in 2004). The reasons cited for non compliance include size of corporation and need for specialist knowledge in non-executive directors.

The UK has arrived at a similar point in a similar way. As in Australia the reforms which prioritise the non-executive director have occurred without legislative change. They derive from a number of industry-generated reports which have gradually increased the number of independent directors required on corporate boards and improved the structures which attempt to make them effective.[31] These reports led to the development of the *Combined Code* which was incorporated into the London Stock Exchange Listing Rules in 1998. The Higgs Report recommended an increase in the number of NEDs required from 33% to a majority and these changes were included in the Code adopted in November, 2003. Corporations must comply with the code or explain their non-compliance.

In the US the legislative response to a series of corporate failures was contained in the *Sarbanes-Oxley Act* enacted in July 2002. Its focus is on financial reporting and audit independence, however, it does require that all audit committees of listed corporations contain only independent directors.[32] Independent directors may not accept any 'consulting, advisory or other compensatory fees' other than their fees for sitting on the board or the

[30] ASX, *2005 Analysis of Corporate Governance Practice Disclosure*, (2006) accessed at http://www.asx.com.au/supervision/pdf/2005_analysis_cg_practice_disclosure.pdf (19/08/06).
[31] Sir A. Cadbury, *The Financial Aspects of Corporate Governance*, Gee and Co Ltd (1992) ; Hampel, Final Report of the Committee on Corporate Governance, Gee Publishing (1998) ; S. Young, 'The Increasing Use of Non-Executive Directors: Its Impact on UK Board Structure and Governance Arrangements' (2000) 27(9) *Journal of Business Finance & Accounting* 1311; D. (Chair) Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, (2003)
[32] Sec. 301 *Sarbanes-Oxley Act 2002*

committees.[33] In addition, independent directors who are committee members may not be 'affiliated' persons.[34] This provision is intended to prevent those who control management of the corporation or any of its subsidiaries, by either voting power or contract, from sitting on the audit committee. The audit committee must contain at least one member with financial expertise.[35] Restrictions are placed on repeated sales of shares by directors and officers and on loans to directors as well as increased reporting requirements to reduce insider-dealing by directors.[36] In addition independent directors are required under the Act to meet without management being present.[37]

In June 2002 the SEC, a federal government regulator, indicated it would be seeking to reform current independence requirements for corporate boards. The SEC also indicated that independent directors should meet regularly without management. [38] The New York Stock Exchange New Listing Rules were adopted in August 2002, in line with the SEC proposal, to require that boards have a majority of independent directors.[39] Independence is defined to exclude those with financial or other material relationships with the corporation.[40] In addition, former employees, auditors, those with directorships of associated corporations or any of their family members cannot be seen as independent until the expiration of a five year cooling off period. The Rules also require that the audit, compensation and nomination committees be staffed exclusively by

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[33] Sec 301, *Sarbanes-Oxley Act 2002*, Rule 10A-3 Exchange Act, Securities Exchange Commission, Final Rule, April 2003, Release nos. 33-8220: 34-47654: IC-26001: File no. S7-02-03. The fees include fees paid directly or indirectly, eg, to a spouse, to a business with which the director has a connection.

[34] Sec 301, *Sarbanes-Oxley Act 2002*, Rule 10A(m)(3)(B)(ii) Exchange Act, Securities Exchange Commission, Final Rule, April 2003, Release nos. 33-8220: 34-47654: IC-26001: File no. S7-02-03.

[35] Sec 407, *Sarbanes-Oxley Act 2002*.

[36] Sec 304, 305,306, 402(a), 403, *Sarbanes-Oxley Act 2002*.

[37] Sec 303A, *Sarbanes-Oxley Act 2002*.

[38] Sec. Ex. Act Rel. 46,120, 77 SEC Dock. 2833 (2002) (proposal)

[39] P. von Nessen, 'Corporate governance in Australia: Converging with International Developments' (2003) 15 *Australian Journal of Corporate Law* 7.

[40] The board of directors of each listed company is responsible for determining whether directors have a 'material relationship' which precludes independence.

independent directors and that independent directors meet regularly without management.

Techniques for Implementing Reform

It is clear from these events that the independent director has become the key to reforms which attempt to remedy problems of corporate governance. One of the interesting aspects of these reforms is the way they have been implemented. While the reforms in the UK and Australia have an indirect connection with the state, the connection is an important one. The reforms can be seen as part of a general movement to employ alternative modes of regulation that can avoid some of the perceived pitfalls with traditional 'command and control' regulation.

Regulatory theory tells us that the state is only one actor of many in the regulatory space. This has two consequences. Firstly, there are a number of additional techniques for regulation that are available to these non-state actors that would not necessarily be available to the state. Further, it means that the state has a role both in shaping state regulation but also in enrolling and influencing regulation from other actors. One impetus for the consideration of regulatory theory has been recognition of the limitations of traditional command and control regulation.

The dissatisfaction with command and control regulation is often cited as a reason for the current preoccupation with regulatory theory. The political environment which allowed other regulatory mechanisms to be explored was provided by the Thatcher and Reagan governments with their preference for deregulation and small government. Ironically this preference led to an expansion in regulation though much of the expansion occurred outside the government sector. In large part the alternatives to command and control were explored through the use of differing techniques of regulation to control newly-privatized government entities.

The reason for these changes was a general acceptance that command and control regulation had significant problems. The major problems attributed to command and control are:

- Lack of expertise: This criticism is based on the role of the state which operates at a distance from those who are to be regulated and therefore suffers from a lack of expertise and/or information.
- Cost: The argument on costs is that the process of creating command and control regulation is costly and the cost rests unfairly on the taxpayer. In addition the rigidity and ineptness of the regulation imposes unnecessary costs on the regulated.
- Difficulty in framing rules: CAC regulation is subject to difficulties associated with drafting rules in such a way that they catch unacceptable behaviour without preventing harmless behaviour. Attempts to avoid over-inclusiveness may lead to complexity.[41]
- Creative compliance: The tendency for CAC to encounter hostility amongst those regulated encourages creative compliance where the regulated exploit gaps in the law to avoid true compliance.[42]
- Problems of enforcement: CAC, as a rule-based system, is particularly vulnerable to problems of enforcement.[43]
- Capture: This refers to the tendency of the state to align itself with the regulated and therefore fail to regulate them sufficiently.[44]
- Rigidity: The complexities of the law-making process mean that CAC regulation cannot respond quickly to specific issues.

In the context of corporate governance CAC is particularly problematic. The need for corporate regulation to straddle the uncomfortable gulf between control

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[41] R. Baldwin, 'Regulation after Command and Control' in K Hawkins (ed) *The Human Face of Law* (Clarendon Press, Oxford, 1997) p. 67.
[42] D. McBarnet and C. Whelan, 'Creative Compliance and The Defeat of Legal Control: The Magic of the Orphan Subsidiary' in K Hawkins (ed) *The Human Face of Law: Essays in Honour of Donald Harris* (OUP, Oxford, 1997) p.177.
[43] R. Baldwin, 'Regulation after Command and Control' in K Hawkins (ed) *The Human Face of Law* (Clarendon Press, Oxford, 1997) p.67.
[44] Ibid. p.66.

and risk means that regulation in this area requires both exquisite targeting and great responsiveness.[45] The complexity of the task is heightened by the diversity in type, goal and activities between corporations. The economic power of the large corporation may mean it is eminently able to capture both lawmakers and regulators. The tendency for corporate regulation to be implemented in the wake of a corporate scandal or failure exacerbates these problems.[46]

However, the state can sometimes enlist a number of alternative techniques which avoid a number of the problems with command and control. One of the techniques which can operate alongside existing CAC regulation is self-regulation. This term has been used to cover a range of possibilities.[47] For some self-regulation is regulation without state involvement. For others it is voluntary codes developed by industry groups. It is also used to describe rules and practices within corporations. Or those codes which are developed and implemented with some state involvement.

We can consider self-regulation as occurring on a spectrum with no state involvement at one end and extensive state control at the other.[48] Black, in her definitional article on regulation, divides self-regulation into four different types:

> *Mandated* self-regulation, in which a collective group is required or designated by the government to formulate and enforce norms within a broad framework set by government; *sanctioned* self-regulation, in which the collective group formulates rules which are then approved by government; *coerced* self-regulation, in which the industry formulates and imposes regulation but only in response to the threat of statutory regulation…and *voluntary* self-regulation, where there is no government involvement, direct or indirect, in promoting or mandating regulation.[49]

The place of the regulation within this spectrum will determine how closely aligned it is to the state. It could be argued that the closer the regulation to the

[45] An interesting discussion of this tension in the context of board composition can be found in B. Cheffins, *Company Law: Structure, and Operation* (Clarendon Press, Oxford, 1997) pp.602-652.
[46] A. Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing, Oxford, 2004) p. 56.
[47] Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World' (2001) 54 *Current Legal Problems* 103.
[48] A. Ogus, 'Rethinking Self-Regulation' in R Baldwin, C Scott and C Hood (eds), *A Reader on Regulation* (OUP, Oxford, 1998) p.376.
[49] Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World' (2001) 54 *Current Legal Problems* 103, p.118.

state the more likely it is to have problems similar to those attributed to CAC regulation.

Self-regulation is suggested as it can respond with greater cost-effectiveness, flexibility and competence to regulatory problems. As it operates outside the state it is less subject to problems of lack of expertise and knowledge. Ultimately it is seen as more effective. Critics of self-regulation point out that it may enable private interests to determine and control the extent and character of regulation.[50] It is also clear that self-regulation fails to comply with measures commonly used to evaluate law; it lacks democratic legitimacy, fails to adhere to the separation of powers and its creators may lack transparency and accountability.[51] In addition some of the problems which are raised in the context of CAC regulation may also be relevant in relation to self-regulation. So problems of enforcement may arise in both cases.[52]

The Hand of the State

Before the reforms which have emphasised the independent director were implemented there were still a significant proportion of independent directors on corporate boards. The appointment of these directors had become a voluntary informal practice adopted by corporate management. The reforms have to some extent formalised that process and shifted it from the category of internal regulation to external regulation.[53] So the appointment of directors has transformed a completely informal and voluntary practice into a semi-formal practice which is required by an external body in the absence of an explanation. The reasons for this shift can only be understood in the context of the rash of

[50] A. Ogus, 'Rethinking Self-Regulation' in R Baldwin, C Scott and C Hood (eds), *A Reader on Regulation* (OUP, Oxford, 1998) p.375.
[51] Dimity Kingsford Smith, 'Beyond the Rule of Law? Decentred Regulation in Online Investing' (2004) 26(3 and 4) *Law & Policy* 439.
[52] R. Baldwin, 'Regulation after Command and Control' in K Hawkins (ed) *The Human Face of Law* (Clarendon Press, Oxford, 1997) p. 80.
[53] I. Ramsey and G. Stapledon, 'Institutional Investors, Corporate Governance and the New Financial Architecture' in I Ramsey (ed) *Key Developments in Corporate Law and Trust Law* (Butterworths, Sydney, 2002) 73. p.80 classify corporate governance mechanisms as instituted by shareholders, internal or external.

corporate failures which shook faith in the operating governance regimes. Not only did there need to be a high proportion of independents but these directors needed to be seen as more effective than their predecessors and the change needed to be seen as a response to the perception of corporate governance problems. By taking steps to formalise an already common practice the ASX was able to satisfy public concern and stave off more interventionalist regulation from government.

At first glance the reforms in the UK and Australia which have focused on board composition and governance structure seem to have occurred at arms' length from the government. The hand of the state is much clearer in the more mandatory US reforms. However, even in the UK and Australia, there are some indications that the state was involved in a subtle yet important way.

In Australia the changes are implemented in large part through Principles attached to the ASX Listing Rules.[54] The Principles were developed by the Corporate Governance Council which was convened and chaired by the ASX and dominated by representatives from various industry and advisor bodies.[55] Therefore the Principles appear to satisfy the definition of self-regulation as their content was determined largely by industry. However the Listing Rules which give force to the Principles are clearly '*sanctioned* self-regulation'.[56] They are included in the *Corporations Act 2001* definition of the 'operating rules of the market'.[57] In addition the Act provides for a process whereby changes to the listing rules are submitted to both ASIC and the Minister for approval.[58] Presumably this means that at least the changes to the Listing Rules which

[54] The exception to this is the requirement that a corporation have an audit committee, ASX Listing Rule 12.7, which is mandatory. The ASX top 300 must have an audit committee which complies with the requirements of ASX principle 4 in the Corporate Governance Council's Principles of Good Corporate Governance (the Principles).
[55] The representatives include three from investor groups, eleven from the industry and six representing the various professional advisors to industry, ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, ASX (2003)
[56] See text accompanying footnote 49.
[57] s. 761A *Corporations Act* 2001(Cth).
[58] s. 793D and s.793E *Corporations Act* 2001(Cth).

required disclosure of compliance or otherwise with the Principles and the provisions about audit committees must have received ministerial consent.

The changes also take on the flavour of '*coerced* self-regulation' as they were developed in the shadow of the threat of legislative intervention.[59] The traditional tensions which underlie most corporate regulation have also leached into the political sphere where governments may find that their ability to respond to problems of corporate governance is limited by their platform. A commitment to policies which promote economic freedoms and enterprise is unlikely to lead to tough CAC regulation in the area of corporate governance. A more overt intervention in the affairs of corporations would have been politically problematic in the Australian context. However, the government has made it clear that where the market fails to regulate itself it is prepared to step in and legislate.

> More specifically, the Government has taken the view that legislation is appropriate where it delineates broad parameters for the conduct of business, removes uncertainty in the operation of the law, and clarifies the rights, duties and responsibilities of stakeholders. Beyond this, however, the Government has been reluctant to legislate without evidence of a clear failure of market-based incentives or sanctions to produce appropriate outcomes.[60]

It is clear that while 'in formal terms the rules are those of the exchanges, in political terms they are those desired by the government'.[61]

In addition to its role in the content and implementation of the reforms the state also has a role in enforcement. While the ASX has the primary role as enforcer of the listing rules it also has obligations under the Act to report any significant breaches of the Listing Rules to ASIC which in turn can implement civil or criminal prosecutions.[62] In addition to this ASIC monitors the ASX's conduct when exercising its supervisory and enforcement functions. In its most recent

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[59] See Leo D'Angelo Fisher, 'The Not Quite Final Word on Corporate Governance', *Australian Business Report* at http://www.fleishman.com.au/abr/apr03/corpgov.html (accessed 26/8/05).
[60] Discussion Paper, CLERP Paper No. 9: Proposals for Reform - Corporate Disclosure, Department of Treasury (2002) Ch. 1.
[61] Dimity Kingsford Smith, 'If Not, Why Not? Hybrid Approaches to Corporate Governance Standards' Manuscript on file with author, p.31; Robert B. Thompson, 'Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation' (2003) 38(3) Wake Forest Law Review 961.
[62] s. 792B and s. 821B *Corporations Act 2001*(Cth).

annual assessment report for the ASX ASIC is critical of the lack of consistency in the ASX monitoring of the disclosure provisions in the Listing Rules.[63]

The UK approach also operates through a code annexed to the listing rules. While the code was initially developed by a series of committees considering corporate governance issues the committees were convened by government and the code they developed was implemented by the Financial Standards Authority in its capacity as the United Kingdom Listing Authority.[64]

The hand of the state is also clear in the US reforms. There 'the federal government has taken a much more direct role in corporate governance'.[65] The process is described by Thompson:

> The SEC chair makes a speech or otherwise calls on the exchanges to do something regarding corporate governance, and the NYSE and others appoint a blue ribbon commission to recommend changes. The exchange's proposal is vetted and negotiated with the SEC staff. Those in corporate America concerned about the rules lobby the NYSE, the SEC, or usually both. What results is a new requirement for corporate governance that comes not from state law and not from federal law, but from the SRO with a strong push from the federal regulator.[66]

So the reforms have allowed the federal regulator to apply political pressure to a self-regulatory body, the NYSE, in order to have them implement policy objectives. When read together with the legislation these reforms are closer to the state and therefore less decentred than those implemented in both Australia and the UK.

Character of the Reforms

Another aspect of the reforms which places it within the spectrum of self-regulatory techniques is the way they are drafted. Not only are the reforms contained within *Principles* attached to the Listing Rules which expressly permit

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[63] ASIC, Annual Assessment (s.794C) Report, (2005) available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASX_report_June_2005.pdf/$file/ASX_report_June_2005.pdf (accessed 26/8/05).
[64] Philip Goldenberg, 'Reforming Corporate Governance--A Very British Solution' (2003) 24(4) *Business Law Review* 82.
[65] Robert B. Thompson, 'Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation' (2003) 38(3) *Wake Forest Law Review* 961, 962.
[66] Ibid., p. 981.

corporations to either ‘comply or explain’ their language also permits considerable discretion. The language used is evidence of a ‘broad, open approach’.[67] This choice has been made to discourage a box ticking approach and encourage compliance with the policy behind the *Principles*. So the *Principles* mention the need for ‘independent judgement’ and recommend that this be achieved through a majority of independent directors.[68] Independence can be determined according to some characteristics listed but the corporation can also decide that their director is sufficiently independent notwithstanding a failure to measure up to the definition in the *Principles*. This is an attempt to avoid the pitfalls of creative compliance and complexity that are associated with CAC regulation.

It is possible that the fact the government intervened in an area not traditionally seen as within its purview may have contributed to the limited nature of the reforms. The reforms are a somewhat tentative response to corporate governance problems in that they only ensure corporations consider and disclose whether their directors comply with a formal definition of independence. If the aim of the reforms is that there are more formally independent directors, the regulation relies on market and/or governmental pressure for its effectiveness. This has the advantage of ensuring the government can point to a visible change in corporate governance whilst maintaining a claim to a hands-off approach.

Whether the reforms are able to deliver substantive independence is open to question. Two areas of concern spring to mind. Firstly, the definition of independence may not be able to provide the ‘independence of mind’ that Higgs identified as critical.[69] The checklist for formal independence can only increase

[67] D. McBarnet and C. Whelan, 'The Elusive Spirit of the Law; Formalism and the Struggle for Legal Control' (1991) 54(6) *The Modern Law Review* 848, 849.
[68] Principle 2 and Recommendations, ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, ASX (2003)
[69] D. (Chair) Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, (2003)

the likelihood that there is substantive independence.[70] Indeed, many have commented that the definition itself is inadequate. So the difficulty of defining independence to prevent directors with strong social connections being characterised as independent is suggested as a flaw.[71] In addition the way corporations can define certain terms has been seen as a problem in the Australian context.[72]

Secondly, the reforms, with their concentration on a formal definition of independence fail to tackle a number of more complex and more critical issues. Even where they do provide substantive independence, the dynamics and culture of the corporation may mean that this characteristic is not useful once directors are on the board. There may be reasons why even the most active and independent director cannot monitor effectively. The reasons include insufficient time, lack of knowledge/expertise and poor incentives.[73] So, for example, management retains its control over information[74] and an unscrupulous management can use this power to control the independent directors.[75]

There is also a body of work which suggests that the independent director will become co-opted by management. This perception is often put forward by those with expertise in small group psychology. Their view is that the influence of management and processes such as groupthink and inner circles will limit the

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[70] Donald C. Clarke, 'Setting the Record Straight: Three Concepts of the Independent Director' (2006) *SSRN*, 28. See also Mason A Carpenter and James D. Westphal, 'The Strategic Context of External Network Ties: Examining the impact of Director Appointments on Boards Involvement in Strategic Decision making' (2001) 44(4) *Academy of Management Journal* 639.
[71] V. Brudney, 'The Independent Director--Heavenly City or Potemkin Village' (1982) 95 *Harvard Law Review* 597.
[72] For example, when considering independence Australian listed corporations can determine if a material connection between a director and the corporation precludes independence. Corporations have taken a liberal line on this with one corporation stating that contracts as a customer or supplier only preclude independence where they exceed $ AUS 100 million. See Horwath, *Corporate Governance Report*, University of Newcastle (2004) p.44
[73] Donald C. Clarke, 'Setting the Record Straight: Three Concepts of the Independent Director' (2006) *SSRN*, 16.
[74] M.J. Nowak and M. McCabe, 'Information Costs and the Role of the Independent Director' (2003) 11(4) *Corporate Governance* 300.
[75] For a description of this process, see the analysis of the HIH collapse in Kamel Mellahi, 'The Dynamics of Boards of Directors in Failing Organizations' (2005) 38 *Long Range Planning* 261.

independent director's capacity to intervene to prevent management misfeasance.[76] So notwithstanding initial compliance with formal independence requirements independence of mind will be gradually lost as a result of the connections with management.

As with the embedded journalist, the independent director must balance two competing public interests and this tension flows through to the conceptions of the role of the independent director. A consideration of the motivations behind the reforms reveals this conflict. The reforms have focussed on increasing the number and independence of the non-executive directors. This suggests that there is a concentration on improving the capacity of these directors to monitor management. The increased number of independent directors has the potential to shift the power balance from management to the independent directors. The independence requirement is intended to increase the likelihood that power is exercised to control management activity. Thus, the reforms appear to be a response to the contractarian concern with the agency problem. This problem arises where management acts in a self-interested or shirking fashion thus incurring agency costs which are passed onto shareholders.[77] This commitment is consistent with the public interest in promoting the economic success of the corporate sector. This means that the main task of the independent director is to monitor management activity and be prepared to step in where there is activity that is likely to reduce shareholder value.

The alternative public interest sees regulation as an opportunity to control the ability of corporations to impose costs on external parties. These theorists tend to prioritise alternate measures of corporate success than the purely economic. It is from this theory that ideas of corporate social responsibility have

[76] Donald C. Langevoort, 'The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability' (2001) 89(4) *Georgetown Law Journal* 797; Katherine Hall and Suzanne Le Mire, 'Independent Directors: Problem or Solution?' (2006) forthcoming *Monash Business Review*.
[77] O. Hart, 'Corporate Governance: Some Theories and Implications' (1995) 105 The Economic Journal 678, 678.

developed[78] and the constituency statutes in the US are a response to their concerns.[79] So those with alternative visions of the corporation have not had an interest in the increased power of the independent director.[80] Under this model the role of the independent director is to legitimate and control corporate power. The governmental influence, emphasis on public disclosure and the notion of a more democratic board have much to offer those who see the corporation as a '*social enterprise'* which gets its legitimacy from the social benefit of its activities.[81] . While economic concerns are important, ideals such as democracy are also a consideration. For these public interest theorists the independent director is seen as a mechanism to improve the democracy, legitimacy and deliberation of the corporate board. So the priority tasks would appear to be being an outside voice for non-shareholder constituencies and improving the decision-making process.

These differing public interests are difficult to reconcile.[82] The danger is that is that a lack of clarity in the goals may damage the independent director's ability to fulfil expectations. So the lack of consensus about the role may lead to confusion as to which of the tasks suggested for the independent director should attract the greatest time and attention. Should these perceptions be shared by management there may be a tendency to treat the independent directors as rubber stamps, hurdles to be overcome or even window dressing for the external audience rather than genuine contributors to the governance process.

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[78] The strength of this movement is considered in E. Scalise, 'The Code for Corporate Citizenship: States Should Amend Statutes Governing Corporations and Enable Corporations to be Good Citizens' (2005) 29 *Seattle University Law Review* 275.

[79] For a discussion of the efficacy of these see J. Springer, 'Corporate Constituency Statutes: Hollow Hopes and False Fears' (1999) *Annual Survey of American Law* 85.

[80] See, for example, L. Dallas, 'The New Managerialism and Diversity on Corporate Boards' (2002) 76 *Tulane Law Review* 1363.

[81] R. Dahl, 'A Prelude to Social Reform' (1972) 1 Business and Society Review 17, 17. The emphasis is in the original; John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, Oxford, 1993).

[82] But see J. Roberts, T. McNulty and P. Stiles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' (2005) 16 *British Journal of Management* S5.

The Effectiveness of the Reforms

The two main reasons for this reform were the need to enhance investor confidence and to improve board decisions. The initiative has achieved significant successes in relation to the first but has been less successful on the second front. Interestingly while the reforms have achieved strong support through investor groups it may be that doubt about the ability of the independent director to actually deliver substantive reform means that industry and academic support is a little more qualified. So in Australia the number of listed corporations complying with the recommendation in the Principles remains fairly low (36%) and has dropped two percent since last reporting year.[83] In academic circles attention has been given to whether or not independent directors are making the contribution expected of them. Much of this work has been critical. It seems likely that if there is a lack of progress in improving board decision-making this will gradually undermine the success that has been achieved in enhancing investor confidence. It is therefore important to consider whether the independent director's effectiveness as a corporate governance mechanism can be improved.

There is considerable reason to suggest that improvements to the way the independent director operates are worthwhile. The independent director is unique in that they are able to intervene in the management of the corporation in order to promote shareholder interests and prevent management misfeasance *at its conception*. Many of the mechanisms which attempt to improve corporate governance concentrate on improving structures within the corporation[84] or exposing corporate activities to scrutiny[85] or imposing liability on corporate

[83] ASX, *2005 Analysis of Corporate Governance Practice Disclosure*, (2006) p.7
[84] Some of the structural changes include dividing the role of chair and CEO, requiring audit, compensation and nomination committees.
[85] The disclosure regime is an attempt to provide information to shareholders which will enable them to make informed choices about their investments which will in turn apply pressure to corporate management.

actors.[86] These reforms have may value because they increase the pressure on corporate management. However, these processes are passive and they tend only to expose corporate misbehaviour after it has occurred or apportion liability after the event. One possible advantage of the independent director is that he/she can intervene before the wrongdoing occurs. The non-executive director who is truly independent, vigilant and resolute may be able to both monitor management and influence management conduct. Therefore the independent director, as an internal proximate monitor of management, is the only active corporate governance mechanism able to change the flow of events.

Despite these grounds for optimism there is significant empirical work scrutinising the existing corporate structure, with independent directors in place, to determine whether there is any measurable benefit. These empirical studies focus either on specified events, the occurrence of which may be different where independent directors exist, or the general performance of the corporation.

The studies that examine corporate performance are unable to demonstrate that an independent presence on the corporate board has any measurable effect on corporate performance.[87] The event studies show a weak correlation between board composition and certain events that indicate independents may be doing their job.[88] They are less positive when considering the prevalence of events which should be reduced where independents are active.[89]

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[86] Such as the provisions which impose liability on directors who trade while the corporation is insolvent, s588G *Corporations Act 2001*(Cth).
[87] B. Baysinger and H. Butler, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1985) 1 *Journal of Law Economics and Organisation* 101; L. Lin, 'The Effectiveness of Outside Directors as a Corporate Governance Mechanism' (1996) 90 *Northwestern University Law Review* 898.
[88] Rita D. Kosnik, 'Greenmail: A Study of Board Performance in Corporate Governance' (1987) 32 *Administrative Science Quarterly* 163.
[89]

If the reforms were successful we would expect to see a more positive results emerge here. There are a number of possible reasons why a negative picture dominates.

- Many of the studies focus on the ability of the independent director to reduce agency costs and this focus may conceal or divert attention from the other contributions that the independent director can make.
- The positive effect of the independent director may not be easy to measure. The tasks of the independent director, and the environment within which they operate, are complex and it is difficult to arrive at conclusions which adequately connect their activities to either events or performance. It is possible independent directors may be working effectively but their positive effect may not be readily apparent due to the many other mediating factors which reduce their impact. For example, if the board is effective but management inadequate any positive actions of the board may be washed out before they can influence overall corporate performance. Alternatively, if the board is effective and management competent but the business in a perilous state due to external factors again corporate performance is likely to be poor.
- While the idea of the independent director may hold considerable promise there may be reasons why the present conception of independent directors is inadequate. For example, the regulatory framework may mean that the independent director is unable to successfully carry out their tasks. Or the fact there is a lack of clarity about what these directors should do may reduce the likelihood that they perform effectively.
- The concept of the independent director may be fatally flawed.

When we consider the embedded journalist our concerns are not focussed on the threshold issue of formal qualifications of the journalist but on their ability to deliver balanced reporting within a military structure. With the independent director there has been a concentration on the independence characteristic with too little attention to the ability of the independent director to deliver once within the corporate structure. It is time to shift the emphasis to deliver reform which improves the output of corporate boards. This is likely to involve examination of the dynamics and processes that can maximise their contribution. At present we appear to ‘risk sacrificing actual effectiveness on the altar of reassuring appearances’.[90] Scholars have begun to focus on a more contextual analysis of the potential of the independent director and this may be part of the answer. Greater attention is being devoted to matters such as the ability of independents to work constructively with management in an environment of trust.[91] In addition the board process is subject to increasing scrutiny. Good information flow, sufficient input into board agendas and advice from external advisers may all play a role in increasing the effectiveness of the independent director. Without good dynamics on the board even the most independent director will be hamstrung.

Clearly this analysis reveals the need for more empirical research which identifies the contribution independent directors can make and how they can achieve their potential. It may be useful to focus on the many independent directors who are making a positive contribution and resolving these tensions in their activities.

The most critical question may yet be what do independent directors have to deliver to succeed. Given the contested visions of the corporation this question is not easily solved, however, without a clearly defined role the independent director operates, like the embedded journalist, in a combative arena where victory will be elusive. It may be, as suggested by Roberts, McNulty and Stiles,[92] that the independent director can perform monitoring and strategy functions at the same time, indeed that they will be more effective when they perform both.

[90] T. McNulty, J. Roberts and P. Stiles, 'Undertaking Governance Reform and Research: Further Reflections on the Higgs Review' (2005) 16 *British Journal of Management* S99, S100.
[91] J. Roberts, T. McNulty and P. Stiles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' Ibid.   S5.
[92] Ibid.

However, the challenge that this poses is increased by the lack of attention and clarity about how these tasks can be undertaken.