

3 June 2009

Mr Gary Banks
Chairman
Executive Remuneration Inquiry
Productivity Commission

By email: exec_remuneration@pc.gov.au

Dear Commissioner Banks

Regulation of Director and Executive Remuneration in Australia

The Australian Council of Super Investors (ACSI) is pleased to provide the following submission to the Productivity Commission.

ACSI represents the interests of 42 superannuation funds who collectively manage over \$250 billion of Australians retirement savings. ACSI provides its members with advice and information on the impact of corporate governance, environmental and social issues on the long term performance of investee companies. On behalf of its members ACSI discusses these issues with Australian listed companies.

ACSI provides a range of services including:

- Advice to members on the governance practices of companies
- Proxy voting services to assist super funds to exercise their voting rights efficiently and effectively
- Engagement with companies to improve governance practices
- Commissioning and producing research to support our policy positions
- Publicly advocating for improved governance practices and standards including promotion of effective legislative and regulatory regimes.

ACSI's interest in the remuneration of directors and CEO's and other Key Management Personnel (KMP's) arises from:¹

- The view that remuneration provides one of the few visible proxies for shareholders to gain insight into whether boards are exercising effective control and monitoring of executives.
- A desire to ensure that boards have in place adequate remuneration mechanisms to motivate, CEO's and KMP's to achieve desired behaviours and performance outcomes in the interests of shareholders.
- Recognition of the contribution of non-executive directors for their governance oversight responsibilities.
- The fact that CEO's and KMP's influence the direction of companies, which ultimately affects shareholder return.
- The view that non-executive directors should be paid in a manner that does not inhibit their ability to oversee executive performance.

Boards are responsible for addressing these issues. In ACSI's opinion boards should be comprised of a majority of independent non-executive directors who select and appoint the CEO and then fix remuneration policy which will apply to them and flow on to the KMP's and other employees.

¹ ACSI supports the current definition of Key Management Personnel as currently defined within the Corporations Act.

ACSI makes the following specific recommendations to further enhance the Australian regulatory regime on executive remuneration:

1. Companies should include in their annual reports information about remuneration consultants.
2. Enforcement of compliance with s 300A(1)(ba) (1) of the Corporations Act 2001 should be improved.
3. ASX Listing Rule 10.14 should be revised to require shareholder approval of any acquisition of securities by a director outside a genuine salary sacrifice arrangement.
4. Shareholder approval should be sought for termination benefits worth more than 12 months' base salary.
5. Companies should be required to include a brief plain English summary of a company's approach to remuneration as part of their s 300 A disclosures.
6. The Corporations Act should be amended to exclude "associates" from voting on a remuneration report.
7. The Corporations Act should be amended to prohibit hedging of unvested incentives and to require greater and more contemporaneous disclosure where vested incentives are hedged.

ACSI's submission follows the format of the Terms of Reference as outlined on page one of the Commission's Issues paper.

TOR 1: Trends in director and executive remuneration in Australia and internationally

ACSI conducts longitudinal studies each year looking into CEO pay and remuneration for Chairs and other non-executive directors in the top 100 Australian companies. This research focuses on the top 100 listed companies as they represent a significant majority of our member superannuation funds holdings and the market capitalisation of the ASX/S&P. The research assists ACSI to make comparisons when providing recommendations to superannuation funds on how to vote on director fees, grants of incentives and the remuneration report.

Attached are the following research reports for the Commissions consideration:

- 'Board Composition and Non-Executive Director Pay in the Top 100 Companies: 2007', and
- 'CEO Pay in the Top 100 Companies: 2007'.

Reasons for growth in CEO remuneration

ACSI cannot provide a definitive reason as to why there has been growth in CEO remuneration. The following may provide some explanation for the executive wage price spiral.:

- company performance
- share price appreciation
- increased job complexity and
- competitive employment and comparison pressures

Some commentators have also suggested that improved levels of remuneration disclosure may have also contributed to the ratcheting up of executive remuneration. It is however, ACSI's long held view that executives and boards have always had access to remuneration data from remuneration consultants with the only change being that shareholders now have access to similar information.

Relationship between Directors and Executive Remuneration

Non-executive directors are remunerated generally as a reward for discharging their 'governing' responsibilities in a company as opposed to 'managing' responsibilities which is the remit of CEO's and KMP's.

In general, non-executive directors are paid fees out of an aggregate pool of fees available to non-executive directors which includes superannuation and committee participation. ACSI supports part of these payments being used to acquire shares from an allocation of fees paid for undertaking their directorship - rather than through an incentive plan in which executives also participate. ACSI has actively opposed non-executive directors participating in share option schemes that apply to directors.

The structure and form of remuneration for non-executive directors reflects a lesser emphasis for reward for risk taking and a greater recognition of their oversight responsibilities.

Relationship between Executive and Employee Remuneration

It is unclear as to whether a relationship exists between executive and employee remuneration in Australian companies. Companies need to be cognisant of a range of factors when ultimately determining pay outcomes and relativities between different parts of the workforce.

We refer to ACSI research ‘CEO Pay in the Top 100 Companies: 2007’ as noted above which has shown that over the period from 2001 to 2007, median fixed remuneration increased by 96.4 percent in total, or 11.9 percent per annum compound, even allowing for the slight decrease in median CEO fixed pay in 2007. Over the same period, average adult weekly ordinary time earnings increased by 32.3 percent, while the consumer price index increased by 17.7 percent.

It should be recognised that companies will vary in their reliance on human or physical capital for their business and therefore result in remuneration practices and expectations varying from company to company. We refer to ACSI commissioned research ‘CEO Contracts and Succession’ in September 2005. A copy of this research is attached.

Intuitively executive remuneration has the potential to damage or enhance company reputations, affect employee morale and affect behaviour. Getting the balance on time scale and appropriate performance measures is critical.

Who should be responsible for setting remuneration arrangements?

ACSI believes that boards are and should be responsible for setting remuneration arrangements.

ACSI has concerns about shareholders seeking to micro manage issues relating to remuneration and would have similar concerns for government or other related agencies applying a prescriptive ‘one-size fits all’ approach to the determination of executive remuneration.

Shareholders do not have the same access to information in relation to business objectives, strategies and remuneration as do boards. Nor do shareholders want this level of information or responsibility as they rely on their agents, the board, to apply effective oversight in the best interests of the company and its shareholders. In this context it is ACSI’s view that shareholders cannot in any meaningful way form a view about the overall size of remuneration applicable to CEO’s and KMP’s of each company.

Boards should take into account a range internal and external factors relevant to business strategy and objectives when setting remuneration levels whilst also keeping in mind reasonable community expectations on levels of reward in light of performance.

Examples of unsatisfactory remuneration practices

It is generally the case that most remuneration practices of the top S&P/ASX 200 companies are appropriately set. However there are recent examples of remuneration practices which were not properly explained, not justified or simply excessive in the case of some termination and cash payments. Please note a number of these companies have subsequently dealt with the substance of shareholder concerns and issues of disclosure. We refer to some examples below:

- **Company A:** The company's 2008 remuneration report received a 58% 'against' vote. The reason why shareholders considered the remuneration report unsatisfactory was predominantly due to a 50% pay increase for the CEO which coincided with the company's fourth year of declining profits.
- **Company B:** The company's 2008 remuneration report received a 76% against vote. The major issue was the increases in executive incentives, these included a guarantee that 75% of short term cash bonuses would be paid over the following two years, in a year where the company's share price had fallen by 54%.
- **Company C:** The board removed a resolution from its general meeting when it was clear that the majority (almost 60%) of shareholders had voted against the proposed termination payments to outgoing CEO. The board subsequently proceeded to make an ex gratia payment to the CEO of \$8.35 million. ACSI engaged with the company on several occasions throughout the year. Disappointingly for shareholders there has been a further deterioration in the company's performance since the payment was made. In addition, notwithstanding a retention payment being made to the ex CEO he stepped down from the board in December 2008.
- **Company D:** 44% of investors rejected the company's remuneration report. The major issue which was included in ACSI's engagement with the company, and subsequent voting recommendations, were the excessive size of cash payments, in lieu of options, made to executives at the time of its demerger. These cash payments were made based on external advice the company received which projected the value of options going forward on the basis of high share price valuations. ACSI met with company representatives and confirmed that over \$50 million of \$80 million in costs related to the demerger was used to buy out the options.

Justification for levels of remuneration

Prior to the downturn in the share market, ACSI engaged with a number of directors of listed companies, some of whom suggested that local and global competition was one explanation driving up pay, with some Chairpersons expressing exasperation behind closed doors that disclosure and external factors have made reining in executive remuneration a near impossible task.

In an endeavour to be constructive on these issues, ACSI commissioned RiskMetrics to conduct research into one common justification for increasing levels of remuneration namely competition for executive talent. This research focuses on factual data which is disclosed in the Annual Reports of listed companies or other company announcements.

The study reviews executive appointments and departures at 50 of the largest ASX listed companies between the end of their 2003 and 2007 financial years. It should be noted that only 13 percent of the confirmed departures involved executives being recruited to other Australian based companies, while only 4.3 percent of confirmed departures were as a result of an executive being recruited by an offshore employer.

Throughout the research period the majority of departures (75.7 %) were due to termination (35.7%), divestment of business units (7%) and retirements (33%).

ACSI recognises that the research may not provide a definitive answer on the question of the competition for talent and its relationship to increasing executive remuneration. However neither does the research provide compelling evidence to justify pay increases for senior executives on the basis of this ‘competition’.

The research also compared the fixed pay of CEOs recruited internally against those recruited externally. Based on the sample CEOs, the median annual fixed pay of an externally recruited CEO was likely to be 4.3 percent higher than that of their predecessor, while the median internally recruited CEO received annual fixed pay that was 11.9 percent lower than that received by their predecessor.

As a consequence of this research, when engaging with companies going forward, ACSI will more thoroughly expect substantiation from companies who may appear to be paying excessive remuneration in order to apparently attract and retain CEOs and KMPs.

A copy of this research is attached for the Commissions consideration.

Relationship between remuneration and corporate performance

CEO’s and KMP’s influence the direction of companies, which ultimately affects shareholder return. Therefore, ACSI supports remuneration structures that encourage and promote superior long-term performance of companies.

CEO’s and KMP’s should not derive significant remuneration benefits in the absence of a direct contribution to long-term superior financial performance of the company.

ACSI has supported the vast majority of remuneration related resolutions and reports that have included reasonable long-term incentive schemes that have been underpinned by stretching hurdles. This is evidenced by the fact that in 2008:

- the average percentage of shareholder votes cast ‘for’ the remuneration reports of S&P/ASX 200 companies was 87.1%.
- The average shareholder vote ‘for’ other resolutions on executive remuneration, such as the approval of options grants and performance rights to senior executives, was 88.1% in S&P/ASX 200 companies.

Those resolutions that have attracted a higher level of dissent related to:

- short vesting periods for long-term incentives i.e. less than three years
- insufficiently demanding hurdles without a clear link to long-term performance
- undisclosed hurdles and
- increased prevalence of short-term or retention payments in lieu of long-term arrangements e.g. ‘de-risking’ of pay.

TOR 2: The effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices

Board Responsibility

Boards of directors are responsible for the establishment of a company's remuneration policy. Such policies should ensure that the whole organisation has the appropriate skill base including leadership qualities to fulfil its strategic objectives to the advantage of shareholders.

ACSI believes that it is a cornerstone responsibility of boards to be able to effectively recruit, motivate, retain and if necessary dismiss CEO's of a company on terms that compliment key strategic objectives approved by the board.

ACSI recognises that this is not a simple exercise and requires boards to absorb a range of factors, both internal and external to an organisation and information relevant to the setting of terms and conditions applicable to a CEO and other KMP's.

It is justifiable for boards to seek expert opinions on remuneration and information that assists to make informed decisions. However, this does not diminish board responsibility for decision making on remuneration issues.

ACSI has found through engagement with companies, that the majority of boards exhibit high levels of understanding of remuneration. However, there have been examples of directors who appear to have been overwhelmed by remuneration consultants (and perhaps by CEOs) which has at times resulted in the introduction of remuneration arrangements that:

- appear very complicated
- are not adequately disclosed
- achieve negligible alignment and
- produce unclear benefits from a shareholder perspective.

ACSI is not convinced that a complicated approach to determining fixed pay and short and long-term incentives and other related arrangements necessarily achieves the best outcome for all key stakeholders.

ACSI encourages boards to embrace clear communication that explains the objectives of remuneration in light of the company's objectives and circumstances.

ACSI has extensive experience engaging with ASX 200 companies in discussions on remuneration issues and encourages companies to engage with shareholders at an early and formative stage, so that there can be a genuine exchange of views and expectations with shareholders. This is generally more desirable than leaving a proposition to be disclosed in the lead up to an annual general meeting with little scope, if any for modification.

Remuneration Committees

Remuneration Committees can provide an efficient way for boards to deal with the development and application of remuneration policy. This approach does not however absolve the board from the responsibility for remuneration policy.

In ACSI's opinion remuneration committees should have written terms of reference which include core responsibilities and a mechanism for the regular review of the committee.

It is ACSI's view that remuneration committees are responsible for:

- developing, reviewing and approving the remuneration of directors, CEO's and KMP's.
- in the case of CEO's and KMP remuneration arrangements, ensuring that the design and implementation of remuneration packages is linked to the company's long-term performance objectives.
- assisting the board to evaluate the performance of the CEO against various performance measures which underlie their remuneration package, including comparison with industry practice or other measures.
- all aspects of executive remuneration, including design and implementation, contract provisions, retention and termination agreements.
- advising the board as to whether remuneration, in the case of non-executive directors, realistically reflects the responsibilities and risk involved in being an effective director.
- appointing remuneration consultants where appropriate. Notwithstanding the receipt of external advice, remuneration policies and practices should always remain the responsibility of the board.
- preparing the remuneration disclosure report, which should be signed off by the board and included in the annual report.

ACSI believes that executives should generally not be members of the remuneration committee due to the conflicts of interest that can arise.

Remuneration Consultants

ACSI welcomes and agrees with the AICD's statement in its *Executive Remuneration Guidelines For Listed Company Boards* that 'Good practice would ordinarily be for the board to engage different advisers and consultants to those engaged by executives. While some of these practices sound unduly strict, they are necessary to ensure the confidentiality and integrity of processes and the proper functioning of the board, and to avoid conflicts of interest. Experience shows that unless these fundamental principles and precautions are adopted, the chance of things "going off the rails", whether at the time of negotiation or in subsequent years, is more likely.'

There is currently no requirement for Australian companies to disclose the identity of their remuneration advisors in the remuneration report. There are however some companies that disclose this information to shareholders voluntarily (BHP Billiton Limited, Iluka Resources Limited and Woodside Petroleum Limited). It is ACSI's view that such disclosures improve the transparency of the remuneration setting.

In the interests of transparency ACSI recommends that companies should include in their annual reports information about remuneration consultants to the company. In particular, the annual report should contain details about:

- The remuneration consultants who have been appointed,
- Who appointed them (i.e. the board or a committee of the board), and
- The types of services provided to the company.

This information is necessary to give shareholders the requisite level of comfort that there is no inherent conflict of interest in the services being provided, and that no prior relationship exists between the remuneration consultant, CEO, KMP or director.

Effectiveness of the Corporations Act and ASX listing rules and guidelines?

ACSI believes that efficient and well informed markets are critical to investors. Regulations should always seek to support this objective, including provisions on remuneration disclosure that should strike an appropriate balance between the objectives of companies and shareholders.

It is important that regulation promotes good governance and does not impose an unnecessary burden on companies.

ACSI believes that there is a place for rules and regulations to promote sensible disclosure and transparency in relation to remuneration.

ACSI considers that the *Corporations Act* and the ASX Listing Rules and ASX Corporate Governance Council Principles and Recommendations provide a reasonable balance of technical and principles-based requirements for companies.

Australia's framework of corporate governance should accordingly be highly regarded when compared with other corporate governance regimes that apply across the globe.

In this context, the existing legal provisions provide a sufficient springboard for shareholders to enter into constructive engagement with companies on these issues. It is not these legal requirements alone that create an environment for companies and shareholders to engage and have constructive dialogue. What brings the parties together is a mutual care for the reputation and long term prospects of the company.

The strength of the approach emanating from the ASX Corporate Governance Council Principles and Recommendations is that 21 diverse business, shareholder and stakeholder organisations have developed and agreed to guidelines that provide a complimentary regime for corporate governance based on an 'if not, why not' model of disclosure and explanation. ACSI believes these provisions provide effective shareholder "empowerment" provisions that support constructive shareholder participation on remuneration issues in Australia.

The ASX Corporate Governance Council Principles and Recommendations introduce a degree of flexibility for companies to explain their adopted framework of corporate governance, which may divert from principles that have been adopted by the ASX Corporate Governance Council. Where such a diversion arises, it is then left to companies to explain their reasons. The success of these provisions is dependant upon companies transparently disclosing when they depart from the principles in plain English.

While the existing *Corporations Act* and the ASX Listing Rules and ASX Corporate Governance Council Principles and Recommendations provide a reasonable framework for companies and shareholders, there are some areas however that requires further attention:

1. Improved enforcement of existing provisions

There are companies that do not disclose the performance conditions attached to short term incentives. We refer to Section 300A(1)(ba) (1) of the Corporations Act 2001 (cth) which requires companies to disclose in remuneration reports a "detailed summary" of the performance conditions applying to performance-based pay. ACSI's concern relates to companies not adequately meeting the spirit and the letter of these provisions.

ACSI is aware of the commercial sensitivities that arise in the disclosure of specific internal Key Performance Indicators or budget related information that is linked to annual bonuses.

However ACSI believes that this can be overcome by an appropriate narrative on these issues.

As annual bonuses are usually paid in cash, they should be linked to clear performance requirements and targets and where commercial confidentiality applies to performance objectives and targets, shareholders should be informed of the parameters adopted in the financial year for the bonus arrangements.

2. *ASX Listing Rule on Share incentives*

ASX Listing Rule 10.14 was amended in October 2005 prior to the introduction of non-binding vote on remuneration reports. Following the amendment, companies are no longer required to seek the approval of shareholders to grant shares as part of a director's remuneration package where they are purchased on market.

ACSI is concerned with the impact of these provisions which was to allow share purchases to occur through salary sacrifice arrangements without the requirement for shareholder approval.

ACSI is aware that some companies namely Boral, GPT, Paperlinx, Qantas and WorleyParsons already voluntarily provide shareholders with the right to approve such grants.

ACSI has previously submitted to the ASX and to the Joint Parliamentary Committee on Corporations and Financial Services that the ASX Listing Rule 10.14 should be revised to require shareholder approval of any acquisition of securities by a director outside the genuine salary sacrifice arrangement.

ACSI notes the majority position of the Joint Parliamentary Committee which stated at paragraph 4.100 that, "on the matter of Listing Rule 10.14, the committee recognises 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 acknowledged concerns about the potential for improper activities that may stem from the exemption. The committee therefore suggested that the government examine the issue as part of its green paper review on corporate governance regulations".

ACSI reiterates that the current version of Listing Rule 10.14 should be revised to require shareholder approval of any acquisition of securities by a director outside of a genuine salary-sacrifice arrangement.

In the absence of a legislative response to dealing with this provision, ACSI notes that shareholders may feel inclined to vote against an entire remuneration report where a company takes advantage of the Listing Rule provisions to avoid shareholder approval on equity grants. This would not be helpful, since as will be noted later in this submission, the introduction of a non-binding vote on remuneration reports has been a useful mechanism for engagement.

3. *Termination payments*

ACSI supports legislative reform that would provide shareholders with a greater say on termination benefit payments. Existing caps currently applicable under sections 200F and 200G of the Corporations Act, that allow for shareholders' approval of termination payments that exceed seven-times annual remuneration are considered to be too generous. ACSI supports shareholder approval for termination benefits worth more than 12 months' base salary. In such circumstances companies should explain the rationale for seeking additional shareholder capital to pay for a termination benefits in excess of 12 months base salary.

Codes of Practice and Role of Voluntary guidelines

ACSI believes that the ASX Corporate Governance Council Principles and Recommendations provide an appropriate code for companies in Australia.

ACSI believes the ‘if not, why not’ regime arising out of the ASX Corporate Governance Council Principles and Recommendations already provides a workable code of practice that has been widely accepted by both companies, shareholders and other stakeholders in Australia. If there were a move to introduce a new code of practice arising out of the Commissions deliberations then this would set aside the need for the continued application of these ASX Corporate Governance Council Principles and Recommendations. The fact that they have been endorsed by such a significant number of diverse interest groups only reinforces their existing strength and importance in the Australian regime of corporate governance.

The existence of these principles has not precluded individual Australian based organisations from articulating their own specific position on key corporate governance issues including remuneration which is appropriate for the needs of each constituency.

ACSI has developed its own Governance Guidelines that were first published in March 2003 as a supplement to existing regulatory and industry standards. Since then, the Guidelines have been updated every two years to take into account the changing regulatory and governance landscape.

These Guidelines aim to provide companies with a clear statement of the practices that ACSI member superannuation funds believe Australian companies should follow in conducting their business. The Guidelines reinforce the accountability of boards and management teams to shareholders.

The Guidelines provide trustees of superannuation funds with a benchmark to assess the environmental, social and corporate governance practices of investee companies, in particular when exercising their voting rights.

ACSI’s overriding belief is that super fund interests are best served by trustees who are properly equipped to address governance issues that arise in companies they invest in, without seeking to ‘micro-manage’ these issues that arise in these companies.

ACSI acknowledges the important contribution that other industry guidelines have made in this space, including the IFSA “Blue Book” Guidelines, the ASA guidelines and the AICD Guide on Remuneration and note the similarity between them, reflecting the fact that good governance principles extend across a range of stakeholders associated with companies. It is noteworthy however that these documents, provide an additional level of specificity on key issues and act almost as a supplement to legal requirements.

In summary, there is an important place for voluntary guidelines that can be used effectively by key stakeholders to articulate a position in a manner that is complementary to legal requirements.

International Guidelines

ACSI supports the principles arising out of the G20 meeting as it applies to remuneration policy.

ACSI has also been able to draw upon the knowledge and experience of the International Corporate Governance Network (ICGN). ICGN is a not for profit body founded in 1995 which has evolved into a global membership organisation of 450 leaders in corporate governance in 45 countries, with institutional investors representing assets under management of around US\$9.5 trillion.

We refer the Commission to the ICGN’s remuneration guidelines which is attached for your convenience.

Disclosure requirements in the remuneration report

In ACSI's opinion the disclosure requirements contained in s 300A (1) with respect to specific remuneration information to be provided by listed companies are not overly onerous.

Company disclosures in remuneration reports tend to be more complicated as a consequence of the design and nature of the remuneration arrangements being complicated in themselves.

ACSI recognises that in these circumstances, it is very challenging for a company to provide in "plain English" a snapshot of its philosophy on remuneration and the implications this has on key management personnel. However, the provisions as they currently apply do not preclude a plain English approach to describe remuneration arrangements. There are a number of companies that have complemented their technical explanations with a useful 'narrative' for investors and other stakeholders. These include but are not limited to BHP, Macquarie Group, Brambles and AMP. The reports from these companies are indicative of adequate technical disclosure being provided that meets the requirements of the Corporations Act coupled with more cogent explanations that connects the reader with the underlying driver of remuneration practice in a company.

ACSI has found that there have been significant improvements in the way companies have addressed their disclosure obligations on remuneration since the introduction of the remuneration reporting regime. However, any encouragement to simplify their disclosures would be welcome.

In particular, ACSI would support the Listing Rules and relevant legislation to encourage a brief summary of a company's approach in plain English to the following areas:

- The company's philosophy on remuneration, in particular the synergies with strategy and performance objectives;
- Rationale for fixed pay arrangements including movements in fixed pay for key management personnel;
- The key performance indicators for short term and long term incentives;
- Alignment with shareholder interests
- Termination payment arrangements which are applicable.

ACSI also believes that companies should improve their narrative approach to reporting by providing more plain English text to properly describe remuneration arrangements. In particular ACSI encourages boards to explain why pay arrangements are appropriate in light of the executives and/or directors and the company's performance. This will ultimately raise the confidence of shareholders and perhaps the general community that boards are considering these issues not in isolation or at the behest of executives or remuneration consultants. Put simply legalistic boilerplate disclosures undermine confidence in boards' remuneration practices.

TOR 3: The role of institutional and retail shareholders in the development, setting, reporting and consideration of remuneration practices

Non-binding vote

In ACSI's experience, the introduction of a non-binding shareholder vote on a company's remuneration report has been the single biggest catalysts for improved levels of engagement between institutional shareholders and company directors.

Since the introduction of the non-binding vote on remuneration reports and the ASX Corporate Governance Council's Principles and Recommendations, more companies are proactively seeking out institutional investors (and their representative organisations such as ACSI) to discuss the company's approach to corporate governance and specifically remuneration.

ACSI believes that engagement between companies and shareholders has made the debate on pay issues less adversarial. There is a risk that if the vote on remuneration reports was binding that companies may revert to a more compliance based approach to disclosure which may also affect the growing positive relationship particularly between institutional investors and boards.

In addition, the remuneration report regime has provided a platform for companies to explain the rationale underpinning their approach on pay, and has given shareholders an opportunity to express their views. This complements the "if not, why not" requirements arising out of the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations.

ACSI provides guidance to its member superannuation funds with respect to recommendations on how to vote on remuneration reports. ACSI believes that in order for companies to attract support for remuneration reports from institutional investors these reports should generally include:

- sufficient explanation and disclosure with respect to the remuneration policies and practices of the company.
- where a company's policies or practices are not consistent with widely accepted principles of good practice on remuneration, the disclosures should include sufficient explanation of how a particular approach to pay is justified given the company's specific circumstances.

ACSI, superannuation funds and fund managers in Australia utilise the remuneration report disclosure and the non-binding vote to either:

- contact the company to raise concerns or seek further explanation on specified issues;
- contact the company to outline the reasons why shareholders voted against a remuneration report.

It is noteworthy, that where remuneration reports have attracted a high "no vote" from shareholders or a majority vote against, most companies have used this as a basis on which to better understand how they can improve the standard of disclosure and/or the substance of their remuneration practices.

ACSI does not support the notion of a binding vote on remuneration reports. ACSI considers that the current legislative provisions and rights of shareholders are appropriate. ACSI also recognises the difficulties that companies would face in the event that a binding vote could be cast on the remuneration report, and were voted down, in particular:

- winding back pre-existing contracts, and
- potential disruption to the company.

In ACSI's view, it is the board that are accountable for the development of remuneration policy - not shareholders - it is shareholders role to provide a view on both incentive structures and quantum. (This important role of the board has not been usurped by the non-binding vote).

In the event that a company ignores the views of shareholders – shareholders can ultimately remove directors. This is a right that is not available in some other major jurisdictions namely the US. However, the movement in the US to introduce a non-binding vote on remuneration may well result in a pyrrhic victory in the absence of the right to vote directors off boards who continue to ignore shareholder views.

Exclusion of directors and executives votes on remuneration reports

A central purpose of allowing shareholders a non-binding vote on remuneration reports is to give shareholders an opportunity to send a message to the company on the appropriateness of a company's remuneration arrangements. In particular, shareholders are interested in the extent to which the remuneration arrangements align executives' interests with shareholders' interests and how they reward executives' performance.

At present, all shareholders (including directors and executives who are the beneficiaries of the remuneration arrangements) are able to participate in the non-binding shareholder vote.

Directors and executives who are the beneficiaries of the remuneration arrangements are conflicted on such matters, since they can approve their own remuneration arrangements thereby resulting in a higher "approval" vote on the remuneration report than might otherwise be the case. Therefore the non-binding vote may not be a true litmus test of shareholder views.

In 2008 a top 100 company's remuneration report was supported by a bare majority of shareholders. ACSI assumes that the main reason the report did not receive a majority 'against' vote was that the company's CEO a significant shareholder – a major beneficiary of the company's remuneration policy – would have voted his holdings in favour of the scheme. (We refer to company D as outlined on page 4 of this submission.

In 2008, consistent with ACSI's recommendations made in its submission to the Parliamentary Joint Committee on Corporations and Financial Services, the Committee's final report included Recommendation 20 'The government should amend the Corporations Act to exclude shareholder directors from voting on their own remuneration packages either directly or by directing proxies.'

ACSI reaffirms its recommendation that the Corporations Act be amended, to exclude "associates" from voting on a remuneration report. This would mean that the shareholder vote on the remuneration report would better reflect the true level of support for the remuneration arrangements amongst shareholders who are not affiliated with the company.

Institutional investors' use of voting rights on remuneration practices

Voting participation in the Australian jurisdiction is currently 55% in S&P/ASX 200 up from 35% five years ago. This is in an environment where voting is not compulsory for institutional investors unlike the US jurisdiction that obliges certain to types funds to exercise their proxy vote.

Participation by Australian superannuation funds has lifted voting participation since 2001.

Institutional shareholders will increasingly exercise their vote on remuneration and board composition issues and thereby influence outcomes at general meetings.

TOR 4: Any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community

A key mechanism to achieve better alignment between executives and shareholders is to encourage companies to introduce reasonably challenging performance measures and hurdles for long-term incentives that complement the company's business strategies and objectives.

Below is the key principles endorsed by ACSI member superannuation funds that outline specific mechanisms to better align the interests of boards and executives with those of shareholders. The reference comes from the ACSI Governance Guidelines and a complete copy of the Guidelines is attached.

Performance measures/hurdles

Executives should not derive significant remuneration benefits in the absence of a direct contribution to long-term superior financial performance of the company.

Remuneration should be regarded as a key tool to motivate executives and employees and harness their support of the long-term growth and success of the company.

In broad terms, a properly structured remuneration scheme for executives should:

- be reasonable in remunerating executives in a way which is aligned with shareholder interests
- strike a balance between shareholder and executive expectations, in particular with respect to determining the overall amounts of company profits to apply to executive compensation and reward
- be measurable against key corporate performance indicators
- be sufficiently market-oriented, within levels of comparability for similar peer group companies in the context of industry, size and business focus
- be properly and comprehensively described to shareholders including base cash remuneration, short-term bonuses and longer-term incentives or other rewards
- separately outline details relating to fixed remuneration, bonuses and incentives and share scheme arrangements
- be fully disclosed, valued and expensed in accordance with regulatory requirements, and
- be acceptable to shareholders.

The performance conditions for long-term incentive schemes (e.g. share option plans and share-based incentive plans) should be designed to reward executives for contributing to long-term, above average corporate performance. To ensure that executives are only rewarded for sustained risk adjusted performance, boards are encouraged to stress test proposed performance metrics.

Companies should explain how high levels of potential reward are tied to stretching and demanding performance conditions, particularly where a company makes an annual grant of options (or other long-term incentive awards) the value of which exceeds one times base salary.

ACSI encourages the utilisation of forward-looking dual performance hurdles which measure the company's performance on an absolute and relative basis, to be satisfied before any share options or other long-term incentive instruments vest.

An example of an 'absolute' measure of performance includes a company's earnings per share exceeding a target established by the board. In this regard, a target should be sufficiently demanding. An example of a 'relative' performance measure is where the company's total shareholder return must place the company at a certain point in a ranking against an identified set of peers.

ACSI will, however, accept the utilisation of one performance hurdle, preferably a relative performance measure that is sufficiently challenging and requires the achievement of outperformance against relevant and disclosed external benchmarks.

In general, ACSI will not support remuneration schemes, or proposed grants of incentives under them, where performance hurdles are not sufficiently demanding. What will be regarded as sufficiently demanding is a case-by-case judgement; however, the following guidance is of general application:

- where a relative hurdle is used, there should be no vesting unless the company's performance is ahead of at least half of peer companies
- ACSI is generally supportive of hurdles which allow for 'variable reward' - under which the number of options (or other long-term incentive instruments) that vest increases on a sliding scale according to the level of corporate performance achieved
- ACSI does not support hurdles that allow for all options (or other long-term incentive instruments) to vest for median, or slightly better than median, performance
- where a share incentive scheme provides for 'performance rights', 'performance shares', 'deferred shares' and other zero exercise price options (zepos) with an exercise price of zero, it is particularly important that challenging performance hurdles are in place. This is because these instruments lack the inherent share-price appreciation hurdle that traditional options possess. ACSI in general would not consider an absolute accounting based hurdle stretching where the scheme provides zepos
- performance hurdles need to be explained clearly - both in the annual report and also in the notice of meeting - when a grant of options (or other long-term incentive instrument) is put to shareholders for approval. Information about the hurdle needs to be sufficient in detail and clarity, to enable investors to determine whether it will allow for executives to be rewarded only if long-term corporate performance is enhanced.

The effect of hedging and alignment

In 2006 ACSI was surprised to learn the existence and use of hedging instruments to limit the downside associated with long-term incentives. Hedging is the use of financial products to remove the risk associated with long-term incentives before they vest.

Allowing executives to hedge their incentives prior to vesting makes a mockery of the aim of these incentives to align the interests of executives and shareholders.

As a consequence, in 2006 ACSI wrote to the ASX/S&P 200 companies to enquire whether their company had a policy that permitted employees to trade in securities and associated products, which operate to limit the economic risk of those securities. 120 responses were received. Eighty-six respondents explained that they had a share trading policy i.e. 72%. Of those, sixty-three covered the issue of hedging and 22 of those in particular would allow hedging of incentives after they vest. However, the general position was that this would still be subject to the share trading policy and trading windows etc.

ACSI's stated position is that companies should not allow their executives to remove the risk associated with share options in their remuneration package through hedging. This is because this practice negates the rationale for variable remuneration schemes that should apply when executives have contributed to above average corporate performance.

Given the reliance placed on long-term incentives to align interests of executives with shareholders ACSI has argued that more needs to be done to improve the disclosure regime. In particular, ACSI is of the strongly held view that companies should be encouraged to disclose if they have a policy in relation to option hedging and they are further encouraged to disclose when it is implemented.

Furthermore, ACSI believes that:

- hedging of unvested incentives should be prohibited.
- where hedging of vested incentives arises, the company should inform the market about the transaction within 2 days of it occurring.

The ASX has amended Corporate Governance Principles 3 which provides that ‘Companies should:... publish the policy concerning the issue of board and employee trading in company securities and in associated products, including products which operate to limit the economic risk of those securities.’

In addition, recommendation 3.2 was amended to include further suggestions for inclusion in the content of a trading policy. In particular the Principles suggest that companies prohibit designated officers from entering into transactions in associated products which operate to limit the economic risk of security holdings in the company over unvested entitlements.

However, ACSI remains of the view that further amendments to the Corporations Act are required in order to prohibit hedging of unvested incentives and, to require greater disclosure where vested incentives are hedged. Attached is ACSI’s research paper on the subject.

Conclusion

In closing, ACSI believes that we have much to be proud of in the Australian remuneration regulatory regime. Aside from some specific reforms as outlined on page 2 ACSI does not believe there is cause for wholesale changes to this regime.

ACSI representatives look forward to discussing these views with the Commission at the public hearings.

Yours sincerely



ANN BYRNE
Chief Executive Officer