
9 Strengthening shareholder engagement

Key points

- Despite some initial scepticism and concern by business, introduction of a non-binding shareholder vote on the remuneration report appears to have fostered more productive engagement between shareholders and boards.
 - Many boards have proven sensitive to significant ‘no’ votes and have amended executive remuneration arrangements in anticipation or in response.
- However, there are cases where this appears not to have happened and there has been a more general rise in the average ‘no’ vote.
- A binding vote on the remuneration report or elements of it (such as the company’s remuneration policy or equity grants to executives) are options to strengthen shareholder powers. A binding vote, however, would pose significant practical difficulties and some risks.
- There are various options to strengthen the consequences of a significant ‘no’ vote, while maintaining the integrity of the non-binding vote.
 - Approaches include a requirement to provide a formal explanation of action taken in response or, in more extreme cases, for directors to stand for re-election.
- Allowing directors and key executives to participate in the non-binding vote on the remuneration report, whether directly or as proxy holders, serves to weaken its signalling role.
- The existing paper-based proxy voting system has a number of shortcomings, including the potential for ‘lost votes’. Electronic proxy voting and a more robust and auditable system would enhance the integrity of voting arrangements.
- There are some concerns associated with current proxy voting regulations, notably the practice of undirected proxies being voted by company chairs and the potential for ‘cherry picking’ of votes by non-chair proxies.

9.1 The non-binding vote in context

Shareholders in a company have the power to elect (and dismiss) the board, as well as to vote on matters where their interests could be compromised by directors acting

in their own interests or in a manner that could diminish shareholder wealth. Accordingly, shareholders are given binding votes on directors' fees, on equity issues to directors involving dilution and on large termination benefits (box 9.1).

These rights accord with the principle that shareholder voting is 'an accountability device of last resort to be used sparingly' (Bainbridge 2005, p. 27). In other words, voting is not intended to provide a means for shareholders to interfere in the operational aspects of the company. Consistent with this, while shareholders have had a vote on the company's remuneration report for several years, this was made 'advisory' only.

9.2 How effective *is* the non-binding vote?

The non-binding vote on the remuneration report was introduced in 2004-05 as part of the Corporate Law Economic Reform Program (CLERP) process. Commentary on the draft provisions of the Bill stated:

... it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives. In performing their function, boards need to be accountable for their decisions and shareholders need to be in a position to exercise their rights in an active and informed way. The provisions of the Bill are designed to achieve these objectives by promoting transparency ... (Treasury 2003, p. 101)

In particular, the non-binding vote was expected to 'facilitate more active involvement by shareholders and improve the accountability of directors for decisions regarding remuneration' (Treasury 2003, p. 105).

The legislation broadly followed arrangements introduced in the United Kingdom in 2002. A European Commission directive for voting on remuneration policy has led to mixed responses by member countries (box 9.2).

What effect has it had?

The non-binding vote provides shareholders with an opportunity to signal their support (or otherwise) for the remuneration policy of a company, and thereby influence board decision-making about remuneration policy and executive pay.

Box 9.1 Rules relating to shareholder voting

When do shareholders vote?

Non-binding vote on the remuneration report — shareholders have a (non-binding) vote on a company's remuneration report (*Corporations Act 2001* (Cwlth), s. 250R).

Election and removal of directors — a company may appoint a director by resolution passed at a general meeting (s. 201G). Where a person has been appointed by other directors, shareholders must confirm the appointment at the next annual general meeting (s. 201H). A group of 100 shareholders or shareholders with 5 per cent of the votes that may be cast on the resolution may propose a resolution to remove a director (s. 203D and s. 249N).

Increase in director fees — an entity must not increase the total pool of non-executive directors' fees without shareholder approval (listing rule 10.17).

Director obtaining equity under an incentive scheme — an entity must not permit a director (or associate) to acquire equity under an employee incentive scheme without shareholder approval, unless the shares are purchased on-market (listing rule 10.14).

Total termination benefits exceeding 5 per cent of a company's equity — a company must ensure that no officer receives termination benefits, if the value of those benefits and the benefits that may become payable to all other officers exceed 5 per cent of the company's equity, without shareholder approval (listing rule 10.19).

Termination payments above an income threshold — a director or key executive must not receive a termination benefit without shareholder approval, unless the payment is less than the average of their base pay over the past three years (s. 250B).

The voting process

Shareholders' voting rights are exercised at company general meetings. A general meeting may be called by a director of the company, shareholders with at least 5 per cent of votes that may be cast at the meeting, or 100 shareholders.

A resolution must be decided on a show of hands, unless a poll is demanded. A poll may be demanded by 5 members, or members with 5 per cent of votes. The chair can also demand a poll, and has a duty to determine the 'will of the meeting'.

Under a show of hands, each shareholder has one vote; however on a poll, a shareholder has one vote for every share owned.

Under a show of hands, the company is not required to disclose the number of shareholders voting for or against the resolution; however, this is a requirement when a resolution is decided by a poll. Regardless of whether a poll or show of hands decides the resolution, the direction of proxy votes received must be disclosed.

While generally all shareholders can vote on resolutions, there are exceptions, usually when there is a direct conflict of interest. For example, directors cannot vote on resolutions to approve their own termination benefits or equity incentive schemes.

Sources: ASX listing rules; *Corporations Act 2001* (Cwlth).

Box 9.2 Shareholder voting on remuneration in other countries

Since 2002, the **United Kingdom** has required an ex-post, advisory shareholder vote on director pay similar to that subsequently adopted in Australia (Ferri and Maber 2009).

In 2004, the **European Commission** recommended that member states require that remuneration policy be an explicit item on the annual general meeting agenda and a vote be required if requested by shareholders representing at least 25 per cent of votes at the meeting (European Commission 2005).

Responses by member states have varied: **The Netherlands** and **Sweden** have introduced a binding vote on remuneration *policy* only; in **Italy**, shareholder approval of remuneration policy is now required for banks. **Denmark** and **Portugal** require a declaration of remuneration policy to be submitted to shareholders at the annual general meeting, but shareholder approval is not required (Ferrarini et al. 2009).

In the **United States**, additional requirements were placed on recipients of Troubled Asset Relief Program assistance in February 2009, including a requirement for an advisory shareholder vote on executive remuneration. Further, the July 2009 white paper on financial regulatory reform included a commitment to introduce non-binding shareholder votes on packages for senior executive officers and on golden parachutes more generally (US Department of the Treasury 2009).

The notion of an advisory, rather than binding, vote has attracted a great deal of discussion. Some regard it as flawed precisely because it is not formally binding and therefore seen as having no teeth or necessary consequence. Others see it as the ‘thin edge of the wedge’ for shareholder usurpation of the role of the board, and its introduction was actively resisted at the time by major business representative bodies (box 9.3).

The case for a vote essentially rests on a view that boards might be ‘captured’ by executives in pay matters, or at least not be sufficiently ‘arm’s length’ from them. From this perspective, the non-binding vote, coupled with enhanced remuneration disclosure, provides a vehicle for shareholders to hold directors to account by indicating their collective view — and, if necessary, expressing ‘outrage’ — constraining through such signalling the scope for otherwise excessive remuneration packages, without unduly reducing board discretion in devising pay arrangements.

In the United Kingdom, available studies have not found evidence that introduction of the vote has led to a reduction in the growth of executive pay, although there has been an increase in performance pay relative to fixed pay. One study suggests that this increase was more pronounced in companies that experienced substantial ‘no’ votes, particularly those with high remuneration levels prior to the vote’s

introduction (Ferri and Maber 2009). The authors conclude that this is consistent with boards having responded to the shareholder vote.

Box 9.3 Business groups were opposed to a non-binding vote

The Australian Institute of Company Directors and the Business Council of Australia expressed opposition to the introduction of the non-binding vote on the following grounds:

Proposing a shareholder vote on the remuneration report is tantamount to suggesting that decisions regarding the remuneration of executive management are a shared responsibility between board and the shareholders. Good corporate governance requires that boards take sole responsibility for their remuneration decisions. Shareholders, if they are unhappy with the board's performance, have the right to make their views known at the [annual general meeting] and to cast their votes against the re-election of the relevant directors ... The introduction of an 'advisory vote' ... will set a precedent for shareholder votes on other matters that are properly the province of boards ... (AICD 2003, pp. 23–4)

The Business Council does not ... support the proposal for a non-binding vote on executive remuneration. The proposal is unnecessary and infringes the basic principle that *'it is generally the function of members to approve the remuneration of directors and the function of directors to determine the remuneration of executives'*. (BCA 2003, p. 12)

Likewise for Australia, although it is difficult to ascribe movements in the rate of growth of executive remuneration to the non-binding vote alone, the period since its introduction has coincided with much greater use of performance-related pay and the adoption of more demanding performance hurdles such as relative total shareholder return, both of which have been strongly advocated by investor groups.

Many participants in this inquiry considered that the non-binding vote had encouraged increased engagement of companies with (mainly institutional) shareholders, and that boards are sensitive to votes against the remuneration report (box 9.4).

CGI Glass Lewis and Guerdon Associates commented:

... directors of listed entities are highly sensitive not just to a report that is 'voted down' (by a majority vote against the report, which is very rare) but also to a significant 'protest' vote against the report (by even a quite small percentage of votes).

The reason for this sensitivity is twofold. The first is a reputational issue; directors of listed entities are very sensitive to their reputations in the public domain ... The second is the prospect that a potential further consequence of sufficient disapproval of a remuneration report is a binding vote against the re-election of the director ... (sub. 80, p. 14)

Box 9.4 Impact of the non-binding vote — views from submissions

CGI Glass Lewis and Guerdon Associates stated that they had:

... experienced a significant increase in dialogue instigated by [non-executive directors] on remuneration issues since the non-binding vote was introduced. ... ten years ago engagement by listed entities with their key institutional shareholders was minimal. (sub. 80, p. 66)

Similarly, the Australian Council of Super Investors observed:

... the introduction of a non-binding shareholder vote ... has been the single biggest catalyst for improved levels of engagement ... (sub. 71, p. 12)

Mercer noted that the vote had increased accountability and transparency:

The non-binding vote ... has allowed shareholders to express their views ... and we believe has provided a higher level of accountability and transparency that has moved boards to look to better align remuneration practices ... (sub. 41, p. 10)

BHP Billiton felt that the non-binding nature of the vote:

... appears not to have limited the vote's effectiveness ... there is no shortage of examples of Australian companies that have responded to a substantial 'Against' vote, by making changes to their remuneration practices. (sub. 45, p. 1)

While remuneration reports of larger listed companies typically receive overwhelming support, the 'no' vote has been rising over time on average, particularly since the Global Financial Crisis.

- CGI Glass Lewis and Guerdon Associates noted that 'the average level in a consistent sample of 'against' votes has almost doubled from 6 per cent to 10 per cent between 2006 and 2008' (sub. 80, p. 65).
- PricewaterhouseCoopers observed that the number of ASX100 companies receiving a 'no' vote greater than 20 per cent had risen from 3 per cent in 2006 to 12 per cent in 2008 (sub. 85, p. 15).

The most recent annual reporting season has brought a larger number of instances of companies receiving significant 'no' votes on their remuneration reports (table 9.1). Among the more significant:

- Transurban narrowly avoided having a majority 'no' vote on its remuneration report in 2009 (47 per cent 'no' vote), with shareholders citing poor long-term incentive hurdles, excessive sign-on bonuses for the new chief executive officer (CEO) and no disclosure of short-term incentive hurdles as reasons for voting against the report (Speedy 2009). This followed rejection of its 2008 remuneration report by shareholders (59 per cent 'no' vote) due to concern over the size of its CEO's remuneration package despite poor company performance

and the lack of disclosure of short-term incentive hurdles (CGI Glass Lewis and Guerdon Associates, sub. 80, p. 131)

- Qantas received large ‘no’ votes in both 2008 and 2009 (41 and 43 per cent respectively), apparently in response to the size of its CEO’s remuneration package. In 2008, the total package was \$12 million. On his retirement the following year, the CEO received \$11 million for nine months with the company, including a payout of \$3 million to compensate for changes in superannuation tax laws (O’Sullivan 2009).

Table 9.1 Substantial ‘no’ votes on remuneration reports, 2009

<i>Company</i>	<i>No vote</i>	<i>Index</i>
Abacus Property Group	31%	ASX200
Aspen Group	48%	ASX300
Avoca Resources	26%	ASX200
Babcock and Brown Infrastructure	32%	ASX200
Bendigo and Adelaide Bank	32%	ASX100
Cabcharge	45%	ASX200
Challenger Financial	29%	ASX200
Clough	36%	ASX300
Crane Group	43%	ASX200
Dominion Mining	37%	ASX200
Downer EDI	59%	ASX100
Energy Developments	60%	ASX300
Kingsgate	52% ^a	ASX200
Lend Lease	42%	ASX100
Macmahon Holding	28%	ASX200
Nexus Energy	27%	ASX200
Novogen	81%	ASX300
NRW Holdings	53%	ASX300
Qantas	43%	ASX50
Ramsay Health Care	32%	ASX200
Riversdale Mining	25%	ASX200
Sims Metal Management	29%	ASX100
St Barbara	58%	ASX200
Straits Resources	48%	ASX200
Transurban	47%	ASX50
United Group	49%	ASX100
Western Areas	56%	ASX200

^a Carried on a show of hands.

Source: Company announcements.

Chartered Secretaries Australia (CSA) conducted a survey in 2005 of company secretaries in the top 200 Australian companies (CSA 2005). On the question of *when* directors should take notice of shareholder concerns, around 90 per cent of

respondents considered that a 20 per cent ‘no’ vote should prompt a response from the board. Only 1 per cent of respondents felt that a majority ‘no’ vote was required before boards should react.

There have been numerous examples of remuneration arrangements being amended in response to minority as well as majority ‘no’ votes. For example:

- Following its annual report in February 2009, QBE Insurance made changes to its remuneration plans after 23.5 per cent of shareholders voted against its remuneration report (Johnston 2009).
- In 2007, Telstra received a majority vote (66 per cent) against its remuneration report. At the time, the head of Telstra’s remuneration committee suggested proxy groups had no expertise in remuneration practices, and that Telstra could not renege on contracts, and therefore the 2007 arrangements went ahead as proposed (Alberici 2007). However, Telstra engaged with its shareholders and changed its remuneration practices by the 2008 remuneration report, which received resounding approval (SBS 2009).
- According to Wesfarmers (which received a ‘no’ vote of 51 per cent against its 2008 report): ‘Wesfarmers has taken the ‘no’ vote seriously and is addressing a number of the issues that were subject to criticism ...’ (sub. 65, p. 2). Wesfarmers received strong shareholder approval on its 2009 remuneration report, with 90 per cent of shares voted in favour of the report.
- In 2008, Boral received a majority vote (58 per cent) against its remuneration report. Shareholders were apparently concerned that the CEO’s remuneration was targeted at the upper half of Boral’s peer group, despite Boral being one of the smallest companies in the group, and that there had been an increase in bonuses despite poor profitability. In 2009, no short-term incentives were granted and Boral ‘explained, in its 2008-09 Remuneration Report, the fundamental review undertaken by the Board and the Remuneration Committee of Boral’s remuneration practices and policies and set out in detail the steps taken to address shareholder concerns’ (sub. DD123, p. 1). Boral’s 2008-09 remuneration report received a 93 per cent approval vote.
- Suncorp-Metway’s 2008 remuneration report received a 32 per cent ‘no’ vote, largely due to high bonuses and pay rises to senior executives despite poor company performance (Walsh 2008). In 2009, Suncorp-Metway did not pay any short-term incentives and froze base pay for both directors and senior executives, which resulted in 96 per cent approval of the remuneration report.
- Following a 43 per cent ‘no’ vote in 2008, Toll restructured its remuneration arrangements, including freezing base pay and moving towards annual

shareholder approval for the CEO's long-term incentive (ABC 2009). The 2009 report received 85 per cent approval.

Many of those business groups which were initially sceptical of the vote now concede that it has been an effective vehicle for improving engagement between companies and shareholders (for example, the Australian Bankers' Association, BHP Billiton, Wesfarmers and Macquarie Group). This assessment is shared by institutional and retail investors (the Australian Council of Super Investors (ACSI) and Australian Shareholders' Association (ASA)), and remuneration consultants and proxy advisers (CGI Glass Lewis, Guerdon Associates, Mercer and Hay Group).

It is recognised, however, that there may have been some costs, including greater pressure on companies to implement pay structures that meet rules of thumb — such as one-third base pay, one-third short-term incentives, one-third long-term incentives, or incentives that are linked to relative total shareholder returns. As discussed in chapter 7, there are risks in 'tick-the-box' approaches that can serve to standardise executive pay arrangements across different companies. That said, boards can reduce such pressures by explaining more clearly how arrangements will promote company and ultimately shareholder interests.

Yet while companies generally respond to significant 'no' votes, there is no formal obligation on them to engage with shareholders or, indeed, respond in any way. As RiskMetrics noted:

That's not to say that there isn't scope for improvement... The non-binding vote... has a disadvantage in the sense that there may not be an immediate consequence but the price of shame sometimes actually does get company directors to respond and that's certainly something that we've observed... Of course you run the risk in a non-binding environment that you will encounter boards or individuals without shame for whom there is no remedy. (trans., p. 362)

Although the majority of boards of major companies have generally responded adequately to shareholder concerns with the remuneration report, some participants felt that there was scope for further improving responsiveness across the breadth of public companies. For example, there have been some recent examples where little response has been evident, with some companies receiving consecutive significant 'no' votes on their remuneration reports (see section 9.3 and table 9.2 below).

Furthermore, the vote on the remuneration report is 'binary' — that is, either for or against — which can blur the signal to boards. There is a range of proposals to 'strengthen' the non-binding vote in the sense of making a significant or majority 'no' vote have tangible consequences. Some participants have also called for the vote to be made binding, while others support the introduction of binding votes on

particular aspects of the remuneration report, such as equity grants and the company's remuneration policy. These options are explored below.

A binding vote on the remuneration report?

Several participants called for the vote on the remuneration report to be made binding. For example, the Australian Manufacturing Workers' Union stated:

The Commonwealth could make amendments to the *Corporations Act 2001* that would enhance shareholder democracy. Shareholders could be given a full right of veto over a board's decision on executive compensation ... (sub. 44, p. 12)

Such a change could significantly increase the influence of shareholders, with the potential to recalibrate the roles of shareholders and their agents, company boards. Effectively, shareholders could determine executive pay.

The remuneration report summarises remuneration arrangements already negotiated and contracted with executives. If a majority of shareholders voted against the report, arrangements would have to be altered or terminated. While remuneration arrangements could be made subject to shareholder approval, this would create uncertainty for executives who might instead take jobs offering more certain outcomes (for example, overseas or with non-listed entities). A board's lack of authority could be particularly problematic when seeking to engage an external candidate. Overcoming such uncertainty would require either shareholders effectively negotiating remuneration arrangements (which would be impractical), or shareholder-approved prescriptive guidelines for boards to follow in remuneration negotiations, which would undermine their need to be able to exercise discretion.

The question is whether such a re-balancing would be desirable. BHP Billiton observed that:

One of the most important functions of a Board is to hire, monitor and where necessary replace the CEO. Giving the Board the responsibility, and holding it accountable, for senior executive remuneration is a logical extension of that primary function. (sub. 45, p. 1)

The case for shifting responsibility for remuneration setting, or significantly constraining the board's decision-making authority in this area, effectively hinges on demonstrating that the public company model is fundamentally flawed, with no possible remedy through enhanced corporate governance. Most participants, including investors and shareholder interests, did not consider this to be the case. ACSI noted that it:

... does not support the notion of a binding vote on remuneration reports ... the current legislative provisions and rights of shareholders are appropriate. (sub. 71, p. 12)

The ASA said it:

... would not support a binding vote on remuneration for the reasons that it is not practical and is unlikely to be helpful given that shareholders will have differing views on what is appropriate in terms of remuneration. (sub. 54, p. 16)

Put another way, most participants accepted that the board structure is an effective, if inevitably imperfect, mechanism for representing the interests of diverse and ever-changing shareholders. Indeed, in light of the potential for a binding vote on the remuneration report to create instability and diminish shareholder wealth, it is conceivable that investors would be less inclined to vent ‘outrage’ by voting against the report.

A binding vote on equity grants or remuneration *policy*?

The non-binding vote applies to the remuneration report in its entirety. A number of participants felt that this muted the usefulness of the vote, because it was unclear which aspects of remuneration caused shareholder concern. The CSA considered that:

Shareholders who approve of a company’s overall remuneration strategy might feel compelled to vote against it because they dislike a single element. (sub. 57, p. 16)

Regnan observed:

It is our view that the current non-binding vote does not require strengthening, as it is already communicating shareholders’ dissatisfaction with board decisions on remuneration. However a key limitation of the non-binding vote is that it allows for neither precision nor constructive feedback to the board. (sub. 72, p. 9)

However, the lack of a clear voting signal can be and apparently is being addressed through pre- and post-vote discussions between shareholders and proxy advisers and boards. Nonetheless, some participants urged separate binding resolutions on aspects of the report: specifically equity grants and the remuneration policy.

Voting on equity grants

Due to potential conflicts of interest, shareholders currently receive a binding vote on the issuing of equity to directors (including executive directors). Prior to 2005, Australian Securities Exchange (ASX) listing rule 10.14 required shareholder approval for a director to acquire securities under an employee incentive scheme. Following a review by the ASX, this rule was amended in 2005 to exempt securities purchased *on-market* from requiring shareholder approval. When the review commenced in 2004, the proposed amendment referred to on-market purchases

through *salary sacrifice* arrangements. Reference to these arrangements was omitted from the final version. Some shareholder groups raised concerns with the amendment (box 9.5).

Box 9.5 Listing rule 10.14 — views from submissions

The ASA suggested that listing rule 10.14 could be exploited by companies:

The ASX listing rules currently require shareholder approval of equity based incentive schemes for directors when new equity is issued, but not where the equity is purchased on market ... It is not unusual for companies to state that if approval is not forthcoming, shares will be purchased on market or the amounts paid in cash. (sub. 54, p. 17)

Fidelity International also expressed concern with current arrangements:

The amendment grants companies an exemption from this requirement if it intends to purchase on-market ... In our experience, no other developed capital market contains such an exemption ... we recommend this exemption be repealed. (sub. 83, p. 5)

ACSI commented:

Listing rule 10.14 however has emerged as a loophole. Boards wishing to avoid binding votes on their long-term reward system can by using shares bought on market avoid a binding vote on:

- the number of shares;
- the terms under which performance is to be measured;
- the vesting arrangements.

... In our opinion, amending listing rule 10.14 should cover all equity-based long-term incentives to directors. ACSI agrees with the preservation of its use in relation to bona fide salary sacrifice, that is sacrificing fixed salary. (sub. DD156, pp. 2–3)

Similarly, RiskMetrics submitted:

... any grant of equity securities to members of key management personnel also be subject to shareholder approval. (sub. 58, pp. 7–8)

A non-binding vote is clearly not adequate protection against the dilutive potential of on-market purchases for insiders using company funds and it is not clear why shareholders' rights to protect themselves against insider share acquisitions on preferable terms should not be restored. (sub. DD164, p. 2)

[Listing rule 10] exists to protect shareholders of the company from having their company taken away on unfair terms by insiders in privileged positions ... This can happen through the issue of new shares on terms that are not available to any other shareholder to a director, or through the company spending its own money to buy shares for a director and then transferring it to them for nothing. Either way, voting and dividend rights pass to insiders on terms that are unavailable to anyone else. (DD trans., p. 246)

RiskMetrics also suggested that the timing of share purchases by a company could in some cases represent insider trading. (DD trans., p. 255)

These concerns relate to:

- the listing rule representing a ‘loophole’, with companies able to purchase shares on-market and thus avoid the need for shareholder approval
- the rule not covering senior (non-director) executives
- the exemption applying more broadly than for salary sacrifice arrangements
- the risk of insider trading.

Despite some participant concerns with listing rule 10.14, the rule is working as intended to apply in circumstances where the issue of shares would have a dilutive effect on shareholders’ stake in the company. In the ASX’s September 2004 exposure draft, it identified that ‘the amendment is proposed to provide a carve-out for circumstances where securities acquired for related parties under an employee incentive scheme are acquired on market, and so do not compromise the policy rationale for the rule [of requiring shareholder approval for any dilution of their holdings]’ (ASX 2004, p. 45). A note to the proposed listing rule stated that ‘salary sacrifice includes incentive payments’ (ASX 2004, p. 45).

The ASX has more recently commented on the reasoning behind listing rule 10.14:

... shareholder approval should be required for any issuance of new shares to directors because even though the dilution of shareholders interests may be less than would otherwise warrant shareholder approval, the conflicted position of directors warrants a shareholder vote even in these circumstances. (sub. 64, p. 7)

... the requirement for shareholder approval under listing rule 10.14 ... is primarily concerned with the dilution of shareholders’ capital interests. Securities purchased on market do not involve shareholder dilution because the shares have already been issued ... (sub. DD142, p. 6)

The CSA similarly commented that the purpose of the rule is to prevent widespread dilution of shareholder equity, hence the exemption for on-market purchases:

Most of the reason for regulating remuneration by shares is the dilution effect on shareholders. If the shares are already issued, then you don’t have the dilution effect. So what you have is a company simply going out to the market and purchasing shares ... It doesn’t have a dilution effect. (trans., p. 120)

Further, the Parliamentary Joint Committee on Corporations and Financial Services, while acknowledging concerns with the amendment, observed that:

... the rule is designed to prevent the dilution of shareholder value through share issues to directors. In this context, the exemption for shares purchased on market is reasonable. However, the committee acknowledges concerns about the potential for improper activities that may stem from the exemption. (2008, p. 64)

Even though, prior to its amendment, listing rule 10.14 may have appeared to cover on-market purchases, in practice this was not the case. The ASX commonly granted waivers from the listing rule to companies that acquired shares on-market for long-term incentive schemes. Between February and November 2005 (when the amended listing rule took effect) 32 waivers were granted, the majority of which related to shares acquired on-market. The ASX typically granted waivers where there was no concern that the recipient would acquire the equity on advantageous terms (generally because the recipient was required to meet performance hurdles) and no dilution concerns.

Some companies nevertheless have voluntarily put equity-incentive plans involving on-market share purchases for directors or executives to a shareholder vote. One example is AMP, which sought shareholder approval for the CEO's long-term incentive plan. Shareholders approved the 2007-08 long-term incentive equity grant, and AMP intends to seek shareholder approval for the CEO's 2009 long-term incentive grant. However, the company indicated that if shareholder approval is not given, a cash payment will be made instead (assuming performance hurdles are satisfied) (AMP 2009). ACSI noted other examples of companies seeking shareholder approval for equity plans involving on-market share purchases, including Boral, GPT, Paperlinx, Qantas and WorleyParsons (sub. 71, p. 9).

The risk of insider trading has also been raised. Specifically, it is argued that some companies may time on-market acquisitions to take advantage of favourable share prices and 'inside' information. However, insider trading is not exclusively related to equity grants or executive remuneration, and is addressed separately under the Corporations Act. Requiring shareholder approval of equity grants would be a very blunt and indirect way of addressing the risk of insider trading. Further, it would not address the timing of equity grants — under listing rule 10.15A, a company has up to three years to grant equity under an incentive scheme following shareholder approval.

If shareholders were given a binding vote on all equity grants — the preferred position of ACSI and RiskMetrics — this would represent a vote on a large part of the remuneration of key executives, particularly in larger companies. Long-term incentives on average account for around a third of total remuneration for CEOs (chapter 3). Some companies are also increasingly providing some of their short-term incentives in the form of company shares. A binding vote for shareholders on a significant proportion of total remuneration would impinge on a key area of director responsibility, and may perversely lead to a movement away from incentive-based pay. Given remuneration fungibility, targeting only one aspect of remuneration with a binding vote could lead to other forms of pay being adopted

instead. This issue was raised by Regnan, who submitted that a binding vote on all equity issuances may:

... drive remuneration away from equity-based incentives to cash-based incentives, thus reducing alignment between executives and the interest of long-term company owners. (sub. DD159, p. 14)

Some participants similarly argued that the vote on equity awards in other jurisdictions has had perverse effects. Hay Group stated:

An example of what can go wrong with too much shareholder influence can be found overseas where there is insistence of many UK institutional investors on approving only [long-term incentives] with tough performance conditions. This has been counter productive and has had unintended consequences. It has led to many plans with a less than 50 per cent chance of paying out and an even lower chance of a meaningful payout — not usually an effective incentive. (sub. 84, p. 27)

In the United States, a study by Ng, Wang and Zaiats (nd) suggested that company behaviour has been influenced by the strengthening of shareholder approval of equity compensation plans from 30 June 2003:

... evidence suggests that companies are choosing not to amend the existing plans and not to adopt the new ones, thereby eliminating the need to put these plans to a vote. (p. 11)

Thus, while removing the exemption for on-market purchases, or confining the exemption to ‘traditional’ salary sacrifice arrangements, would reduce the potential for conflicts of interest for directors, the downside might be discouragement of equity-based incentive arrangements for executives in favour of cash salary. As in AMP’s case, if the equity grant is rejected, the executive is likely to be paid in cash instead. In this light, the current focus of listing rule 10.14 solely on dilution of shareholder equity would appear appropriate.

A vote on remuneration policy?

Instead of introducing a non-binding vote on the remuneration report, the Netherlands and Sweden have introduced a binding vote on remuneration *policy*. Some participants proposed that Australia introduce a similar vote. In Australia’s case, a vote on remuneration policy would be additional to the annual advisory vote on the remuneration report, with the agreed policy providing a framework against which to assess the remuneration report.

As discussed in chapter 8, The Australian Human Resources Institute (AHRI) went further, proposing that all company remuneration policies should comply with a code of practice and that compliance of the annual remuneration report with the

formalised policy should be audited, with any qualifications by the auditor automatically triggering a shareholder vote:

... the board should put up their detailed plans and proposals for executive remuneration to shareholders based on [a] code of practice ... and that should be subject of a binding vote. Once that's done, then ... subsequent remuneration reports could be non-binding, but ... those reports should be audited as to conformity to the plan that shareholders have approved. If there are ... qualifications in the audit ... then those qualified matters should be excised and automatically triggered to a binding vote.

... [the company would have] freedom to vary [the remuneration policy], but then it would be subject to another binding vote. (trans., pp. 131–2)

More details of AHRI's proposals are contained in box 9.6. While obtaining shareholder endorsement for remuneration policy could lead to a degree of 'buy-in' by shareholders, and set out an agreed framework within which boards would have authority to set executive remuneration, it is not clear that this would achieve better outcomes than the present arrangements.

- Shareholders change over time and today's cohort might not support the policy agreed to a few years earlier.
- Remuneration policies might be written in very general terms so that they have little practical impact.

This latter point was noted by PricewaterhouseCoopers, who suggested that in countries that have a binding vote on remuneration policy, the detail contained in the policy is limited:

... however to our knowledge only the Netherlands and Sweden require shareholders to have a binding vote on the remuneration policy. Even in these circumstances, we understand the detail provided in the remuneration policy is limited. (sub. 85, p. 10)

To preclude this, policies could be required to comply with a code of practice as suggested by AHRI. The code could ensure that remuneration policies focus on specific areas important to shareholders. However, in practice, it may be difficult for a code to strike the right balance between promoting meaningful remuneration policies on the one hand and, on the other, avoiding being overly prescriptive about how companies should structure pay. AHRI's proposal for remuneration practices to be audited (presumably by external remuneration practitioners) against the policy, suggests that the code and therefore policies would need to contain more than high-level principles (which is what remuneration reports currently seem to provide, as illustrated by box 8.3 in chapter 8).

Box 9.6 Australian Human Resources Institute proposals

AHRI's preferred model incorporates:

- a 'two level away' rule — for example, CEO pay would be recommended by the remuneration committee, for approval by the full board
- board approval for all share and option schemes
- for very senior executives, the board seeking outside advice and data.

It stated that:

It would be possible to extend these principles into a Code of Remuneration Practice ... (sub. 49, p. 6)

AHRI also recommended:

A binding vote on a company's prospective remuneration plans and programs for say the next five years including a transparent alignment of the former to a Remuneration Code of Practice ... [and] in subsequent years a non-binding vote on the annual [remuneration report] ... which could also be the subject of a quality assurance audit certificate that such plans are being pursued fairly and diligently. (sub. 49, p. 6)

Where an aspect of remuneration was subject to a qualified audit, these amounts should be held in reserve subject to a binding vote by shareholders (sub. 49, p. 6).

AHRI elaborated on these recommendations at the public hearings, to the effect that the code could include quantitative information which placed a value on the role to be performed:

I think if you focus the core remuneration decisions on the size of the role then you are being equitable to the individual and to the market ... So within the framework I am advocating you can pay the top performers and structure their remuneration so they're being treated fairly and if they're a really top performer you know what they should be paid at the upper end. (trans., p. 135)

In a supplementary submission, the National President of AHRI outlined some additional requirements:

- information on 'operation critical executives' (in addition to key management personnel), albeit with reduced disclosure requirements for these executives
- board assessment and reporting on the riskiness of the company's pay structures
- a short-form remuneration report
- disclosure of remuneration skills and experience on the board
- the inclusion of an adviser code of conduct to cover remuneration and proxy advisers (AHRI, sub. 104).

While the binary advisory vote is not a perfect mechanism for gauging the opinion of shareholders on the remuneration report, it has promoted constructive engagement between shareholders and boards. Further, it has only been in operation since 2005. Though supporting a remuneration code, AHRI acknowledged that

more time would be required in order to judge the effectiveness of the non-binding vote:

Whilst AHRI still sees merit in such a Code forming a very useful part of a future governance regime, we accept the Commission's perspective that the best next steps for Australia are to give the non-binding remuneration report framework more time to work, and also to focus on streamlining and improving its content ... (sub. DD114, p. 6)

With options to improve disclosure and engagement around the advisory vote, it is not apparent that a binding vote on remuneration policy is required or desirable.

9.3 Elevating the consequences of a significant 'no' vote?

Currently, boards receiving significant 'no' votes face reputational consequences and the risk of being voted against at re-election if they do not respond to shareholder concerns. In this regard, CGI Glass Lewis commented that it:

... applies a policy of recommending against the re-election of a director who is the chairman of a remuneration committee that puts out a remuneration report that CGI Glass Lewis regards as seriously sub-par. (sub. 80, p. 14)

And the ASA's new executive remuneration policy (to apply from 2009-10) states:

Where there has been a significant, for example 20 per cent, vote against a Remuneration Report by independent shareholders and the board concerned has failed to take appropriate corrective action, the ASA intends to vote undirected proxies against the re-election of any of the directors at the next AGM of that company. (ASA 2009, p. 2)

In addition to increased activism by shareholders, several participants favoured measures to strengthen the consequences of a significant 'no' vote to ensure responses from boards. One option would be to require the board to report back to shareholders with an explanation of how shareholder concerns have been addressed or, if they have not been addressed, why not. Other possibilities include requiring that the chair of the board, entire board or remuneration committee stand for re-election following one, possibly two 'strikes' — where the trigger is either a majority or some other threshold 'no' vote.

The ASA argued for a requirement that the chair of the remuneration committee at the time of a majority 'against' vote, automatically face re-election at the next annual general meeting of the company (sub. 54). This is similar to a recommendation of the recent Walker review of UK banking institutions, although

that review proposed a 25 per cent ‘no’ vote trigger rather than a majority (Walker 2009, p. 22).

Requiring an explanation

While many boards already explicitly address shareholder concerns in their remuneration reports, formalising this as a requirement where a remuneration report receives a significant ‘no’ vote would extend the practice where it may be most needed to promote shareholder trust and engagement. Such a response could also be encouraged as best practice even where reports attract a small but non-trivial level of protest. Such an explanation could be especially helpful to retail investors, who would be unlikely to have the benefit of discussions with board representatives on remuneration matters.

Confining mandatory explanations to remuneration reports that received less than 50 per cent support would mean that, on current voting patterns, relatively few companies would be compelled to report their response. A lower ‘no’ vote trigger (for example, a requirement for 75 per cent to be in favour, in line with the level of support required for special resolutions) would have greater reach, and arguably better align with voting levels commonly accepted as indicative of serious shareholder concern about remuneration.

Directors to face re-election?

A further option to strengthen consequences would be for directors to face re-election following a substantial vote against the remuneration report. Such a consequence would counter the potential for any board complacency on the remuneration report vote attributable to its non-binding nature and provide stronger incentives to engage with shareholders. Further, such a provision would be expected to put most pressure on recalcitrant boards.

The sanction of an automatic director re-election following a substantial vote against the remuneration report undoubtedly would further focus directors’ attention on executive remuneration and shareholder demands. But enhancing shareholder influence must be balanced against the desirability of maintaining the board’s authority to set executive pay: it would not be desirable to allow the non-binding vote to become a de facto binding vote on remuneration, for reasons elaborated earlier. Moreover, if investors felt that the consequences of a significant ‘no’ vote could destabilise the company (and thus the share price), they might shy away from expressing discontent about executive pay in the first place. Hence it is crucial that any measures to strengthen the consequences of a significant level of dissatisfaction

with executive remuneration are carefully designed, well-targeted and proportionate.

In this context, an automatic requirement for one or all directors to face re-election following *one* negative vote on the remuneration report would mean that directors would potentially be penalised even if they had listened and responded to shareholder concerns. In other words, they would face a sanction even if they did the ‘right’ thing and the subsequent remuneration report was strongly supported (as has often been the case). Of course, if directors had responded to the satisfaction of shareholders, they would likely be re-elected. The vote in this case would be unnecessary yet potentially destabilising. Perversely, this possibility could heighten the potential for a ‘chilling’ effect on the vote in the first place. Either way, the objective of fostering better engagement between boards and shareholders would be subverted rather than promoted.

A ‘two strikes’ approach?

While the non-binding vote appears to be working well overall and has been a catalyst for increased company and shareholder engagement, there are instances where companies have received significant consecutive ‘no’ votes on their remuneration report. As shown in table 9.2, companies receiving consecutive no votes of 25 per cent or more in 2008 and 2009 represent about 5 per cent of the ASX200. In addition, as noted earlier, the average level of ‘no’ votes has been gradually increasing, with a small, but significant number of large companies receiving majority ‘no’ votes in the most recent reporting season (table 9.1).

A so-called ‘two strikes’ approach — that is, an automatic requirement for director re-election if two consecutive remuneration reports attracted substantial disapproval — has greater potential to target boards that are apparently consistently unresponsive while maintaining the integrity of the non-binding vote. Such an approach would complement a formal requirement for an explanation of the board’s response to the first ‘no’ vote. If shareholders judged the response or explanation unsatisfactory, they could then seek to remove the board or particular directors.

However, a number of participants observed that a two-strikes approach could bring the potential for excessive shareholder influence on pay decisions, or board instability and with it the potential for a chilling effect on voting against the remuneration report. Some other participants discounted these concerns (box 9.7).

Table 9.2 Consecutive ‘no’ votes > 25% on remuneration reports and voting results for least popular director seeking re-election
ASX200 companies

	2007		2008		2009	
	<i>Rem report ‘no’ vote</i>	<i>Director ‘for’ vote</i>	<i>Rem report ‘no’ vote</i>	<i>Director ‘for’ vote</i>	<i>Rem report ‘no’ vote</i>	<i>Director ‘for’ vote</i>
	%	%	%	%	%	%
Abacus Property			50	85	31	73
Babcock and Brown Infrastructure	32	78	30	91	32	67
Challenger Financial			37	81	29	95
Crane Group	36	96	34	100	43	98
Qantas			41	98	43	96
St Barbara			61	100	58	100
Suncorp/Suncorp- Metway	43	98	32	91		
Toll Holdings	32	100	43	100		
Transurban			59	66	47	100
United Group			38	97	49	99
Western Areas			27	96	56	58

Source: Company announcements.

Conflating feedback and sanctions?

Arguably the key concern with director re-elections is that the potential for board disruption and directors becoming distracted from performing core oversight functions could discourage shareholders from voting against the remuneration report, particularly where a first strike has already been triggered (a ‘conflation effect’). As table 9.2 demonstrates, shareholders apparently deliberately distinguish between concerns with remuneration and broader concerns about the performance of the board, as rarely — if ever — has a vote against directors been anywhere near the level of dissatisfaction expressed about remuneration reports. Participants have suggested that a mechanism that tied the two could therefore make shareholders wary of voting against a remuneration report. As Freehills noted:

While institutional shareholders have been willing to send a protest vote through the non-binding advisory vote (because they are able to do so without damage to the company and their investment), they are not likely to do so where that ‘protest’ vote could actually result in a board spill. This will, in effect, ‘silence’ institutional shareholders who will not wish to risk a board spill. (sub. DD130, p. 3)

Box 9.7 Responses to the ‘two strikes’ draft proposal

In support of the proposed ‘two strikes’ approach, ACSI stated:

ACSI supports the proposal that calls for greater accountability and potential Board re-election if there are at least 25% of ‘no’ votes on a remuneration report in the first year and at least a 50% ‘no’ vote in the second year.

We believe that these provisions would, for the majority of companies in the ASX200, remain largely irrelevant and would only act as deterrent for recalcitrant companies that continue to ignore shareholder concerns on remuneration. We consider this mechanism to provide a potential consequence for ‘inaction’ on the part of companies who do not seek to engage with shareholders on substantive remuneration issues. (sub. DD156, pp. 8–9)

Similarly, Regnan submitted:

Even if instances of a second strike occurring are few, it is anticipated that the mere threat of the consequences of a second strike will be enough to drive further company engagement with shareholders on remuneration. (sub. DD159, p. 13)

Andrew Murray noted the ‘two strikes’ proposal would encourage board responsiveness to shareholder concerns:

Recommendation 15 should have a useful chilling effect on boards that continue to ignore significant shareholder sentiment.

I concur with Recommendation 15, in that it will positively affect board conduct and increase board responsiveness to shareholders views on remuneration. (sub. DD112, p. 7)

However, other participants, including the Business Council of Australia, Chartered Secretaries Australia and KPMG opposed the ‘two strikes’ proposal:

The proposal elevates the issue of the remuneration report above other key strategic issues to be decided by the board. The recommendation puts inappropriate power in the hands of minority shareholders and could be used for ulterior motives. These concerns are particularly acute should a low threshold be adopted for the second ‘trigger’. (BCA, sub. DD152, p. 7)

Clearly it is desirable to have a mechanism available to shareholders to express their dissatisfaction with the board ... However, given the extremely negative consequences that could arise from an exercise of the proposed shareholder power to dismiss the entire board at one meeting ... CSA believes that shareholders will be very reluctant to exercise the proposed power ... CSA believes that it is unlikely that it will achieve the outcome intended. (CSA, sub. DD147, p. 11)

The requirement for a full re-election of the board could be a costly and de-stabilising process. If directors were being turned over at a high rate, a company may suffer significant strategic damage due to a lack of continuity at board level ... The potential cost and strategic damage that can arise in respect of a full board re-election can also result in a real risk that shareholders may be less inclined to vote ‘no’ in respect of a remuneration report. (KPMG, sub. DD145, p. 7)

RiskMetrics expressed similar concerns, noting that a ‘two strikes’ approach:

... could potentially dilute the non-binding vote’s effectiveness as a feedback mechanism on remuneration practices. This is because shareholders, confronted with the possibility of forcing a board spill as a result of voting against a remuneration report

at a company where shareholders are generally satisfied with company performance and board oversight, may be unwilling to vote against. (sub. DD164, p. 3)

Given the desirability of having a clear and unambiguous signal from the non-binding vote, shareholders should not be inadvertently discouraged from voting. Consequently, were a two strikes mechanism to be introduced, there might be benefit from providing an ‘opt out’ option from an otherwise automatic trigger to require some or all directors to face re-election. For example, the ASX (sub. DD142) suggested that at the time that shareholders voted on the remuneration report (for a second-strike vote), they could be given the opportunity to indicate whether, in the event the second strike were triggered, they also wished to vote to re-elect directors.

Will shareholders pursue issues unrelated to remuneration?

It has been claimed that the potential for a board election arising from a ‘two strikes’ vote may allow minority shareholders to use the vote for reasons unrelated to remuneration — a ‘trojan horse’ argument. For example, the vote may be used indirectly to promote more serious strategic plays such as takeovers (and empower single issue groups). The Australian Institute of Company Directors (AICD) stated:

The current system of non-binding votes on remuneration reports often sees shareholders use this as a way of expressing their discontent with the general performance of the company, the share price, strategic decisions by the board and so on. While there are other mechanisms shareholders could conceivably use ... the non-binding vote on remuneration could be used as a ‘cloak’ for destabilising the board or company — for reasons unconnected to executive remuneration (e.g. environmental issues). (sub. DD149, p. 20)

The possibility of a ‘trojan horse’ scenario eventuating cannot be dismissed, but would be highly context specific, and such a strategy is likely to be difficult to disguise in practice.

Will directors ‘walk away’ from a second strike election?

According to the Business Council of Australia, forcing directors to stand for re-election over remuneration issues may result in them not submitting for re-election — with detrimental implications for board capacity and experience, succession planning and board performance:

Where a board is spilled, the company may lose the experience, skills and the corporate knowledge of the directors that have been serving on the board. This is especially the case where board members who have been ‘spilled’ may be understandably disenfranchised and reluctant to stand for re-election. (sub. DD152, p. 8)

Many directors, being in the latter years of their business careers, are likely to undertake their directorships for non-pecuniary reasons, such as intellectual stimulation, ‘relevance’, and reputational and social benefits.

Companies left in limbo?

A concern expressed by some participants about the Commission’s Discussion Draft proposal was that boards could end up being expelled ‘en masse’ leaving a void and, ultimately, company control in the hands of executives. For example, the Business Council of Australia stated:

If the board were to be spilled, the executives upon whose remuneration the shareholders had voted would ... in fact assume the responsibilities of the board until such time as a new board is elected. (sub. DD152, p. 8)

However, the prospect of this happening is remote. Any re-election would apply only to elected board members, not managing directors. All board members would have continued in their positions until the annual or extraordinary general meeting. At that meeting, elected directors would present *individually* for re-election. The record of director re-elections at meetings where substantial ‘no’ votes have been recorded on a remuneration report, establish that the likelihood of any directors achieving less than 50 per cent of votes cast would be extremely low, let alone all directors simultaneously. Were this extreme outcome to arise, various constitutional provisions relating to casual vacancies would be used to meet the legal requirement for companies to operate with at least three directors. While these outcomes may not be ideal, companies would not be left without boards.

Will remuneration practices become ‘homogenised’?

While ramping up the consequences of a ‘no’ vote is designed to increase shareholder ‘say’ on pay to some degree, this needs to be balanced against maintaining the board’s discretion to determine remuneration arrangements that promote the company’s interests. As noted earlier, even the non-binding vote may have led to companies adopting pay structures that meet certain rules of thumb, but which may not be optimal for them (‘vanillaisation’). Some participants considered that a ‘two strikes’ approach may unduly increase the influence of shareholder groups, large institutions and proxy advisers to promote their preferred pay structures. For example, Mercer submitted that a ‘two strikes’ approach:

... will be instrumental in promoting a homogenised approach to the structure of executive remuneration. Such an institutionalised outcome may limit the extent to which boards feel free to design executive remuneration programmes to suit the specific needs of their respective enterprises. (sub. DD139, p. 10)

‘Vanillaisation’ of pay practices has also emerged as an issue in the United Kingdom, where shareholders have stronger powers in regard to approval of long-term incentives. Main et al. stated that remuneration arrangements have become homogeneous:

Confronted with a desire to do the right thing and the need to be accountable for the outcome of their decisions, remuneration committees reach for the security of the institutional isomorphism and set in place remuneration arrangements that look very similar to those of their neighbours. (2007, p. 24)

It could be argued that it is up to boards to convince shareholders of the benefits of pay structures that differ from a form they prefer. However, if shareholders or representative organisations have immutable preferences, boards may be inclined to fall into line if the consequences of a negative vote outweigh the costs of implementing what they regard as sub-optimal pay structures. The risk of ‘vanillaisation’ of pay practices is credible and it underscores the need for good communication between boards and shareholders (especially institutional shareholders) and importantly, boards and proxy advisers (see section 9.4 for further discussion on the role of proxy advisers).

Can downside risks be moderated?

Participants have identified numerous downside risks associated with the ‘two strikes’ approach presented in the Discussion Draft. The prospect of some of these risks occurring, such as the ‘conflation effect’ and ‘vanillaisation’, will depend on the calibration of the ‘two strikes’ mechanism. In particular, separating the second strike from a decision to re-elect directors would directly address concerns about conflation.

With appropriate checks and balances in place, the Commission considers that the important benefits from a ‘two strikes’ approach can be attained cost-effectively. These benefits include added pressure on boards to better engage with, and be more responsive to, shareholder concerns about executive remuneration. Ultimately, shareholders should have a mechanism to sanction boards that prove unresponsive to such concerns, provided such a mechanism does not have adverse effects on boards that are responsive to the best interests of shareholders.

The critical design features of a ‘two strikes’ approach are explored further in developing the Commission’s recommendations in chapter 11.

9.4 Facilitating voting

In principle, the non-binding vote (and other areas of corporate voting) can hold boards accountable to their shareholders. However, the effect in practice will depend on the extent to which shareholders are considering and exercising their voting rights or otherwise engaging with the board, and whether there are any impediments to them doing so.

Are shareholders exercising their voting rights?

The voting turnout is one indicator of the level of shareholder engagement. Votes on the remuneration report will obviously have more impact, the greater the number of shareholders voting or otherwise engaging with the company.

Historically, the extent of voting in Australia has not been high by international standards, although there has been an increase in recent years. ACSI estimates that ‘voting participation in the Australian jurisdiction is currently 55 per cent in the [ASX200], up from 35 per cent five years ago’ (sub. 71, p. 13).

Information provided by ACSI also indicated that for the 2008 calendar year voting participation on ASX200 companies averaged:

- 54 per cent on remuneration report resolutions
- 57 per cent on director election/removal resolutions
- 57 per cent on increases in director fee pool resolutions (ACSI, pers. comm., 10 August 2009).

Egan Associates (sub. DD160) also provided data on the extent of voting in Australia, indicating that the median percentage of votes cast in a top 200 company was 54 per cent in 2008 (table 9.3). This has implications for what constitutes a majority vote, if there were a presumption that voting abstinence represented tacit endorsement.

It is sometimes observed that the voting rate in Australia is below that in the United States (which, according to Norges Bank (2006), averaged around 80 per cent in 2006). However, as ACSI noted, ‘this is in an environment where voting is not compulsory for institutional investors unlike the US jurisdiction that obliges certain types of funds to exercise their proxy vote’ (sub. 71, p. 13) (box 9.8).

Table 9.3 Percentage of votes cast on company resolutions in the 2008 reporting season

<i>Companies</i>	<i>75th Percentile</i>	<i>Median</i>	<i>25th Percentile</i>	<i>Average</i>
	%	%	%	%
Top 25	59	52	46	55
Top 50	65	58	48	57
Top 100	68	59	46	57
Top 200	66	54	43	54

Source: Egan Associates (sub. DD160).

While the extent of voting by shareholders is one indicator of engagement, institutional investors and advisory agencies may discuss issues with a company before the annual general meeting, including on issues related to the remuneration report (chapter 8). For example, in 2008, ACSI ‘engaged’ with 70 of the ASX200 companies (ACSI 2008a). In this way, investors may bring about changes to a company’s remuneration practices without necessarily voting against the remuneration report. This was emphasised by the AICD:

Institutional investors have a lot more influence than is generally recognised. We note, in particular, there has been a considerable increase in active engagement by large institutional investors on remuneration issues ... This occurs through the exercise of voting rights, but increasingly also through direct engagement out of the public limelight with company board members ... (sub. 59, p. 49)

The extent to which a shareholder will wish to be involved in corporate governance matters will depend on a number of factors, including the level and purpose of their investment, any statutory responsibilities associated with it, their interest in such matters and other priorities. Investors will weigh up the costs and benefits associated with monitoring, engaging and voting. For a small retail investor, the benefits associated with voting are likely to be small. Given the size of their investments, institutional investors are more likely to engage with a company and have the power to influence their remuneration practices. In total, institutional investors account for around one half of transactions on the ASX (ASX 2009d).

While the voting participation rate in Australia has increased, there may be principal–agent issues between funds and their investors, which may result in funds exercising their votes in ways that are not aligned with investors’ interests (or not exercising them at all). To deal with this, some inquiry participants have suggested making voting by institutions compulsory, or requiring institutions to disclose their voting record.

Box 9.8 Compulsory voting and voting disclosure — international approaches

United States

Compulsory voting

The US Department of Labor interpretive bulletin 2509.94-2 effectively requires US pension funds to vote on company resolutions, where the resolution may have an impact on the fund's assets. The bulletin offers an interpretation of the Employee Retirement Income Security Act of 1974, which sets out the fiduciary duty of pension funds with respect to proxy voting. The interpretive bulletin states that:

The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock. (US Department of Labor 1994, p. 1)

Further, the bulletin states:

An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under [the Employee Retirement Income Security Act of 1974] where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved. (US Department of Labor 1994, p. 3)

Proxy voting disclosure

In 2003 the Securities and Exchange Commission (SEC) issued a new rule, requiring managed investment funds to disclose their proxy voting record. This rule requires the investment fund to file its voting record annually with the SEC. Further, the fund must make available to shareholders, either via their website or on request, their proxy voting record. The proxy voting disclosure must include:

- the name of the company
- the resolution voted on
- whether the resolution was proposed by management or the shareholders
- whether the fund voted on the resolution, and if so how it voted
- whether the fund voted for or against management recommendations (SEC 2003).

United Kingdom

Section 1277 of the Companies Act 2006 allows the Treasury to make regulations requiring institutional investors to disclose their voting records. This provision was introduced to allow the Government to make disclosure mandatory if there was not a significant increase in voluntary disclosure (LAPFF 2007).

Should institutional shareholders be required to vote?

It is claimed that the increased voting participation rate resulting from an obligation on institutions to vote would enhance the effectiveness of the voting system, with increased shareholder engagement and board accountability. A further argument is that institutional investors have a fiduciary duty to act in the best interests of their members, and that this requires them to take an active interest in corporate governance matters. Andrew Murray took this view and submitted:

It would be ideal if institutions voted on all resolutions put before shareholders ... At the very least, as a consequence of fiduciary responsibility, by law the voting record of institutions should be required to be made public. (sub. 28, pp. 8–9)

Further, since a large proportion of institutional investment derives from Australia's compulsory superannuation contribution system, it may be important that institutions investing these funds play a strong role in corporate governance matters (chapter 2).

Compulsory voting also has disadvantages. As noted earlier, institutional (and retail) investors make an assessment of the net benefits of considering and analysing the information required to make an informed vote. Where they choose not to vote, this may be an appropriate decision on their part, consistent with their voting policy, and a decision that minimises their costs and hence costs to their members. For example, the Investment and Financial Services Association (IFSA) has stated that compulsory voting 'may result in added costs for fund managers with little or no extra benefit to investors or company performance' (IFSA 2001, p. 14).

This view was supported by the CSA:

A decision to abstain from voting on a matter, which may result in no proxy form being lodged and no attendance at a meeting, may be in accord with investor consideration or policy. Some institutional investors have decided not to vote on director elections, but to sell the stock if they do not agree with the board's decisions. (sub. 57, p. 28)

Consistent with institutional investors determining for themselves when it is in their best interests to vote, it is important to note that not all resolutions are equally important. Expending resources on routine voting matters may add unnecessary costs to institutions, paid for by their members, for little benefit. Hence, failure to vote cannot be taken as evidence of a lack of interest in company and corporate governance matters.

In addition, compulsory voting may lead to institutions ‘contracting out’ decision-making to consultants, or simply adopting a ‘tick-a-box’ approach to voting. Some have also questioned the value of compulsory voting in the United States:

There is evidence that some external fund managers have created formalised procedures and voting guidelines that are basically window-dressing. (Stapledon 2001, p. 226)

Making voting compulsory also raises the need for enforcement, which could be problematic to implement in an effective or comprehensive way.

Disclosure of voting records

An alternative is to require institutional investors at least to *disclose* whether and how they voted. Potential investors would then be able to see how a fund has voted, and it would presumably be advantageous for a fund to be seen to be taking an active interest in corporate governance issues. However, unlike compulsory voting, institutional investors would not have to vote where they assessed there were no benefits in doing so.

Disclosure of voting records would also allow a company to see how institutions voted, promoting engagement on issues such as the remuneration report. The AICD noted that it can sometimes be difficult for boards to identify which shareholders voted against the board:

Many listed companies have made genuine efforts to engage with shareholders, in particular institutional shareholders, on various issues including executive remuneration. However, this is not always a straightforward issue, particularly for larger companies. One of the problems boards have in engaging on issues such as executive remuneration with shareowners is often identifying those parties who decide how to vote on particular issues. (sub. DD149, p. 15)

The main disadvantage with disclosure of voting records would be the compliance burden placed on institutional investors. This could be reduced, however, by requiring the information to be disclosed electronically on websites only.

Some institutions (such as UniSuper) already provide detailed information about their voting record on their websites. In addition, IFSA (a not-for-profit organisation representing over 145 members, collectively responsible for investing over \$1 trillion) requires members to provide an annual summary of how they voted in the previous year. This must include the number of resolutions for which the institution voted, the number the institution voted for, against or abstained from, and

the number of resolutions where the institution took no action. This summary is generally placed on the website of the institution.

However, some participants argued against disclosure of voting records. The Business Council of Australia suggested that such disclosure may inhibit, rather than encourage voting:

It is possible that such a disclosure requirement will inhibit rather than encourage institutional holders from voting or voting against board-supported resolutions. Institutional investors may wish to avoid public conflict or the need to articulate reasons publicly from voting at all or from voting against board-supported resolutions. (sub. DD152, p. 12)

The CSA suggested that disclosure of voting records would force institutions to vote according to the ‘popular line’:

The political pressure to vote according to a popular line could potentially overshadow the benefits being achieved through ongoing dialogue between the institutional investor and the board. Compelling the disclosure of a vote can introduce distortions in voting outcomes. (sub. DD147, p. 9)

However, institutions have a fiduciary duty to act in the best interest of their members. As such, it is unlikely that disclosure of voting would inhibit voting against resolutions. Further, institutions that currently disclose their voting records, such as UniSuper and VicSuper, vote on the majority of resolutions, and often vote against board recommendations. (In its submission, UniSuper stated that it has voted against 15 per cent of remuneration reports (sub. DD118, p. 1).)

An additional issue is which institutions should disclose their voting records. Institutional investors include superannuation funds, life insurance companies and mutual funds (chapter 2). As noted earlier, in light of Australia’s compulsory superannuation system, participation in corporate governance matters by superannuation funds is desirable, and disclosure of voting records may assist this. However, for smaller institutional investors, disclosure of voting records may impose a large compliance burden, for little real benefit.

Securities lending

A further complication is the practice of securities lending by institutions, which involves an institution lending shares (usually to another institution), while retaining all economic rights to the shares, including dividend payments. However, as the title of the share is transferred, the voting rights associated with the shares are transferred to the borrower. This can result in votes being cast on resolutions by

those with no economic interest in the company, or shares being borrowed for the sole purpose of influencing a resolution. According to RiskMetrics:

This decoupling of voting rights from an economic interest in the company carries the potential for shares to be borrowed for the principal purpose of casting the votes attaching to the shares. This can distort the results of shareholder voting, particularly in relation to controversial matters or other matters on which shareholder views are finely balanced. The voting result in that situation may not necessarily reflect the interests of the majority of shareholders that hold both title to and the economic incidents of shares. (sub. 58, p. 15)

Whether an institution should also disclose information on the number of shares loaned out is another issue. In this regard, the Commission notes that the Reserve Bank of Australia and the ASX are considering making security lending more transparent, including by disclosing daily the aggregate number of loan transactions for each security on the ASX (RBA 2009). Further, IFSA recommends that its members discuss policies relating to securities lending arrangements, and ensure that all lending activity is lawful and voting entitlements exercised appropriately.

Both IFSA (sub. DD144) and Guerdon Associates (sub. DD119) argued that stock lending has positive effects, such as contributing to market liquidity. Further, ACSI (sub. DD156) suggested that funds that lend stock generally provide for recall of the stock if voting is required. IFSA noted that the incidence of securities lending for voting purposes in Australia is relatively rare (IFSA 2009). As such, the concerns regarding the impact of securities lending on voting do not appear to be widespread. However, it is important that disclosing voting records does not inadvertently inhibit securities lending.

Avoiding ‘lost votes’

In order to facilitate shareholder engagement, it is important that an effective system of voting exists whereby shareholders can vote despite not being able to attend a general meeting. In the absence of a direct voting system, proxy voting allows shareholders to appoint a person to vote on their behalf.

It is obviously important in assessing the views of shareholders that the proxy voting system can correctly process shareholder votes. An emerging issue with proxy voting is the phenomenon of ‘lost votes’, where proxy votes from shareholders are incorrectly processed, or not processed at all. For example, AMP Capital Investors (2009) found that in the main proxy season of 2005, at least 4 per cent of their voting instructions had been lost.

Submissions suggested that this may be a consequence of the current paper-based system of proxy voting. Paper-based voting has potential for processing errors, and does not offer a full audit trail (investors receive no confirmation as to whether their votes have been accepted). In addition, the cut-off date for determining a shareholder's voting entitlements can result in shareholders submitting more votes than they are entitled to, resulting in all their votes being rejected (box 9.9).

Paper-based proxy voting

The issues surrounding paper-based voting are of long standing. They have been considered recently by the Parliamentary Joint Committee on Corporations and Financial Services. The Committee concluded that:

... the integrity of the proxy voting system could be improved if more companies established an electronic proxy voting capability that provides a clear audit trail ... processing votes via a paper-based system is outdated and prone to error. (2008, p. 46)

An electronic voting system would clearly alleviate some of the issues associated with the antiquated paper-based system. Electronic voting could still be a proxy-based system, but would enable both the appointment of a proxy and subsequent voting to occur over the internet. The Corporations Regulations allow for the appointment of a proxy to be made electronically. However, the Parliamentary Joint Committee on Corporations and Financial Services (2008) and IFSA (2007) suggested that, since the Corporations Act does not explicitly require a company to offer electronic voting, there may be some uncertainty as to whether a company is permitted to use electronic voting where this is not provided for in its constitution. The Australian Securities and Investments Commission, however, suggested that electronic voting was legal without constitutional amendments:

ASIC believes that the [electronic] appointment and authorisation of proxies is permitted currently by the *Corporations Act 2001* and in most cases can be implemented without a company needing to change its constitution. (sub. DD162, p. 2)

Internationally, particularly in the United States and in the United Kingdom, the use of electronic voting is more widespread (box 9.10). All FTSE 100 companies in the United Kingdom offered electronic proxy voting in 2006. In contrast, Computershare reported that the number of Australian votes received electronically in the 2008 proxy season was 10 per cent of votes cast (Computershare 2009). However, there is some evidence that the take-up of electronic voting is increasing. The Australasian Investor Relations Association noted: '... certainly in the meeting season that has just been in May, I noticed a significant increase in the number of proxy forms that provided for electronic lodgement' (trans., p. 105).

Box 9.9 Causes of 'lost votes' — views from submissions

The CSA commented on the current paper-based system:

We are aware of the issue and we believe it is true that in some cases proxy votes have gone missing ... We think the problem needs to be solved, that it's probably a cumbersome process which is largely a paper-based process, and in this day and age we should probably be moving beyond that. (trans., p. 123)

It also stated that:

IFSA set up a Roundtable ... to investigate lost votes. The stakeholder group identified the manual processing of paper-based instructions, the lack of audit trail and time pressure (caused by a coincidence of dates for proxy form lodgement and the determination of vote entitlement) as key weaknesses in the current system. (sub. DD147, p. 10)

Similarly, RiskMetrics stated:

... a bigger problem is missing votes or a complete lack of an audit trail ... with dozens of instances where votes have simply gone missing ... (trans., pp. 366–7)

The Law Council of Australia advocated electronic direct voting to prevent lost votes:

The Committee believes that the introduction of electronic direct voting would overcome many of the issues which arise in relation to proxy voting ... and many of the issues associated with a paper based system ... (sub. DD150, p. 5)

A further issue raised by RiskMetrics is the cut-off date for the company's determination of voting entitlements (record cut-off date):

Under the present proxy voting arrangements in Australia, there are two cut-off dates ... (a) proxy appointments must be received by a company at least 48 hours before a meeting; and (b) the company's determination of voting entitlements for a meeting must be based on the persons who were shareholders not more than 48 hours before the meeting.

The coincidence of these two cut-off dates creates the potential for discrepancies between the votes lodged via proxies and the votes held at the second of these cut-off dates. (sub. 58, p. 14)

The Australasian Investor Relations Association recommended that:

... the record cut-off date be increased to five business days prior to the shareholder meeting ... (trans., p. 104)

By removing most of the manual elements in proxy voting, problems such as illegible proxy forms and human processing errors, would be eliminated. An electronic proxy voting system would also facilitate the introduction of a proper audit trail. This would enable investors to confirm that their votes had been processed according to their instructions, and provide reassurance about the accuracy of voting outcomes on contentious issues.

Box 9.10 **Electronic voting — approaches overseas**

United Kingdom — UK law was amended in 2000 to allow electronic voting. In 2006, the proportion of FTSE 100 shares that were voted electronically was 45 per cent, with the proportion voted by paper 11 per cent. In addition, all general meetings of FTSE 100 companies, and 74 per cent of meetings in FTSE 250 companies, allowed for electronic voting (Myners 2007). The UK system allows for a shareholder to receive information electronically, cast their proxy online, and offers a clear audit trail.

United States — most US states allow for proxy votes to be made electronically, with Delaware going as far as to allow the exclusive use of a virtual shareholder meeting. According to Broadridge, a leading US share registry, 91 per cent of votes through Broadridge in 2009 were voted electronically (Broadridge 2009).

In 2007, the **European Union** issued a directive to their members on shareholder voting, stating that:

Companies should face no legal obstacles in offering to their shareholders any means of electronic participation in the general meeting. Voting without attending the general meeting in person, whether by correspondence or by electronic means, should not be subject to constraints other than those necessary for the verification of identity and the security of electronic communications. (2007, p. 5)

In relation to electronic voting, the **OECD's** principles of corporate governance state:

The objective of facilitating shareholder participation suggests that companies consider favourably the enlarged use of information technology in voting, including secure electronic voting in absentia. (2004, p. 35)

Some participants raised concerns that, were electronic voting widely implemented, it would completely replace the paper-based system of voting (Macquarie Group, sub. DD157; Colin and Anna MacKenzie, sub. DD117). The Commission does not envisage this would be the case, and notes that the Corporations Act requires a company to specify a place and a fax number for the receipt of (paper-based) proxy appointments (s. 250BA).

Electronic voting could facilitate direct voting, bypassing the need for a proxy, and thus avoiding many of the flaws associated with a proxy voting system. According to the CSA (2007), direct voting does not require legislative change, and can be provided for in the company's constitution (by a special resolution of members).

The Parliamentary Joint Committee on Corporations and Financial Services noted that in 2008, direct voting was permitted in 13 per cent of the ASX200 companies' constitutions. On the issue of direct voting, the Committee stated:

Widespread implementation of direct voting would overcome many of the problems associated with proxy voting as identified during the inquiry. Companies should be encouraged to amend their constitutions to provide for direct absentee voting, which could be assisted by the ASX Corporate Governance Council including an 'if not, why

not' provision on direct voting in its Corporate Governance Principles and Recommendations. (2008, p. 52)

While there have been no estimates of the cost of implementing electronic voting (for proxy or direct voting), the Parliamentary Joint Committee considered that it would not be prohibitive. Moreover, once established, the ongoing cost to the company of processing a vote electronically would be significantly less than paying for the mailing and processing of a paper-based vote. For the United States, Broadridge reported that in the 2009 proxy season, cost savings arising from paper reduction and postage savings from use of their ProxyEdge electronic voting platform amounted to US\$42 million (Broadridge 2009).

Record cut-off date

There are two cut-off dates that are of relevance for proxy voting: one for confirming shareholder voting entitlements (record cut-off date), and one for submitting proxy votes.

- The record cut-off date is 48 hours or less before the general meeting. This is as close to the meeting as possible to ensure that an accurate picture of the shareholder group at the time of the meeting is captured.
- The deadline for submitting proxy votes is 48 hours or more before the meeting. This is to provide the company sufficient time to process the proxy votes prior to the meeting.

The difference in timing of these two cut-off dates may give rise to lost votes. The cut-off dates can result in shareholders submitting their proxy prior to their voting entitlements being determined, leading to a discrepancy between voting entitlements and the number of votes cast. If the number of proxy votes submitted exceeds the number of votes a shareholder is entitled to, this can result in all votes from the shareholder being rejected. In addition, the dates may result in many votes being submitted at the last minute, leaving little time to resolve any queries.

IFSA suggested the record cut-off date should be extended to five days before the general meeting. This was also recommended by the Australasian Investor Relations Association (box 9.9). Treasury indicated that this 'may be a very valuable reform, but that it had not been raised with Treasury directly' (Parliamentary Joint Committee on Corporations and Financial Services 2008, p. 46).

Extending the record cut-off date would provide an increased buffer between the establishment of voting entitlements and submitting votes. This would decrease the risk that shareholders (especially institutional investors) lodge more votes than they

are entitled to. Further, as it would allow institutions to vote earlier, there may be more time to resolve any potential discrepancies.

There are some disadvantages associated with extending the record cut-off date. Such a change would increase the risk that votes may be cast by shareholders who no longer have a substantive interest in the company. That is, shareholders may sell their shares before the meeting (but after the record cut-off date). Similarly, shareholders may buy shares after the record cut-off date and therefore not be able to vote at the meeting. These issues are amplified the further out from the meeting the record cut-off date is set.

It should be noted that the need for a record cut-off date is reduced with the introduction of electronic voting. The US state of Delaware (where most US companies are registered) has recently changed its regulations to move the cut-off date closer to the general meeting. The new regulations allow for the board to set a record cut-off date, differing from the date the notice of meeting is sent. There is no limit on how late this date can be set — potentially it could be set on the day of the meeting (Hanley 2009).

Consequently, encouraging electronic voting may be a better option as it would also reduce the risk of a discrepancy between voting entitlements as determined at the record cut-off date compared to entitlements at the time of the meeting. In the absence of the widespread take-up of electronic voting, extending the record cut-off date becomes more important as a means of reducing lost votes. Options are explored further in chapter 11.

The role of proxy advisers

Prior to exercising their vote, shareholders may seek advice from proxy advisers. Businesses such as RiskMetrics and CGI Glass Lewis — which dominate this market segment — undertake research on companies and offer advice to their subscribers on how to direct their proxy vote. This can be an important service for institutional investors who have invested in a large number of companies, as well as for smaller investors who may lack the time or resources to carry out such research themselves. Some submissions have raised concerns that proxy advisers may have become too influential in deciding the outcomes of company resolutions (box 9.11). These issues relate to:

- institutional investors simply following the recommendations of proxy advisers without question (for example, some institutions may have insufficient resources domiciled in Australia to analyse the advice)

-
- proxy advisers lacking the time and resources, particularly during the company reporting season, to engage with companies about areas of concern, and/or adopting inflexible positions on remuneration issues that may not be appropriate for all companies
 - the incentive for proxy advisers to find fault with company governance arrangements in order to generate business.

It remains the case, however, that institutional investors have a fiduciary duty requiring them to vote in the best interest of their clients. In addition, while proxy advisers may have incentives to highlight poor corporate governance practice, they will need to be able to back up their recommendations, or risk losing credibility and clients. RiskMetrics further observed that proxy advisers operate in a free market, and that if they did not offer useful advice, companies would not use them:

... there's no compulsion to buy our service, there is no compulsion at all to follow our advice and frankly, it's ridiculous to suggest that in some way, our very sophisticated clients would donkey vote off the back of our recommendations. It is true though that we have influence and we have influence only insofar as we can back up what our recommendations are. ... If we weren't providing value, our clients would not employ us. (trans., pp. 360–1)

A further concern raised is that some proxy advisers do not engage with a company prior to recommending a 'no' vote. For example, the AICD stated:

We went to the AGM a couple of weeks ago ... we consulted with all of the people through that process and we were not aware of anything until a few days before a [proxy adviser] that we had not engaged with came out with a report, clearly no consultation with the company, and had recommended to their clients to vote against it ... We engaged with them and clearly there had been a misunderstanding in terms of their understanding of what is a relatively novel awards system. (DD trans., p. 130)

While it is unclear how widespread such practices are, *the Commission sees obvious merit in proxy advisers engaging with companies prior to recommending a 'no' vote*. Ensuring that proxy advisers fully understand the rationale behind any 'novel' elements of a company's remuneration arrangements can only lead to more informed recommendations. Further, early engagement between companies and proxy advisers could potentially lead companies to improve, or better explain, their remuneration outcomes.

In light of the influence of proxy advisers, there are some who have contended that they should be prevented from making recommendations on resolutions. However, since investors are not obliged to follow the guidance of proxy advisers, even if some have that as their default position, such a proposal seems excessive and could perversely result in a reduction in the availability of relevant market information.

Box 9.11 The power of proxy advisers — views from submissions

The CSA raised the following concerns:

... proxy advisory services do wield influence and that influence should not be underestimated. The recommendations put forward by proxy advisory services will be attended to by those who commissioned the research. In some instances, investors may not exercise their discretion or may be reluctant to vote against the recommendations of proxy advisory services. (sub. 57, p. 28)

Similarly, Charles Macek stated:

In my capacity as the Chairman of a Board Remuneration Committee I have received verbal and even written confirmation by some investors that they follow or, in some cases, are required to follow the recommendations of a specific proxy adviser. (sub. 55, p. 9)

The AICD also noted the influence of proxy advisers, and suggested it may be in their interests to find fault with companies:

... proxy advisers who advise clients on how to vote remuneration and other corporate governance issues can be influential regarding voting outcomes, yet they typically have no ... 'skin in the game'. Such advisers face a potential moral hazard, insofar as it could be said to be in their commercial interests to be highlighting their worth by finding fault with company governance arrangements. (sub. 59, p. 49)

Along similar lines, Charles Macek suggested:

There is also an inherent conflict between providing objective research that shareholders can use in considering how to vote and advocacy. This is reinforced by a moral hazard which is created by the desire to demonstrate value from a low margin service i.e. proxy advice. This can be done by emphasising 'bad' practice and exaggerating its prevalence, rather than highlighting good practice. (sub. 55, p. 8)

KPMG suggested that proxy advisers adopt a tick-a-box approach, that may not be appropriate for every company:

... remuneration practices that meet the 'tick-a-box' requirements of corporate governance and proxy advisers ... may not be effective for the particular business or executive and will not necessarily be the most appropriate policies to create shareholder value. (sub. DD145, p. 7)

CGI Glass Lewis and Guerdon Associates suggested that institutional investors do not blindly follow the advice of proxy advisers:

In practice, however, institutional clients of the proxy advisers use the analysis and voting recommendations of one or both proxy firms as part of their input into reaching their own final voting decision. This is borne out from CGI Glass Lewis's experience and review of actual voting results ... (sub. 80, p. 42)

9.5 Reducing conflicts of interest

It is important for the integrity of the voting system that conflicts of interest do not occur. In regard to the non-binding remuneration report vote, conflicts of interest

may mute the shareholder ‘signal’, and limit the usefulness of the vote. Conflicts of interest in the voting system can arise where a person who may gain a material personal benefit from a resolution can influence the result of the resolution, either by voting their own shares or acting as a proxy holder.

Should directors and executives vote on the remuneration report?

All shareholders in a company are able to vote on that company’s remuneration report, including those who are named in the report — that is, directors and executives whose remuneration is being voted on. This conflict of interest was raised in numerous submissions (box 9.12).

While the influence on the outcome of directors and executives voting is likely to be negligible in most cases, in some instances the shareholdings of a director or executive are significant and potentially influential. Stephen Mayne noted the significant share holdings of Frank Lowy (170 million shares or 10 per cent of Westfield) and Paul Little (10 per cent of Toll Holdings) (trans., p. 238).

Precluding those named in the remuneration report from voting on it would address the potential conflict and give investors some confidence that the vote on the remuneration report accurately reflects their support for it. However, some have argued that the prohibition on voting needs to apply only to key management personnel, and not non-executive directors, because the director fee pool is already set by shareholders and directors are under a fiduciary duty to act in the best interests of the company.

While it is true that non-executive directors have a fiduciary duty, the non-binding vote on the remuneration report represents one of the few areas where shareholders have an ‘automatic’ (in the sense that there is an annual vote on the report) and relatively direct avenue for voicing their concerns (short of selling their shares). It is therefore important that this avenue is able to capture clearly the views of ‘outside’ shareholders. It can also be argued that the non-binding nature of the vote on the remuneration report makes it a special case, which minimises concerns about excluding directors from voting on other resolutions they have a role in proposing.

This issue is further discussed and recommendations presented in chapter 11.

Box 9.12 Remuneration report conflicts — views from submissions

The CSA and RiskMetrics both raised concerns with those named in the remuneration report also voting on the report:

There is a conflict of interest in directors and CEOs voting on their own remuneration policies. CSA believes that this disempowers shareholders. (CSA, sub. 57, p. 26)

The primary role of the non-binding remuneration report is to allow shareholders to convey their view of a company's remuneration practices to the board. As such, it appears counterproductive to allow members of key management personnel to be able to vote on this resolution ... (RiskMetrics, sub. 58, p. 8)

Macquarie Group felt that excluding executives would have little impact on the vote:

The resolution is not binding and for most large corporations the number of votes held by such executives would be small and unlikely to influence the outcome. This would be an issue where a dominant shareholder took excessive remuneration. (sub. 52, section 2, p. 8)

BHP Billiton and the AICD agreed:

In the majority of companies where shares are widely held by investors, there would not be a material impact in restricting the ability of Directors to vote ... (BHP Billiton, sub. 45, p. 8)

On balance, we see little marginal benefit, if any, in prohibiting voting by those individuals named in the remuneration reports ... (AICD, sub. 59, p. 48)

Other submissions drew a distinction between directors and executives voting on the remuneration report. For instance, Origin noted:

Since non-executive directors have their aggregate remuneration or fees approved directly by shareholders, and recommend the Remuneration Report, there is no logical basis on which non-executive directors should be prohibited from voting their own shares. (Origin, sub. DD129, p. 2)

Similarly, for a range of reasons Guerdon Associates did not think directors should be excluded from voting, including:

- a. The Corporations Act does not allow directors and related parties to exercise votes on resolutions where they have a pecuniary conflict of interest
- b. Directors have a legally binding fiduciary obligation ... (Guerdon Associates, sub. DD119, p. 4)

While the ASX supported the prohibition on key management personnel voting their shares 'where there is a direct conflict of interest' (sub. DD142, p. 5), it added:

... ASX is not supportive of the wide scope of the proposed prohibition ... such that directors (and their associates) are excluded ... where they will not directly obtain a benefit from the outcome of the resolution ... ASX notes that where there is a direct conflict ... directors are excluded from voting their shares under the Listing Rules ... (sub. DD142, p. 5)

Proxy voting

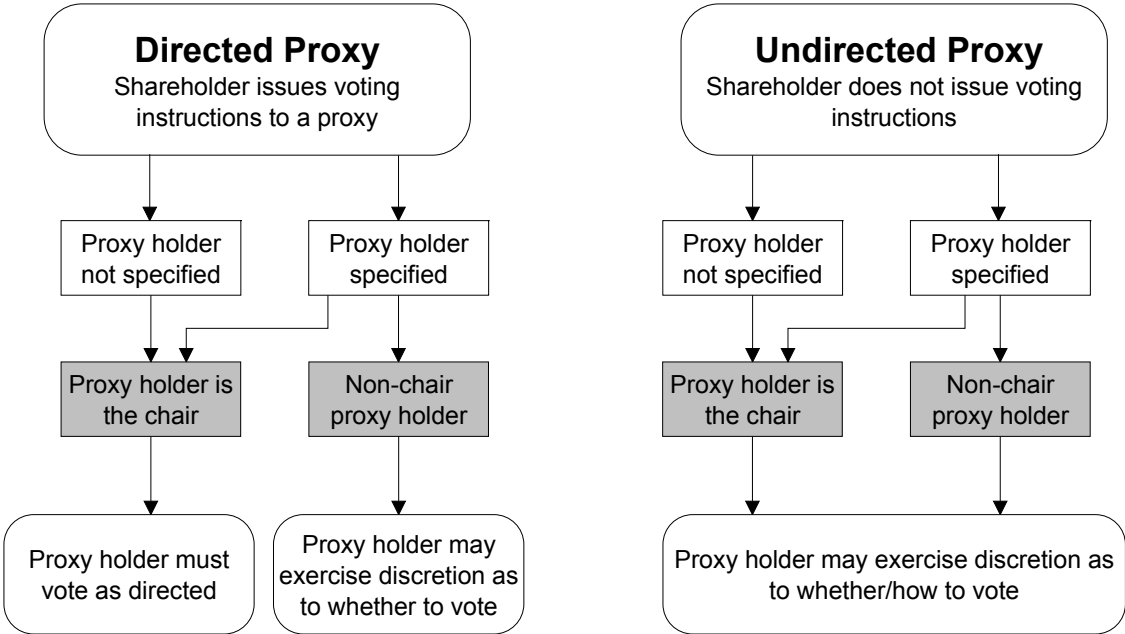
Regardless of whether a director or executive is banned from voting their own shares on a resolution, they may still be able to affect the resolution's result through

the proxy voting system. Under part 2G.2 of the Corporations Act, a shareholder can provide either ‘directed’ or ‘undirected’ proxies to their proxy holder.

- With directed proxies, shareholders make known their voting instructions to the proxy holder. The chair of the meeting must vote all their directed proxies, however non-chair proxy holders are under no obligation to do so.
- Where voting instructions are not specified, this is an ‘undirected’ proxy, which allows the proxy holder to choose which way to vote.

Figure 9.1 illustrates the proxy voting framework under both directed and undirected proxies. Particular issues in the proxy voting system arise in relation to undirected proxies to the chair and the potential for ‘cherry picking’ of votes by non-chair proxy holders.

Figure 9.1 Proxy voting framework



Undirected proxies to the chair

Under current arrangements, if a proxy is ‘undirected’, the proxy holder has discretion to determine how to vote the proxies. Generally, if the shareholder does not appoint a proxy, the proxy defaults to the chair. Under ASX listing rule 14.2.3, if the chair is excluded from voting his or her own shares, the proxy form must contain:

- a statement as to how the chair intends to vote undirected proxies

-
- a notice stating that the chair may have a conflict of interest in a resolution. Shareholders must mark a box noting that they understand this statement. If the box is not marked the undirected proxies must be disregarded; otherwise chairs may exercise undirected proxies at their discretion.

Notwithstanding these statements, chairs may be conferred with voting powers in areas where they would otherwise be formally excluded from voting their own shares.

Directors exercising undirected proxies on resolutions where they are otherwise prohibited from voting represents a potential conflict of interest, which regulation has seen fit to remove in regard to the director's own shares. Under current legislation, there is potential for such a resolution to be approved due to the exercise of undirected proxies by those receiving a material benefit from the resolution. An option for reform is to disallow the chair from voting undirected proxies in such circumstances. This could be important with respect to the non-binding remuneration report vote — the primary purpose of which is to signal to the board shareholder views on remuneration. The chair exercising undirected proxies may mute this signal, particularly where undirected proxies are large enough to influence the outcome of a vote.

The Commission examined the results of remuneration report resolutions in ASX100 companies in 2008 (table 9.4). Undirected proxies accounted for 1.8 per cent of total proxy votes received in the median ASX100 company (it should be noted that this figure takes into account undirected proxies received by any shareholder, not just directors). This figure rose to 3.3 per cent for the median ASX20 company. In some atypical cases, undirected proxies accounted for over 10 per cent of proxy votes.

Some organisations have argued against excluding undirected proxies, on the basis that such a reform may disenfranchise retail shareholders:

Origin's concern with [excluding undirected proxies] is that its primary effect is to disenfranchise retail shareholders. It is a legitimate choice for shareholders to express confidence in and support for their board by giving their undirected proxies to the Chair or another person, including a member of management or a director. (Origin, sub. DD129, p. 2)

Shareholders currently provide undirected proxies to individuals that they trust. Inability to exercise would nullify and disenfranchise these investors' votes. (Guerdon Associates, sub. DD119, p. 4)

Table 9.4 Proportion of undirected proxies to total proxies received^a on remuneration report resolutions, 2008^{b, c}

<i>Company group</i>	<i>Average</i>	<i>Median</i>
	%	%
ASX20	3.3	3.3
ASX50 (excluding ASX20 companies)	2.6	2.0
ASX100 (excluding ASX50 companies)	3.9	1.4
ASX100 (all companies)	3.3	1.8
All ordinaries ^d (excluding ASX100 companies)	5.0	1.4

^a Excluding proxies with a direction for the proxy holder to abstain. ^b Note that the figures represent undirected proxies given to all proxy holders as a proportion of total proxies. Undirected proxies received by *directors* as a proportion of total votes cast will be a lower figure. However, Commission estimates suggest that proxy votes often account for around 99% of total votes cast on a resolution. ^c Some ASX100 entities (such as trusts and overseas companies) did not have a remuneration report resolution in their 2008 general meeting, and have been excluded from the sample. The sample includes 82 ASX100 companies. ^d A sample of 20 randomly selected all ordinaries companies.

Sources: Company announcements; Productivity Commission estimates.

A further argument against excluding undirected proxies is that the chair has a fiduciary duty to the company, and must exercise the proxies in accordance with this fiduciary duty:

Shareholders who intentionally make the choice to leave their proxies open for the chairman or other non-executive directors of the board to vote are quite likely to be signalling that they trust the chairman/directors to act, in accordance with their fiduciary responsibility, in the interest of the company. (ASX, sub. DD142, p. 6)

It could be argued that shareholders should have the choice to give an undirected proxy to the chair, and that disregarding undirected proxies may also not give a true indication of shareholder opinion — shareholders may wish to simply follow board views on resolutions. However, shareholders would still have the option of following board recommendations. Boards generally state on the proxy form their voting recommendations, and in the case of the remuneration report, the board's position on the resolution is clear. A shareholder simply needs to issue a directed proxy that follows the board's recommendations — that is, vote for the remuneration report.

However, requiring shareholders to issue directed proxies may result in shareholders' votes being ignored, despite them wishing to support the board. The CSA estimated that, when listing rule 14.2.3 was introduced in 2001, 20 per cent of shareholders issuing undirected proxies did not understand the rule change, and so had their votes disregarded despite wishing to voice support for the board (DD trans., p. 105).

While the board often indicates which direction they intend to vote their undirected proxies, RiskMetrics suggested that requiring shareholders to give a directed proxy may be preferred as there is some uncertainty as to whether chairs are legally bound to follow these voting intentions:

... it's not just a matter of undirected proxies that can be voted by the chairman in favour of these things but the very fact that a chairman, according to the Jervois Mining decision earlier this year, can change their mind on the floor of the meeting and be subject to no fiduciary duty to vote in accordance with what they had declared prior to the meeting. (trans., p. 366)

However, the Law Council of Australia (sub. DD150) suggested that this uncertainty should not be overplayed. In the Jervois Mining case the proxy form contained voting intentions that were contradictory to those on the notice of meeting. Normally, 'a chair is likely to be precluded from voting contrary to the intention statement by laws relating to misleading or deceptive conduct' (Law Council of Australia, sub. DD150, p. 3).

It should also be noted that excluding undirected proxies would result in Australia's treatment differing from other countries. Undirected proxies in the United Kingdom and the United States are handled in a similar way to the current Australian system (box 9.13).

In light of the potential disenfranchisement of retail shareholders, the Commission considers that listing rule 14.2.3 is appropriate in most circumstances. However, there are strong arguments to disallow the chair from voting undirected proxies in the special case of the remuneration report. Here, the purpose of the vote is to send a (non-binding) signal to the board on 'outside' shareholder views of remuneration policy. As such, influence by the board on the result of the vote should be minimised. The use of undirected proxies by the chair may mute the shareholder signal, diminishing the usefulness of the non-binding vote.

These issues are considered further and recommendations presented in chapter 11.

'Cherry picking'

Under current regulations non-chair proxy holders are not required to exercise all their directed proxy votes when they vote their own shares, allowing for 'cherry picking'. This can arise where proxy holders hold directed proxies with voting instructions opposite to their own voting intention (that is, to how they will vote their own shares). Proxy holders may exercise their own votes and proxy votes that support their view, and ignore other proxy votes. Note that the chair is obligated to exercise all directed proxies.

Box 9.13 Conflicts of interest — approaches overseas

United States — regulation of proxy voting in the United States is similar to Australia. Securities and Exchange Commission rule 14a-4 sets out the requirements of the proxy. In particular, the rule states that the chair may vote undirected proxies at its discretion, on the provision that the proxy form states clearly how the board intends to vote undirected proxies.

United Kingdom — in relation to undirected proxies, the UK listing rules state that the proxy form must notify the shareholder that if the form is returned without voting instructions, the proxy may exercise their discretion as to how to vote.

Canada — Canadian federal corporations law requires a person who solicits a proxy, and is appointed as a proxy holder to attend the general meeting and comply with the shareholder's instructions. Where management solicits proxies, a circular must be attached to the proxy form, outlining any material interests in a resolution of each director and senior executive of the company.

In 2007 the **European Union** issued a directive on shareholder voting, stating:

The proxy holder should therefore be bound to observe any instructions he may have received from the shareholder and Member States should be able to introduce appropriate measures ensuring that the proxy holder does not pursue any interest other than that of the shareholder, irrespective of the reason that has given rise to the conflict of interests. (2007, p. 6)

The **OECD's** principles for corporate governance state:

... it is important to the promotion and protection of shareholder rights that investors can place reliance on directed proxy voting. The corporate governance framework should ensure that proxies are voted in accordance with the direction of the proxy holder ... (2004, p. 35)

The 'cherry picking' problem has been considered previously by the Australian Treasury. A proposed amendment (Corporations Amendment Bill (No. 2) 2006) to the Corporations Act contained reforms to prevent 'cherry picking'. In relation to 'cherry picking', the proposed amendment stated:

If the proxy is not the chair — the proxy need not vote on a poll, but if the proxy votes on the poll in any capacity, the proxy must vote on the poll in the exercise of the proxy appointment and must vote in the way specified in the proxy appointment. (Corporations Amendment Bill (No. 2) 2006, p. 4)

Under the reform, non-chair proxy holders would be under no obligation to cast their proxies, but if they did cast a vote, they would be required to cast all their proxies. However, other proposed amendments under the bill (such as the abolition of the '100 member rule' for calling extraordinary general meetings) were not supported by the states, and as such, this bill has not yet been put to Parliament.

The Parliamentary Joint Committee on Corporations and Financial Services considered the same issue and recommended: 'The government should amend the

Corporations Act to prevent non-chair proxy holders from cherry picking votes’ (2008, p. 48).

The proposal, as outlined in the Corporations Amendment Bill (No. 2) 2006, would end the practice of ‘cherry picking’, thereby increasing the transparency and effectiveness of shareholder voting — the vote would more clearly reflect the view of all shareholders who returned their proxy forms.

However, the proposed reform would not entirely remove the conflict of interest for non-chair proxy holders. If proxy holders receive a large amount of proxies that do not support their views on a resolution, they would have the option of simply not voting *any* proxies. To counter this, a further reform option may be to require non-chair proxy holders to vote all their directed proxies, regardless of whether they vote their own shares in a poll.

The explanatory memorandum to the Corporations Amendment Bill (No. 2) 2006 suggests that this may be too onerous a requirement, stating that a proxy holder may be unknowingly appointed and there may be legitimate reasons why they are unable to attend a meeting or vote on a poll. However, the proposed amendment also states that the requirements on non-chair proxy holders would only apply when:

- (i) the person agreed to act, or held himself or herself out as being willing to act, as proxy at the meeting and was aware of his or her appointment as proxy; or
- (ii) the company held the person out, with the person’s consent, as being willing to act as proxy at the meeting and the person was aware of his or her appointment as proxy. (Corporations Amendment Bill (No. 2) 2006, p. 5)

Thus the legislation would only apply where the proxy has consented to, and is aware of, their appointment. It should also be noted that where a non-chair proxy holder does not attend the meeting, the proxy generally defaults to the chair of the meeting (who is currently required to exercise the directed proxies). As such, there may be scope to require proxy holders to vote all their directed proxies, regardless of whether they vote their own shares. However, it is important to consider that there may still be circumstances where a non-chair proxy holder is unable to vote on a poll (for example, if they need to leave the general meeting early) and it is important that a non-chair proxy holder not be penalised where they are unable to vote their proxies for legitimate reasons. These issues are considered further in chapter 11.