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Executive Remuneration in Australia

Submission to the Productivity Commission

June 11 2009

Submitted by FIL Investment Management (Australia) Limited

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Fidelity INTERNATIONAL

About Fidelity International[1]

- FIL Limited (established 40 years ago) and its subsidiaries, otherwise collectively known as Fidelity International, operates in markets outside of Americas. Fidelity International manages over A$200 billion for investors around the world – major institutions as well as private individuals. [2]
- Fidelity International's U.S affiliate, Fidelity Management and Research LLC (FMR) was founded in 1946 and is one of the world's largest mutual fund companies and, with its subsidiaries, manages over A$1.9 trillion.[3]
- Fidelity International has been investing in the Australian market since 1974, and increased its involvement in the local market in 2003 with Fidelity International's establishment of a local Australian funds management team. Our Sydney-based team is backed by our global research network. In total, Fidelity International and FMR actively invest over A$7.4 billion in Australian securities[4].
- The scale of our operations enables us to maintain a team of corporate governance specialists who monitor and advise internally on executive remuneration matters.
- We recognise that the structure of an executive's incentive pay arrangements may influence the strategic decisions the company makes and thus may affect stock price valuation. Our investment professionals' research approach involves actively engaging management in dialogue around corporate governance issues. Our research approach thus provides us with the opportunity to share our views with management regarding the value to shareholders of good corporate governance practice in relation to executive remuneration.
- For the Commission's reference, we are providing a copy of Fidelity International's "Principles of Ownership". We share this document with the management teams of the companies in which we invest around the world, as a guide to them on our likely voting on a range of issues. Section D on Remuneration Policy is of relevance to the Commission's enquiry. Our comments following focus on areas of greatest variance between our Policy and current Australian remuneration practice.

[1] FIL Investment Management (Australia) Limited is a member of the FIL Limited group of companies commonly known as Fidelity International.
[2] As at 31 March 2009
[3] As at 31 March 2009
[4] 30 April 2009

Fidelity™ INTERNATIONAL

❖ Best Practice in Executive Remuneration

1. Pay for performance

   - Fidelity believes in pay for performance. We are very happy to pay well for high performing executives but we do not welcome executive remuneration structures that result in reward for executives even when performance is relatively poor.

2. Balanced structures

   - In our experience, pay arrangements for executive directors and other senior executives at most publicly-listed companies contain three core elements:

     - Annual salary, typically cash

     - Annual bonus, typically cash (the value of which may be determined relative to short-term or internal performance metrics), and

     - Performance-tested equity incentive schemes, ie, shares, performance shares, options, etc.

   - Of these elements, we believe that performance tested equity incentive schemes should make up a significant component of the remuneration package.

   - One of the chief purposes of the third element—equity-based schemes—is to align the interests of company management with those of its shareholders, thereby reducing the "agency costs" commonly associated with separating the ownership from management of the public corporation. Consequently, the scheme should contain performance criteria that link directly the vesting of awards with the company's share-price performance. Thus, all else being equal, Total Shareholder Return (TSR) is often the most appropriate metric for such schemes.

3. Transparency

   - All relevant information should be disclosed to enable shareholders to reach an informed decision on the likely costs and benefits of the scheme and unnecessary complexity should be avoided.

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❖ Australia in Comparison to Other Markets

1. We have a perspective across many countries. In general, Australian executive remuneration practices compare well against other markets internationally. Specifically:

   - Remuneration structures are typically balanced across the three elements and have a component of at-risk pay
   - Equity incentives are generally performance tested
   - There is high use of relative TSR as the preferred performance metric
   - There is disclosure on executive remuneration plans
   - Overall remuneration levels are not excessive relative to value creation over time
   - Shareholders have an annual, non-binding advisory vote on the Remuneration Report; however, the impact of ASX Listing Rule 10.14 has significantly reduced the ability of shareholders to vote directly on share-based incentive schemes for executive directors (see below).
   - Most companies maintain a separate CEO and chairman of the board of directors.

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❖ Suggested Improvements

1. **Amend or repeal the 10.14 carve out**

   - In 2005, the ASX amended Listing Rule 10.14. Prior to the change, section 10.14 had required listed companies to obtain shareholder approval for equity-based incentive grants to executive directors. The amendment grants companies an exemption from this requirement if it intends to purchase on-market the shares to fund such awards. In our experience, no other developed capital market contains such an exemption. Given the very limited opportunities afforded shareholders to exercise voting rights in respect of equity-based incentive schemes, we recommend this exemption be repealed.

2. **Improve the content of the Remuneration Report**, specifically, require more disclosure on:

   - **The progress of previous years' schemes** – the extent to which hurdles have been achieved; the proportion of shares which have vested; the proportion of vested shares which have been exercised, and the price at exercise; and the cumulative, net mark-to-market benefit to the executive.

     - Disclosure on the actual ultimate outcomes of share schemes would, among other benefits, provide the basis for a more balanced discussion in the community regarding compensation.

   - **Termination payment plans** – the compensation measures which have been agreed *ex ante* for various departure circumstances; and any actual *ex post* outcomes from the period.

     - Excessive termination payments are of concern to us, but we believe improved disclosure within the Remuneration Report would enable poor structures to be addressed by dialogue between shareholders and companies, and the existing non-binding vote.

   - **Change of corporate control provisions** – circumstances under which options vest before their planned maturity.

3. **Lengthen vesting and / or holding periods for options**

   - The current standard period for options vesting is three years, however we are in favour of this being extended to four or even five years for at least a portion of the total options granted. Alternatively, an additional

holding period beyond the vesting period could be introduced; this is not currently required by most companies.

4. **Prohibit the retesting of option hurdles**

   - We oppose schemes which give the company's board or senior management the discretion to amend performance hurdles attached to awards if the original criteria are not achieved.

5. **Require disclosure of share dealings by the top 5 employees**

   - The current requirement is for directors only to disclose their dealings, however the share trading of executives is perhaps more at risk of being inappropriately timed and greater disclosure would help investors to assess this.

6. **Require the use of remuneration consultants to be limited to a direct engagement by the Board**

   - Our understanding is that currently, for companies which use remuneration consultants, these consultants are retained by the management team. The attraction of direct engagement by the Board is that it should reduce the incentive of remuneration consultants to provide advice that only ever ratchets "upwards".

7. **Strengthen boards**

   - In cases of excessive or inappropriate executive remuneration the *proximate* cause may be a poorly designed compensation scheme, but the *ultimate* cause is almost certainly a weak or ineffective Board, in particular the independent non-executive members of the Board. If the company is overpaying its management team this is ultimately a failure of the Board in carrying out its fiduciary duty to shareholders, so in broad terms **the best way to reduce offensive pay packets is to strengthen the quality of company Boards, particularly their independent component**.

   - Suggested changes: measures which would force an enlargement of the pool of company directors, in order to promote Board diversity, such as:

     - Limit Board membership by any one individual to, say, no more than three listed companies.

- Prohibit current CEOs from serving on the Boards of other listed companies, in order that they may fulfill their fiduciary responsibility to their primary employer.

FIDELITY INTERNATIONAL

Principles of Ownership

October 2008

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A. Introduction

Shareholders are the ultimate owners of companies and the basic goal of the board of directors is to ensure the long term success of companies in the collective best interests of shareholders. In addition to maximising shareholder wealth, directors should also have regard to the fostering of fruitful relationships with employees, suppliers, clients and fund shareholders, the maintenance of a sound business reputation and consideration of the company's impact on the community and the environment. We believe that high standards of corporate responsibility make good business sense and have the potential to protect and enhance investment returns. Consequently, our investment process takes social, environmental and ethical issues into account when, in our view, these have a material impact on either investment risk or return.

B. Stewardship

FIL Limited and those of its subsidiaries engaged in fund management activities around the world (notably based in London, Hong Kong and Tokyo, together referred to throughout as "FIL") pursue an active investment policy through portfolio management decisions, voting on resolutions at general meetings and maintaining a continuing dialogue with management. This involves holding regular meetings with companies to discuss specific results or events as well as a more informal dialogue incorporating site visits and other research initiatives. Regular access to executive management is a key part of FIL's investment process and we encourage management to provide regular trading updates to the market in order to facilitate this dialogue as much as possible.

As a general policy we are supportive of the management of the companies in which we invest but we will nonetheless form our own views on the strategy and governance of a business. This forms part of our dialogue with companies. On occasion our views will differ from those of management and where this is accompanied by a failure to achieve our reasonable expectations for shareholder return we will consider promoting change. Our specific response will be determined on a case by case basis and we will weigh up the relative merit of intervention or a sale of the shares. Typically we will choose to intervene to promote change when the expected benefits of intervention (through increased returns to our investors) outweigh the anticipated cost.

Where there is disagreement we will initially promote our views through discussions with the company's advisors and/or independent directors although we may also speak to other shareholders and third parties. Wherever possible we seek to achieve our objectives in a consensual and confidential manner but in extremis we will consider requisitioning an Extraordinary General Meeting to enable shareholders as a whole to vote on matters in dispute.

In instances where our clients own shares in more than one party to a transaction or where there are potential conflicts of interest, we will always act in the interests of the specific funds/clients holding the investment in question.

FIL is able to accept price sensitive information through its corporate finance group. The corporate finance group operates separately from the dealing and fund management activities and is able to discuss proposals with companies without compromising the fund managers' ability to deal. This facilitates a full and open dialogue with the companies in which we are invested and we encourage companies to consult with us at an early stage when they are contemplating major strategic or corporate initiatives. The corporate finance group also provides a focus for intervention if that is deemed necessary.

In the UK FIL supports the Statement of Principles drawn up by the Institutional Shareholders' Committee setting out the responsibilities of institutional shareholders and agents as well as the Statement of Principles Disapplying Pre-Emption Rights issued by the Pre-Emption Group and we also support the recommendations of the Combined Code on Corporate Governance.

C. Voting Policy

It is FIL's policy to submit voting instructions for General Meetings unless the loss of liquidity as a result of attendant share blocking is deemed to outweigh the expected benefits to be gained from exercising the votes. However, even in markets subject to shareblocking FIL will vote at least 50% of its shareholding provided the investment exceeds our minimum size criteria. We have a set of proxy voting guidelines which generally direct our voting behaviour although we do also take account of the particular circumstances of the company concerned, and of prevailing local market best practices. Our voting guidelines are reviewed on a regular basis.

Subject to these guidelines we usually vote in favour of company proposals reflecting our broadly supportive investment philosophy although this does not preclude us from voting against management on specific occasions. In instances where we vote against a board's recommendation we seek to ensure that management understand the reasons for our opposition and whilst it is not our usual policy to attend General Meetings we will on occasion vote in person and make a statement explaining our position. On occasion we may also decide to abstain where we have insufficient information or where we wish to give a cautionary message to a company.

We encourage boards to consult with shareholders in advance rather than risk putting forward resolutions at General Meetings which may be voted down. In our view confrontation with companies at General Meetings represents a failure of corporate governance.

We oppose anti-takeover proposals as well as any moves which adversely affect the voting rights of existing shareholders. We generally oppose the transfer of authority from shareholders to directors and we do not favour shares with restricted or differential voting rights. We will also generally oppose unusual or excessive authorities to increase issued share capital, particularly in respect of proposed increases for companies in jurisdictions without assured pre-emptive rights.

D. Remuneration Policy

It is in the interest of shareholders that boards should have the ability to attract and retain the highest quality of executive directors. In our view setting appropriate remuneration levels is the responsibility of the remuneration committee of the board and will be a market-based judgment although all remuneration arrangements should be aligned with the interests of the shareholders and proportionate to the contribution of the individuals concerned. Other than upon initial appointment in particular circumstances, we generally do not support rolling service contracts for executive directors of more than twelve months' duration.

We encourage management ownership of shares. Frequently this can be achieved through participation in appropriate long term incentive schemes and over time we expect executive directors to build a shareholding in the company which is material in the context of their remuneration.

For incentive schemes the remuneration committee should play a key role in ensuring the correct balance between the potential rewards and the dilution of shareholders' interests. Schemes should be approved and voted on by shareholders and should be designed to ensure that the rewards reflect genuine outperformance and the creation of additional shareholder wealth by the executives. All relevant information should be disclosed to enable shareholders to reach an informed decision on the likely costs and benefits of the scheme and unnecessary complexity should be avoided. It is also helpful if the remuneration committee discusses how the schemes are expected to operate in practice in addition to the legal framework of the scheme itself.

We favour the use of performance driven vesting criteria and we generally prefer incentive schemes which incorporate a combination of absolute and relative return targets. Boards should not sanction reward for failure and should seek to mitigate termination costs. Ex-gratia payments to directors should always be the subject of a specific vote of approval from shareholders.

FIL evaluates share plans on a case by case basis but we generally vote against proposals if:-

1. The dilution effect of the new shares authorised under the plan plus the shares reserved to be issued under all other stock option plans is greater than 10% in any rolling 10-year period; or
2. The Board may materially alter the plan without shareholder approval; or
3. There is a performance retesting period for grants of new shares. If performance targets for a given year are not met then awards for that year should be foregone; or
4. The period for performance measurement and vesting is less than three years. Ideally the period used for performance measurement and vesting should be a minimum of five years with a further holding period between vesting and sale.

In addition, in the case of share option plans FIL will generally vote against the plan if:

1. The offering price of options is less than 100% of fair market value at the date of grant; or
2. The plan's terms expressly authorise the repricing of options. We oppose the repricing of options for directors.

For plans that grant awards whose vesting conditions are based in whole or in part upon the company's performance relative to a comparator group, FIL will generally vote against such plans if they allow for any portion of the award to vest for below-median performance. In this regard, we encourage the use of sliding scales which correlate the reward potential with a performance scale and we also encourage the use of a comparator group comprised of a reasonable number of constituent companies whose business profiles are broadly similar to that of the subject company. For plans that grant awards whose vesting conditions are based in whole or in part upon attainment of internal measures of performance such as earnings per share, FIL will have regard to consensus expectations in determining reasonable targets. In the event of a change of control, performance conditions should not be waived and awards should also be determined in a time pro-rated basis.

E. Take-over Bids

As stated above our general policy is to support incumbent management in good standing but we reserve the right to support hostile bids when either the management has consistently failed to achieve our reasonable expectations for shareholder return or where, in our judgment, the level of a bid fully recognises the future prospects of the company in question. We will always try to give a fair hearing to the arguments of both sides before determining a course of action. As a general rule we will not sign irrevocable undertakings to accept an offer.

We regard corporate acquisitions as amongst the most risky but potentially rewarding steps that a management can take and in these instances we will expect companies to have investigated both the operational and financial consequences of any acquisition in exhaustive detail. Where we are a significant shareholder and where the transaction is material in the context of our investment we encourage direct consultation at an early stage. In mergers between two companies we encourage the non-executive directors of both companies to meet together at an early stage and to have a meaningful role in determining the composition of the management of the combined group.

Management buy-outs can be an effective means of delivering value to shareholders but they also give rise to serious conflicts of interest. In these instances we look to the independent directors on a board to take control of the process at an early stage and to ensure that it is as transparent and non-exclusive as possible. Specifically, we recommend a competitive tender process before any particular financial backer is granted exclusivity and where possible we encourage boards to validate any proposal by seeking competing offers from third parties. In instances where we are a significant shareholder we once again encourage direct consultation at an early stage.

F. Returns to Investors

In circumstances where risk adjusted returns exceed a company's cost of capital we encourage companies to invest subject to maintaining appropriate controls and capital structure. The potential returns from investment in the business should also be tested against dividends or share re-purchases to determine the optimum return for shareholders. We regard dividends as an integral part of shareholders' reward for investing in a business and we therefore also encourage the payment of a dividend as a validation of the cash flow of the business, even where companies are sustaining high growth rates and/or high internal rates of return on projects.

When a company cannot find projects generating a return which exceeds the cost of capital we favour a capital distribution either by enhanced dividend payments or by share re-purchase. In our view this does not imply any lack of strategic vision but rather reflects what is best for shareholders at a given moment in time. The taxation position of both the company and shareholders should be taken into account when determining the precise course of action in this regard.

G. Corporate Social Responsibility

FIL believes that high standards of corporate social responsibility ("CSR") will generally make good business sense and have the potential to protect and enhance investment returns. Consequently, our investment process takes social, environmental and ethical issues into account when, in our view, these have a material impact on either investment risk or return. Social, environmental and ethical best practice should be encouraged provided it enhances long term financial return.

We do not screen out companies from our investment universe purely on the grounds of poor social, environmental or ethical performance but rather adopt a positive engagement approach whereby we discuss these issues with the management of the companies in which we invest on behalf of our clients. We use the information gathered during these meetings both to inform our investment decisions and also to encourage company management to improve procedures and attitudes. We strongly believe that this is the most effective way to improve the attitude of business towards CSR.

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