

Australian Human Resources
Institute Limited
ABN 44 120 687 149
T (+613) 9918 9200
F (+613) 9918 9201
Level 10, 601 Bourke Street
Melbourne Victoria 3000
www.ahri.com.au

22nd October, 2009

Mr Gary Banks AO,
Chairman,
Productivity Commission,
Level 28,
35 Collins Street,
Melbourne, Vic, 3000

Dear Gary,

Draft Report into Executive & Director Remuneration

I am writing to you on the subject of the Productivity Commission's Draft Report on Executive Remuneration, published at the end of September. On behalf of AHRI, I would like to make a number of comments on that report.

First of all, my Institute would like to congratulate you and your colleagues for providing an excellent and well integrated piece of analysis on the subject of Executive & Director Remuneration. As we all know, this is a difficult and contentious field of public debate, as well as of private activity – but all of that has been very well served by an outstanding piece of work provided to the community by the Commission. For us, you have filled many of the major gaps with data, implications, and policy options that will inevitably enhance decisions that must be taken by both Government and corporations in this arena.

The Commission's report on executive remuneration has provided many practical remedies that would add value to the performance of top pay determination. It is to be commended for staying away from blunt and heavy handed solutions to cap pay by ineffective regulations. Most Australians would accept from your analysis that not only are our top CEOs paid in line with counterparts in smaller European countries and not at the alarming heights of the US and UK, but moreover that this is a reasonable place for them to be benchmarked. And it's been well demonstrated in your analysis that Australia competes in a global market for executives, and accordingly should pay fair value within that marketplace.

The Commission observed a number of very senior Boards fell asleep at the wheel during the 1990s and imported a lot of 'good luck' pay virus regimes from US based CEO & adviser advocates, but this disease of excess began to abate after 2000, as public alarm emerged and then governance processes toughened up. It's unsurprising the Commission has recommended strengthening protocols and greater transparency on the role of remuneration consultants. While they perform a necessary function, the respected US businessman, Warren Buffett, is not entirely wrong in describing the practices of some firms as "Ratchet, Ratchet & Bingo".

Whilst AHRI largely agrees with both the principles and recommendations in the Draft Report, there remains a number opportunities to enhance those recommendations within the framework of the Commission's final report to Government. The Commission has rightly focussed on the structure and operational drivers for the executive remuneration market, and the substantial implications they have for governance issues, ethical requirements and best practice guidelines related to our nation's Boards of Directors.

Within that framework, AHRI sees a more active encouragement of diversity as a critical issue to facilitate higher quality discussion, review and innovation at the board table. AHRI sees the Commission's data that only 8% of senior directors are women to be little short of a national disgrace, given our Institute's knowledge of the abilities, skills and aspirations of female executives and prospective directors. This ratio is in sharp contrast to leadership statistics within our Federal Parliament, where 20% of Ministry and shadow Ministry members are women, and this is also observable within the two Houses of our national legislature, where women hold 30% of all seats. One doubts these public sector ratios have yet peaked, and hopefully the irony of this public – private leadership diversity record will not be lost on our parliamentarians – especially as they consider some of the more contentious aspects of the Commission's findings.

Furthermore, it is not surprising that two other well known indicators of diversity – people with disabilities and representatives from indigenous cultures – aren't measured across our top companies' Boards and senior management echelons. The reason is relatively simple – there appears no observable data to measure. In short, the available evidence confirms what was set out in AHRI's original submission to the Commission, and which has been quoted in the Commission's draft report.

AHRI would like to make the following specific comments on the Commission's 15 Draft Recommendations. These are couched within your five areas of principle, with which AHRI agrees completely, as an appropriate context to review and expound upon a reform agenda.

- Improving Board Capacities – Draft Recommendation 1 “Shareholders setting maximum number of directors”

AHRI agrees in principle with this recommendation and will defer to experts in corporate and corporations law as to how best to give effect to it. Whilst there is a risk that Boards will grow to full complements, and perhaps too large by some yardsticks, this can be rectified by a company changing its Constitution to redefine the Board’s maximum size more towards a desired optimum.

In terms of the Commission’s second invitation in this recommendation for a comment on barriers to entry, AHRI does have some additional suggestions to make.

As stated above, AHRI believes diversity is a major issue for our most senior Boards. They have not kept in step with the rest of society, and on the evidence available, are most unlikely to do so of their own volition, which is to the potential detriment of both the community and shareholders. AHRI further recommends the Commission include within their final Report that:

- Leading ASX Corporations include statements within their Annual Report and / or Sustainability Reports as to their *policies targets and practices with respect to diversity at a whole-of-company level (i.e. including management and board levels)*. Companies aspiring to be included in the Dow Jones Sustainability Index (DJSI) already do this, and the DJSI is becoming an accepted modern standard for responsible CSR-based corporations. Going forward Australia should adopt comparable standards.
- Institutional and Retail Shareholder groups be encouraged to take explicit steps to develop a *shadow market and/or registry of potential men and women* aspiring to board leadership positions and to work with our leading advanced educational institutions to provide a curriculum on board skills and governance practices, and to facilitate publication of assessment results. Further that market should be informed by regular communication from such shareholder groups as to when vacancies are becoming available on the boards of ASX listed companies, and also to facilitate a subsequent expression of interest and selection / screening process in order to identify and sponsor merit-based candidates for such posts at annual general meetings of shareholders.
- Finally AHRI believes the two above recommendations are unlikely of themselves to provide durable change to diversity outcomes on our most senior boards. Whilst it is true Directors need time to understand the affairs of a company whose Board they have just joined, it is also true that Director’s independence can be eroded by ‘staying on board far too long’. Accordingly

AHRI recommends that the Commission itself consider recommending further to government that the Corporations Law be changed to require directors in leading ASX companies

- who are facing re-election for the second or subsequent time, or
- who have served 5 years or more,

as at the date of a forthcoming AGM, be deemed to hold '*contestable board seats*' which are open to nomination from other candidates. The other candidates for such seats could either be nominated by shareholders, say on application from 100 shareholders or more, or by any group of shareholders comprising 1% of share capital or more. It would be healthy if, in cases of such contestable board seats, the board's own Nomination Committee sponsored say their three best candidates, one of whom was the 'board-recommended candidate'. That way, shareholders at an AGM would have genuine choices when facing the opportunity to re-elect longer serving directors. Such elections could be on a simple 'first past the post' basis, and this environment would provide more contestable market circumstances than exist now. In an environment with three such 'board-sponsored candidates', having at least one of the candidates satisfying clear diversity criteria becomes within a board's reasonable reach. All other Board seat re-elections would be deemed *casual Board vacancies*, and follow the current process. AHRI sees such a recommendation for 'contestable board seat vacancies and elections' as being within a broad but reasonable interpretation of the Commission's Term of Reference number 4 from the Minister. If the Commission does not agree with AHRI on that interpretation, we would request your final report include a recommendation that another appropriate arm of Government review board directorship markets, contestability, and diversity.

- **Reducing Conflicts of Interest – Draft Recommendations 2 – 7: “Compositions of remuneration committees, voting rules and prohibited actions”**

AHRI agrees with these draft recommendations in full. AHRI believes the answer to the Commission's second invitation for comment under Draft recommendation 3 is 'yes'.

AHRI supports all these recommendations which accord with the principle that if a right is conferred on a party, there is a related obligation to discharge it reasonably, transparently and responsibly, and/or to abstain if there is or is likely to be a material conflict of interest.

- **Improving Relevant Disclosure – Draft Recommendations 8 and 9: “Remuneration reporting and coverage”**

AHRI recommended something substantially similar to the Commission, and so we agree with these recommendations. By way of further clarification, in recommendation 8 – we believe the Commission should state actual levels of remuneration received and receivable by executives should show clearly the quantum of the components based on fair value, and also that the *total results for each executive be shown in one table*. Regrettably at present in the annual reports of some companies, you have to go hunting across many tables in many places to work out this total number, if you are of a mind to do so, and it would seem many shareholders are. As well as being “written in clear English”, such reports should be “reasonably transparent and easily accessible to shareholders” in their forming of a detailed and overall assessment of senior executive remuneration. For recommendation 9, we believe banded data for other executives is important and should be emphasised more in the core final recommendation.

- **Improving Relevant Disclosure – Draft Recommendation 10 and 11: “Use of remuneration expert advisers”**

AHRI agrees with these recommendations. We think the mix of recommendations 10 and 11 are fine, and wouldn’t support the extension of ASX listing rules to all companies if recommendation 11 were not adopted, based on value for money and efficiency grounds with smaller ASX listed companies.

- **Improving Relevant Disclosure – Draft Recommendation 12: “Institutional investors – voting disclosure”**

AHRI sees significant benefit in a voluntary code of conduct being developed by key industry and shareholder associations to give greater substance to this recommendation. Accordingly AHRI recommends that attribute becomes part of this final recommendation.

- **Well conceived remuneration policies – Draft Finding 1: “The Commissions checklist”**

AHRI proposed in its original submission to the Commission that a national code of practice for remuneration (a “Rem-Code” as it was called), be recommended with two purposes in mind:

- Such a code would form a set of *best practice guidelines* for all companies to use in developing and applying remuneration policies and practices within their organisations

- The 'Rem-Code' would be the basis of a ***governance regime*** where principles, actions and audits would be undertaken in a four-step process, including two binding shareholder voting points.

Whilst AHRI is appreciative of the extensive consideration and review it made of our proposals in its draft report, we are of the view that such a code was not included within your recommendations mainly because of its couching within a binding-vote imperative under the second rationale above. Whilst AHRI still sees merit in such a Code forming a very useful part of a future governance regime, we accept the Commission's perspective that the best next steps for Australia are to give the non-binding remuneration report framework more time to work, and also to focus on streamlining and improving its content as per the range of recommendations in your draft report.

Nevertheless we see value in the content of the Rem-Code forming part of a set of best practice guidelines that all companies can use as they develop and apply their practices on executive remuneration. It is interesting to note the following fields where best practice standards and guidelines are reported on currently by very many corporations within their Annual Report

- ISO 14001 – Environmental Management
- ISO 9001 & HACCP 9000 – Quality
- ISO 27001 – Information Security Management
- AS 4801 – Occupational Health and Safety

AHRI sees merit in the Commission's checklist, and also for the best practice suggestions in AHRI Rem-Code being taken together with the checklist and further developed into guidelines by Standards Australia, SAI Global or an appropriate industry body for remuneration reporting that all companies, particularly smaller ones operating without the same level of resources and guidance as ASX100 firms, can use to take their efforts here to the next level.

AHRI advocates that the development of a best practice standard or guide on remuneration be included within the Commission's recommendations in its final report.

To this extent, AHRI notes the flavour and content of the Commission's checklist in its draft finding 1 to be consistent with that. Specifically we also recommend two small additions to the checklist.

At dot point three, we recommend the current sentence end with a comma and the following words in bold italics be added

“...metrics were selected, *and how such market benchmarks have been applied.*”

Our reasons are as follows. The executive remuneration market is a privately operated one that has potential public-benefit implications. From AHRI’s own research, it would seem one of our profession’s key concerns is aligned to that of the community; namely, the observation that there is evidence of upward bias creep from some boards over time. Accordingly seeking some explicit statement or comment that market values are paid, or what particular benchmarks are adhered to, would seem critical disclosures to achieve and sustain future public confidence.

Further at the end of dot point 4 we suggest the following clause in bold italics also be added:

“... unexpected changes (for example in the share price), *and how deferral principles and forfeiture conditions work within incentive pay arrangements*”

The reasons for this suggested variation is the mixed evidence and continuing public concerns that incentive payments have been asymmetric with particular and relevant economic and business conditions.

- Well conceived remuneration policies – Draft Recommendation 13: “Taxation of Equity Based Instruments”

AHRI recommended substantially the same, and so we support this recommendation.

- Facilitating Shareholder Engagement – Draft Recommendation 14: “Electronic Shareholder Voting”

AHRI agrees with this recommendation.

- Facilitating Shareholder Engagement – Draft Recommendation 15 “The two strikes proposal – 25% ‘no’ vote followed subsequently by a ‘no’ vote above a prescribed threshold”

AHRI agrees with the principle behind this recommendation that there should be an accountability consequence for very poor Board decision making on pay. AHRI has followed the public debate on this recommendation, and has the following advice to offer, in terms of the Commission’s three invitations for comment:–

1. *Issues with the 25% threshold* – In combination with the Commission’s other recommendations as to how votes are to be cast on remuneration reports (draft recommendations 4,6 & 7), this 25% recommendation would

be a more tightly framed voting context than has probably occurred previously. AHRI recommended renewal votes for Directors be set at 75% positive, and so this ratio – 25% negative – is consistent with that, but more effectively focusses on a board’s future non-performance within the field of executive remuneration.

The main concern we have with the proposed practice for this principle is the critical risk vesting with the second or “explanatory” strike. If this is just over 25% negative, it would trigger the Board’s re-election in the following or third year, but would be highly likely to see that Board re-elected in any event as the 75% accepting the board’s explanation would probably support them in the next year’s spill. This would be much less likely to happen if the second strike percentage point was set to be higher than 25%. AHRI believes a second strike point of ‘above 45% or 50% negative’ would be preferable to 25%. A number of our senior AHRI members have recently raised the issue that a company can acquire 19.9% of another company’s shares without declaring a takeover, and could use the second strike point of 25% to destabilise the Board – ie for reasons unrelated to remuneration.

This variation of percentages proposed by AHRI would maintain a reasonable pressure from the two strikes proposal, but would confine the consequence of Board spills to the more extreme cases. AHRI encourages the Commission to review and/or canvass such alternative percentages as a way of retaining this core principle, but moreso to focus it’s application on only those companies that heavily transgress reasonable community and shareholder expectations.

AHRI believes that a combination of the two strikes policy at 25% / 45%, plus a situation of contestable Board vacancies after 5 years service would together provide

- a better focus on extreme behaviour with pay;
- more continuous pressure to renew the Board mix and thereby to improve diversity in a more streamlined and less disruptive way.

2. AGM or EGM –

In specific answer to your question of AGM or EGM, the circumstances will vary. Those who feel the issue should be sorted out quickly will support an EGM. Others who feel a longer transition time is necessary to select an appropriately credentialed alternative Board of Directors will favour the 12 months until the next AGM. I think the final recommendation should

preserve the flexibility to choose, and not elect one of these options, as this would add unnecessary controversy to the important principle within.

3. *Consequences* – Further AHRI believes that the ‘two strikes’ principle forcing a re-election of directors should be confined only *to the non-executive directors*, and not the managing director, or any other executive director. The reasons for that view are as follows:

- a. The managing director / executive directors are to be excluded from such remuneration report decisions and votes as to their own pay, which would have caused the ‘two strikes’ principle to be invoked;
- b. The managing director / executive directors are most usually the subject of a separate employment contract with the company, through the non-executive directors of the board, and inclusive of the former’s own separate termination provisions;
- c. The managing director / executive directors may be needed to ensure continuity of oversight for management of the company were there to be any issue or hiatus in subsequent AGM / EGM election processes.

- o **General**

AHRI believes that the moves by government to transfer regulation of all major aspects of securities to the ASIC from the market operator – the ASX – are sensible and appropriate. We see the ASX and any other future market operator as sponsoring and developing best practice guides as appropriate, to support and extend market practices from the legislative standards set by the people through the Parliament, and as administered by ASIC.

On behalf of AHRI, the writer is available and seeks to appear at one of the Commission’s public hearings on the Draft Report, and in particular to elaborate on our:

- o Three proposals to enhance Draft Recommendation 1;
- o Specific suggestion to enhance Draft recommendations 8 & 9;
- o Three recommendations to expand Draft Finding 1;
- o Three proposals to review and/or expand Draft Recommendation 15.

Finally AHRI would like to thank the Commission for the positive and professional reception with which it has received our submissions through the presiding

Commissioners in this inquiry, and also for the way you have considered and evaluated our proposals for reform.

AHRI strongly endorses the progress of your draft recommendations and findings into the Commission's Final Report to government, and we encourage Commissioners and staff to consider the extensions and clarifications to such draft recommendations, as proposed in this letter.

Yours sincerely,

A handwritten signature in black ink, reading "Peter Wilson". The signature is written in a cursive style with a large initial "P".

Peter S Wilson AM
National President