ASX Limited
ABN 98 008 624 691
20 Bridge Street
Sydney NSW 2000
PO Box H224
Australia Square
NSW 1215

Telephone 61 2 9227 0867
Facsimile 61 2 9227 0917
www.asx.com.au

29 May 2009

Executive Remuneration inquiry
Productivity Commission
Locked Bag 2
Collins Street East
MELBOURNE VIC 8003

Via email: exec_remuneration@pc.gov.au

Dear Sir / madam

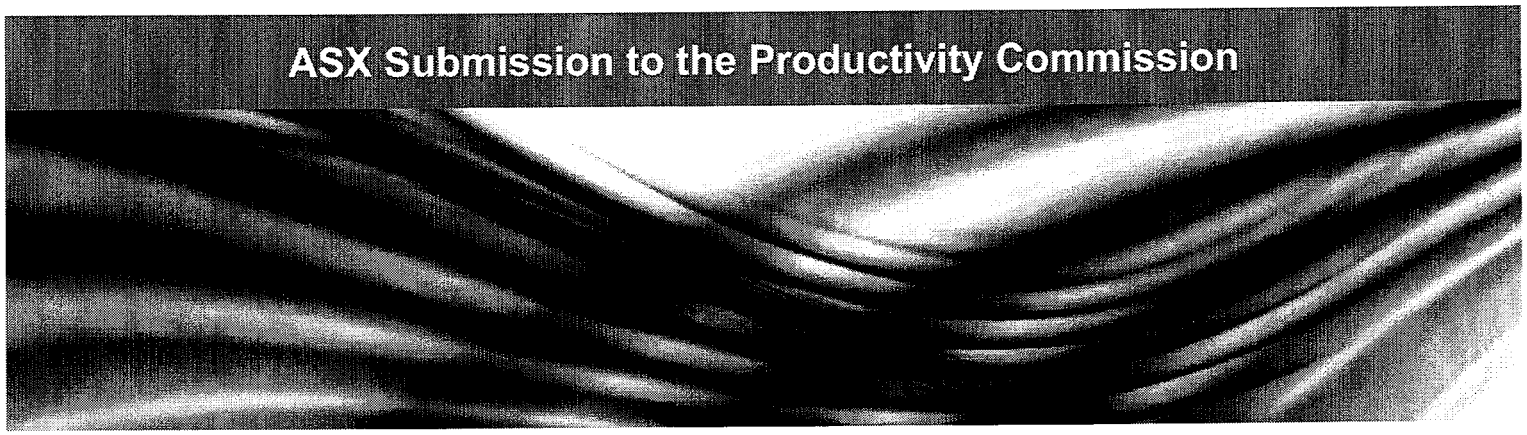
Regulation of Director and Executive Remuneration in Australia

It is with pleasure that I attach ASX's submission in response to the Productivity Commission's Issue Paper of April 2009 regarding the Regulation of Director and Executive Remuneration in Australia.

Yours sincerely

Malcolm Starr
General Manager
Regulatory and Public Policy

Regulation of Director and Executive Remuneration in Australia



29 May 2009

INTRODUCTION

ASX welcomes the opportunity to comment on the Productivity Commission's Issues Paper, *Regulation of Director and Executive Remuneration in Australia*, as part of the Executive Remuneration Inquiry. The Commission faces a significant challenge, given the tension between responding to community pressures to "do something" and allowing boards the freedom to exercise their responsibilities.

There is a role for regulation, albeit a small one, in addressing this challenge. There is an even bigger role for other mechanisms which accord due recognition to the importance of boards having flexibility to design remuneration arrangements that are appropriate for the particular entity and, as such, achieve a better alignment of the interests of executives and shareholders.

Not all Boards have used the current flexibility to produce appropriate outcomes. As a result, there is more thinking to be done, particularly about the best way of bringing corporate governance practices in this minority of Australian companies up to the standards of leading companies.

In recognition of ASX's role as a market operator and supervisor of its Listing Rules, this submission reflects ASX's views in relation to its three main capacities: as the market operator/listing authority; as a leading member of the ASX Corporate Governance Council; and as a listed company which provides critical services to the financial sector.

The first section of the submission considers the current regulatory arrangements and primarily includes commentary from ASX in its capacity as a licensed market operator and provider of the Listing Rules framework for the issuance and trading of corporate securities.

The second section of the submission canvasses some of the key issues that should be considered in the context of proposals for enhanced regulatory arrangements. The commentary in this section reflects ASX's views as a listed corporate entity in the finance sector.

As the provider of the Listing Rules framework, ASX acknowledges that there may be a role for it to complement the outcome of the Government's adoption of Productivity Commission recommendations. Specifically, if the Commission and Government endorse ASX's view – that a small number of matters currently the subject of obligations imposed on listed companies by ASX Listing Rules might usefully be re-located because they have application to a broader range of entity – ASX could repeal those rules after their substance had been reflected in legislation.

SUMMARY THEMES

- There are significant risks associated with prescriptive legislative responses to challenging corporate governance issues, one of which is director and senior executive remuneration structures. These risks include:
  - inadvertent creation of incentives to remain outside the scope of the prescriptions; and
  - failure to achieve the objective of aligning the interests of executives and shareholders.

- Ways of addressing these risks include:
  - limiting the use of legislation touching on executive remuneration to mechanisms, particularly disclosure mechanisms, that leave room for appropriate judgements to be made by boards;
  - relying on the "if not, why not" approach underpinning the ASX Corporate Governance Council Principles and Recommendations as the continuing central mechanism for establishing good executive remuneration practices.

CURRENT REGULATORY ARRANGEMENTS

The current framework governing director and executive remuneration in Australia, comprises legislation, ASX listing rules, guidelines backed by listing rules (the "if not, why not" approach underpinning guidelines promulgated by the ASX Corporate Governance Council) and voluntary guidelines issued by industry associations and shareholder representatives.

Overall, ASX is supportive of the existing mix of obligations and voluntary arrangements in Australia. They generally address conflicts of interest adequately and provide shareholders with the information and tools to hold boards accountable, while also providing boards with the flexibility required for the development of appropriate remuneration policies and packages for the entity to achieve its long-term performance goals.

ASX Listing Rules

The ASX Listing Rules form part of a suite of rulebooks administered by ASX.

Listed entities (trusts and companies) enter into a contractual relationship with ASX to comply with its Listing Rules. The Rules contain minimum standards for the admission and expulsion of entities, and ongoing quotation of an entity's securities. ASX's Listing Rules have evolved over time in response to trends in market regulation, emerging issues, and product development and innovation. In some circumstances, the Listing Rules have been supplemented, or superseded by, legislative initiatives. Prior to completion of the transition from the Listing Rules to legislation as the source of all relevant obligations in a particular area, there is often a stage reached where the proportion of matters within that field that is covered in legislative obligations so outweighs the proportion remaining in listing rules that it would be more convenient for legislation to cover the entire field. This stage may well have been reached in relation to listing rules that touch on executive remuneration.

There are only five listing rules which touch, directly or indirectly, on remuneration of directors. Only two of these also deal with termination payments made to executives (that are not directors).

Notwithstanding the evolution of the Listing Rules, they currently contain several 'legacy' rules on director and executive remuneration and related party issues that are relevant to director and executive remuneration. The relevant listing rules are:

- *Listing Rule 10.11* – an entity must obtain security holder approval to an issue of securities to a related party. This rule is directed at preventing a related party from obtaining securities on advantageous terms and increasing their holding proportionate to other holdings (only un-associated security holders' votes are counted). The rule supplements the related party provisions of the Corporations Act;

- *Listing Rule 10.14* – an entity must obtain security holder approval for an issue of securities to a director of the entity or an associate of the director under an employee incentive scheme (only un-associated security holders' votes are counted). The rule contains an exception where securities are purchased on market. The rule supplements the related party provisions of the Corporations Act;

- *Listing rule 10.17* - an entity must not increase the total amount of non-executive director's fees payable without approval of holders of ordinary securities. This rule enables security holders to review and approve proposed increases in non-executive director remuneration. At the same time, it does not restrict the ability of the board to align fees with differing responsibility levels within the board. This rule also requires that if a non-executive director is paid, he or she must be paid a fixed sum;

- *Listing rule 10.18* – an officer of an entity or child entity must not be entitled to termination benefits if a change in the shareholding or control of an entity occurs. This rule supports the takeover regime in the Corporations Act because it prevents an impediment in the market for a change in corporate control; and

- *Listing rule 10.18* – an officer of an entity must not be entitled to termination benefits, unless approved by shareholders, if the value of the benefits payable exceeds 5% of the equity interest of the entity as set out in the latest accounts given to ASX.

ASX is of the view that since the majority of the regulation concerning related party issues and director and executive remuneration is already contained in the Corporations Act, there is a case for consolidating the subject matter of the Listing Rules discussed above in the Corporations Act. Consolidating the Listing Rules in the Corporations Act would provide the following benefits:

- Increase the ease of access to provisions dealing with similar issues;

- Provide a wider range of enforcement options in the event of a breach of a rule by a company; and

- Provide the ability to introduce enforcement options targeted at individuals, which is not possible under the listing rules because they are underpinned by a contract between a company and the ASX.

ASX Corporate Governance Council Principles and Recommendations[1]

As a leading member of the ASX Corporate Governance Council (the Council), ASX is very supportive of the role the ASX CGC's Principles and Recommendation play in supporting the legislative framework and providing guidance on corporate governance issues, including executive and non-executive director remuneration. The Council's non-prescriptive and principles-based approach provides flexibility for the guidelines and commentary to accommodate the specific circumstances of a range of listed entities. The Council's Principles and Recommendations have also been a useful tool in increasing disclosure on a range of corporate governance issues.

Under ASX Listing Rule 4.10.3, entities are required to provide a statement in their annual report disclosing the extent to which they have followed the Council's Recommendations and explaining, where applicable, why they have not adopted a particular recommendation.

[1] The ASX Corporate Governance Council has submitted a separate submission in response to the Productivity Commission's Issues Paper 'Regulation of Director and Executive Remuneration in Australia'.

ENHANCED REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION

ASX's philosophical starting point with respect to remuneration of directors and key executives is that it is a matter to be determined by the board, albeit with direct and indirect involvement by shareholders on particular aspects to address conflicts of interest and provide mechanisms for board accountability. ASX considers that any proposals to enhance the regulatory arrangements governing director and executive remuneration should be focused on ensuring adequate disclosure and good governance in remuneration policy rather than on displacing or usurping the role of boards.

ASX considers that it is not appropriate for government to intervene in the market with prescriptive legislative requirements for remuneration policies, including setting limits on the quantum of remuneration and restrictions on the structural design of director and executive remuneration packages. Such prescription entails a 'one-size-fits-all' approach that would impede the ability of the board to structure remuneration packages appropriately for the entity and would be too inflexible to take account of the different circumstances faced by different companies.

What is an appropriate remuneration structure to align interests and provide for long-term performance will necessarily vary widely between industries, companies and even within companies (between different levels of staff). Such variation reflects many factors, including the size of the company, the nature of the business activities undertaken, the goals of the company and its culture. Given the necessary variation in remuneration policies, there is, arguably, a greater role for principles-based approaches that guide boards in how to tailor the remuneration policy to the specific circumstances of the organisation and still be consistent with norms established through vehicles such as the Council.

The introduction of legislative restrictions and artificial limits on the quantum or the structure of remuneration could be expected to have distorting effects on the market and potentially lead to unintended consequences, such as a new misalignment of incentives or dynamic inefficiencies. An often cited example of unintended consequences in this area is the increased adoption of equity-based executive incentive plans following the introduction of the of the US$1 million limit on the tax deductibility of an executive's base salary by the US Congress in 1993.

ASX considers that government regulation focused on ensuring good governance with respect to remuneration policy is likely to be of 'net benefit' compared with that focused on the design or prescription of remuneration structures. Such regulation could seek to prevent excesses and a misalignment of interests by setting out processes and structures for the design, operation and review of remuneration policies. For example, regulation could require that a company's board actively oversee the design, operation and review of remuneration policies of the company, which could include processes for the review of executive remuneration, evaluation of the performance of the board, and the reporting to the board by management of the effectiveness of these policies and review processes. This is consistent with existing Council Recommendations with respect to the establishment of nomination and remuneration committees.

This limited role for Government in responding to community concerns about the quantum of remuneration is consistent with shareholders being the ones whose assets are involved. Conversely, Government should have a more significant role, reflecting their financial interest, where they have made capital injections into financial institutions. As such injections have not occurred in Australia, there is no obvious case for government involvement in determining remuneration structures beyond the type of regulation inherent in the ASX Listing Rules instanced above.

A case for broader government involvement does arise in relation to financial institutions whose operations warrant prudential oversight because of systemic risk

considerations. ASX notes that APRA's work on developing a risk-based framework for remuneration of directors and executives is consistent with this analysis.

While APRA's May Discussion Paper 'Remuneration – Proposed extensions to governance requirements for APRA-regulated institutions' indicates that APRA does not propose to prescribe details relating to the design of remuneration in the Prudential (Governance) Standards, it does indicate that APRA will develop a prudential practice guide, which will include extensive guidance on these matters.

While the details of what will be included in the prudential practice guide are yet to be disclosed, a risk-based framework for executive remuneration that involves active supervision of financial institutions by APRA is not a regime that could or should be replicated beyond APRA-regulated entities. In the case of large systemically important institutions that are regulated by APRA, it is more likely that the costs associated with an APRA model can be justified against the benefit of contributing to a reduction of the systemic risk that arises from excessive risk-taking. The economic rationale for this approach is to incorporate pricing for the externalities that can result from executive remuneration structures that incentivise excessive risk-taking, such as systemic risks.

There is not the same rationale for extending the application of a risk-based APRA framework for director and executive remuneration to non-APRA regulated financial institutions or non-financial corporations. The significant costs associated with such a framework would be difficult to justify for smaller financial institutions and for financial institutions that do not pose a systemic risk. ASX also considers that APRA's work is not particularly relevant to non-financial corporations where the notion of capital adequacy relates more to the prudence of capital structure decisions than the relativity of equity capital to financial assets in financial corporations. In such cases, the cost of regulation would likely exceed any potential benefits.

Competitive Distortions

The current application of Government legislation affecting director and executive remuneration is generally confined to those entities which seek funds from the public: listed companies and other 'disclosing entities'. Hence the rationale for governmental involvement has an 'investor protection' flavour.

Whilst this is an understandable conceptual basis, there is an inherent risk of competitive distortions being created between 'disclosing entities' and other entities if this conceptual basis were to be retained and the content of obligations on boards of 'disclosing entities' (but not other entities) were to be significantly increased.

If the significant increase in content took the form of prescriptive measures that responsible boards regarded as inappropriately limiting, then the scope to take the company outside the reach of the new measures is likely to be explored. The obvious solution would be de-listing. For talented executives, the obvious solution would be to seek employment with businesses that either are unlisted (including private equity) or only have a foreign listing.

In examining the case for discriminatory treatment with respect to the introduction of enhanced regulatory arrangements for all financial institutions, based on an APRA model or otherwise, consideration should be given to the competitive distortions such an approach would introduce in the domestic labour market for directors and executives. An unintended consequence of such an approach is that it may reduce the ability of the financial sector to attract and retain highly talented staff vis-à-vis other sectors of the economy.

The issue of distorting the relative competitiveness of Australian financial institutions with regard to their ability to attract and retain highly qualified staff also applies at the international level. If other jurisdictions do not implement enhanced regulation of

director and executive remuneration that is similar in scope and depth, then there would be a real possibility that there would be an adverse impact on the ability of Australian financial institutions to attract and retain highly qualified and skilled financial sector executives. Such an outcome would be contrary to the Government's stated objective of promoting Australia as a leading financial services centre in the region.

Accountability to Shareholders

If boards are to retain the flexibility to make the decisions on remuneration issues which they consider to be in the best interests of the company, it is important that current shareholders have some capacity to ensure that boards are responding to their concerns.

Achieving the appropriate 'accountability' is not easy. The representatives of shareholders have been clear in rejecting the proposition that shareholders should have a binding vote on remuneration issues generally. For example, the Australian Council of Superannuation Investors has said "Shareholders do not have the expertise to develop policies that accommodate each individual company's strategy - they can advise the board as to their satisfaction with long term alignment. The current non binding vote on remuneration provides shareholders with the opportunity to engage with boards of companies on their long term strategies".[2]

There has been less unanimity around whether shareholders should have a vote in relation to that component of remuneration package which takes the form of equity in the company. A number of companies elect to put their executive equity plans to shareholders for approval. Some don't.

The principle which has guided ASX's consideration of this issue is that 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.

Of course, the fact that ASX has not identified any principle that would justify it mandating that listed entities obtain shareholder approval for employee share schemes (that don't extend to issuance of shares to directors) does not preclude any entity from seeking such approval if they find this a useful way of providing the board with a timely assurance that a plan is reasonable.

CONCLUDING REMARKS

While the global financial crisis has been the catalyst for the current examination of director and executive remuneration, the challenge in calibrating regulatory responses so as not to produce counterproductive outcomes is considerable. A prescriptive approach in response to the current crisis would introduce significant competitive distortions and likely have adverse implications for economy-wide productivity. While there is an important role for regulation in ensuring that there is appropriate board accountability to shareholders and a role for principles-based approaches that provide best practice guidance to boards, it must be balanced against the need for boards to have the flexibility required to determine director and executive remuneration that aligns interests for the particular entity.

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[2] ACSI Media Release 'Binding Vote on Pay', 3 March 2009
http://www.acsi.org.au/documents/03.03.09.Media%20Release.Binding%20Vote%20on%20Pay.pdf