

30 October 2009

Inquiry into Executive Remuneration
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne VIC 8003

Dear Sir

Please find attached UniSuper's submission regarding the Productivity Commission's Discussion Draft Paper in relation to executive remuneration in Australia.

I trust that the Commissioners will find this submission of assistance, particularly in providing them with the view of one of Australia's largest not for profit superannuation funds.

In considering the issues, a balance needs to be struck between appropriately enfranchising shareholders, board accountability, the owner/board/management distinction and commercial practicalities. Our submission focuses on the so-called "two strikes" and "no vacancy" proposals and essentially puts forward the following propositions:

Two strikes proposal

- If a "two strikes" rule is introduced, UniSuper considers that the second arm of the rule must only be triggered where a majority of the votes cast are "No" votes.
- Requiring an entire board to stand for re-election is potentially punitive and could cause instability detrimental to the company and the interests of shareholders. The response should be targeted and hold the relevant directors accountable, such as those comprising the Remuneration Committee.

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No vacancy rule

- UniSuper is not in support of the proposal to remove the “no vacancy rule”, as doing so is considered to be a blunt instrument by which to achieve increased board diversity. Further, UniSuper believes that it is a matter for each board to determine its optimal size within the specified minimum and maximum parameters (as outlined in the company constitution).
- There are other more appropriate means by which to encourage increased board diversity (refer to page 3 of UniSuper’s submission).

Yours sincerely



John Pearce
Chief Investment Officer

Encl.

Submission to the Productivity Commission's Inquiry into the Regulation of Executive Remuneration in Australia

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Background to UniSuper

UniSuper is one of Australia's largest and longest-standing industry superannuation funds and is dedicated to those who work in Australia's higher education and research sector. UniSuper represents more than 435,000 members Australia-wide and has assets under management of approximately \$21.8 billion (as at 30 June 2009)

We are one of the few Australian superannuation funds that still offers defined benefit as well as accumulation style benefit options, with a significant proportion of our members enjoying much higher than industry-standard employer contributions (up to 17% of salary) by virtue of a long-standing and continuing consensus among key stakeholders in Australia's higher education sector.

We were also one of the first Australian superannuation funds to adopt a comprehensive approach to proxy voting when, in 2004, we adopted a general policy of requiring all of our Australian fund managers to ensure that all votes attaching to UniSuper's holdings are exercised.

UniSuper therefore welcomes the opportunity to participate in the Productivity Commission's initiative to make significant incremental enhancements to the governance of listed Australian companies.

It is hoped that the Productivity Commission will find our comments, which we have drawn from our experience in these matters, useful and insightful.

Introduction

UniSuper considers that the draft recommendations contained in the Productivity Commission's September 2009 Draft Report are largely uncontroversial and will in general further strengthen the Australian corporate governance regime.

However, UniSuper has some concerns regarding the proposed introduction of the "two strikes rule" (as currently formulated) and the possibility of the "no vacancy rule" being removed.

Our concerns, and some alternative proposals for reform, are outlined below.

The proposed two strikes rule

By way of background, UniSuper generally votes all of its proxies across the S&P / ASX 200 (Australia), the FTSE 350 (UK), the FTSE Eurofirst 300 (Europe ex Greece) and the S&P 500 as well as all stock held across various Asian indexes.

In doing so, UniSuper and its investment managers carefully consider the resolutions to be voted on (including those regarding remuneration). UniSuper does not blindly follow the boards' voting recommendations and this is reflected in the statistics. Historically, UniSuper has voted "Against" remuneration reports in Australia approximately 15% of the time.

As such, we are in a position to express a view as to whether changes relating to the approval of executive remuneration arrangements are likely to be beneficial from a shareholders' point of view.

Comments on the effectiveness of the status quo

UniSuper is of the view that the non-binding shareholder vote on executive remuneration has encouraged directors to focus on matters pertaining to executive remuneration. Specifically:

- The non binding vote provides a mechanism by which shareholders can express their views on a company's remuneration practices;
- Where a company does receive a significant vote "Against", its board will often take steps to remedy the issues that shareholders had with the remuneration report and engage in open and constructive communication with its shareholders – this has certainly been UniSuper's experience; and
- If shareholders remain dissatisfied, they can vote against the re-election of directors as and when they come up for re-election.

However, the fact is that non-binding shareholder votes are, at the end of the day, non-binding. UniSuper is therefore open to proposals that ensure that the collective voice of shareholders is strengthened, while continuing to recognise the distinction between owners, boards and management.

Concerns regarding the "two strikes rule" in the form proposed

Based on our understanding of the proposed "two strikes rule", there would be two aspects associated with the proposal:

- Firstly, where a company's remuneration report receives a "No" vote of 25% or higher, the board would be required to report back to shareholders in the subsequent remuneration report, explaining how shareholder concerns have been addressed or, if they have not, why; and
- Secondly, where a company's subsequent remuneration report receives a subsequent "No" vote above a certain (yet undetermined) threshold, all elected board members would be required to submit for re-election (either at an EGM or the next AGM).

The introduction of a "two strikes rule" clearly seeks to provide shareholders with greater leverage regarding remuneration issues.

UniSuper is in favour of initiatives that strike a balance between shareholder expectations and the need for companies to be able to enter into executive remuneration arrangements on a commercial basis.

In our view, the first arm of the proposed rule would essentially codify what generally occurs in practice and is not particularly contentious (regardless of the 25% threshold). However, the second arm of the rule needs to strike a balance between appropriately enfranchising shareholders, board accountability and commercial practicalities.

The setting of the percentage threshold would therefore be critical. If the threshold were to be a 25% "No" vote (as for the first arm), this would seem to be too low and would theoretically enable a minority to veto the approval of a 75% majority.

An alternative proposal: measuring the level of approval

If a “two strikes” rule is introduced, UniSuper considers that the second arm of the rule must only be triggered where a majority of the votes cast are “No” votes. To set the threshold any lower would give the minority undue influence and the disruption caused could be disproportionate to the benefit achieved.

An alternative proposal: targeting the consequences

Consistent with principles of accountability and the importance of not inadvertently causing instability and discontinuity at board level, UniSuper would suggest that only the members of the Remuneration Committee be required to stand for re-election (as opposed to the entire board) if the second aspect of the “two strikes” rule were to be triggered. This approach would be more targeted and would hold the relevant directors accountable, in contrast to the current draft proposal that is more punitive in nature given its indiscriminate application to all directors.

If such a two strikes rule is introduced, it is important that shareholders are educated regarding the significance of such a rule.

Removal of the no vacancy rule

Hesitations regarding the draft recommendation

The Discussion Draft commented that use of the “no vacancy rule” constrains the ability of shareholders to elect new directors, may limit the potential for greater diversity of boards and could inhibit access to a wider pool of talent. However, consistent with the views expressed by the AICD and Professor Peter Swan (University of New South Wales), UniSuper considers that removal of the “no vacancy rule” may lead to larger boards (as boards will presumably ensure that all positions are filled) which is not always desirable as it could be more costly for shareholders and may lead to decreased board efficiency and effectiveness.

Further, UniSuper recognises that there are good reasons why a board may not have been filled to capacity. For example:

- Not replacing a director in difficult financial times would result in cost savings to the benefit of shareholders; and
- Where a board has identified a good candidate, but the departure of a pre-existing director is not imminent, it would be advantageous for the board to appoint the new candidate, in advance of a pre-existing director leaving.

An alternative solution

Notwithstanding the above, UniSuper does acknowledge that board diversity in its broadest sense (gender, age, ethnicity, qualifications, experience / expertise, and ability to challenge conventional thinking) is an area that requires ongoing attention. However, it is UniSuper's view that:

- Removal of the “no vacancy rule” could be a blunt instrument by which to achieve increased board diversity; and
- Each board should determine its optimal size within the specified minimum and maximum parameters (as outlined in the company constitution).

Further, as noted at the CGI Glass Lewis / Guerdon Associates briefing session held on Monday 19 October 2009 (at which Commissioner Banks was present) there are also

alternatives to removing the “no vacancy rule”. For example, it might be more appropriate to place increased focus and emphasis on the nominations process and operation of the nominations committee, such that the importance of the nominations process is elevated to the same level as remuneration. Other methods by which to increase levels of board diversity might also include:

- Investors raising the issue of diversity with Boards (for example, in October 2009 UniSuper, in conjunction with ACSI, attended five meetings with the Chairs of ASX 100 listed companies, and the issue of board diversity was raised at each meeting);
- Encouraging boards, as a matter of best practice, to include diversity in the Board Charter;
- The ASX Corporate Governance Council considering this issue (as highlighted in the Financial Review, Friday 23 October 2009); and
- The AICD placing continued emphasis on this matter, including mentoring of underrepresented groups (again, as highlighted in the Financial Review, Friday 23 October 2009).