IFSA

Investment & Financial Services Association Ltd
ACN 080 744 163

9 November 2009

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

Dear Chairman

Re: Productivity Commission discussion draft: Executive remuneration in Australia

IFSA congratulates the Commission on its comprehensive discussion draft report into executive remuneration in Australia.

IFSA is the national peak body which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 140 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

IFSA has been a strong supporter of, and an active participant in, the development of sound corporate governance practices underlying executive and director remuneration in Australia. Our members, both as the custodians and managers of other peoples' money and as institutional investors in their own right, have a vested interest in ensuring that executive remuneration is set at a reasonable level and structured appropriately.

Importantly, we continue to believe that it is the ultimate responsibility of the Board of Directors to approve the design of executive remuneration arrangements and take responsibility for hiring key executive staff and approving the terms of their employment.

While IFSA is broadly supportive of the Commission's recommendations, there are a few exceptions, most significantly in relation to Recommendation 15. If unchanged, we believe this recommendation has the potential to create serious unintended consequences. As long term responsible shareholders, we are concerned at the risk of being disenfranchised by a minority of shareholders who may be pursuing narrow unrelated issues and interests – totally unrelated to remuneration.

Please do not hesitate to contact Martin Codina, Director of Policy, on (02) 9299 3022 if you wish to discuss these matters further or have any questions.

Yours sincerely

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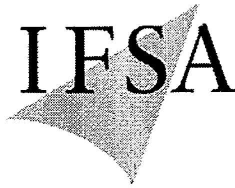

Investment & Financial Services Association Ltd

PRODUCTIVITY COMMISSION DISCUSSION DRAFT: EXECUTIVE REMUNERATION IN AUSTRALIA

IFSA SUBMISSION

Recommendation 1

Fundamentally, IFSA believes that the Board is best positioned to determine the number of directors (and mix of skills) that it requires to efficiently and effectively discharge its governance obligations. We also recognise that the optimal number of directors will vary with the circumstances of the company and its operating environment.

IFSA notes that under the ASX Corporate Governance Council (ASX CGC) Principles, companies are required to make the following information, relevant to Board composition, publicly available:

- Description of the procedure for the selection and appointment of new directors and the re-election of incumbent directors.
- Charter of the Nomination Committee or a summary of the role, rights, responsibilities and membership requirements for that Committee.
- The Board's policy for the nomination and appointment of directors.

IFSA believes that disclosure of these matters by Boards provides shareholders with an adequate opportunity to engage with the companies in which they have invested to ensure that there is an appropriate level of Board diversity and that the Nominations Committee is considering candidates from a broad potential director talent pool.

Recommendation 2

IFSA supports this recommendation and notes that introducing a listing rule as proposed should provide consistency between the position of audit committees and remuneration committees under the ASX Listing Rules.

Recommendation 3

IFSA supports this recommendation.

Recommendation 4

IFSA supports the proposal to exempt key management personnel and all directors from voting their shares on remuneration reports and related resolutions.

Importantly, IFSA suggests that further consideration be given to the application of the 'associate' test in this context. For example, under the current definition of 'associate', it is possible that a major shareholder with a nominee on the board could be prohibited from voting on remuneration matters. This does not appear consistent with the intent of the Commission's Report.

Recommendation 5

IFSA concurs with the Commission that hedging by executives against company-specific risks associated with equity-based remuneration weakens the intended link between pay and performance. As a result, IFSA does not support the practice of hedging "at-risk" remuneration as it is contrary to the alignment of interests between long term investors and company executives.

IFSA therefore supported specific guidance with respect to hedging being inserted in the revised version of the ASX CGC Principles. IFSA also supports the requirements under the Corporations Act, section 300A(da), which broadly require the remuneration report to discuss board policy on executives limiting exposure to risk and the mechanism to enforce the policy.

IFSA notes, however, that there does not appear to be clear evidence that companies are not complying with the Principles in this area, with the Commission itself noting that "the practice [of hedging] appears uncommon".[1]

IFSA submits therefore that the ASX CGC could instead be requested to monitor compliance with this aspect of the Principles and report to the Government should evidence of market misconduct in this area become apparent.

Recommendation 6

IFSA supports this recommendation and notes that more can be done to enable shareholders to be more engaged in exercising their rights through voting directly.

The voting process is still predominately paper based which makes it cumbersome and prone to errors. IFSA therefore believes that companies should be encouraged to move to an electronic voting platform that allows shareholders to vote directly.

Recommendation 7

Proxy voting is important in promoting shareholder engagement and is generally the only feasible means of voting for most institutional shareholders.

Given that many shareholders are unable to attend company meetings, it is vital that the view of all shareholders who have voted either through the lodgement of proxies, or by attending the meeting, prevails. IFSA is therefore supportive of methods to promote the integrity of shareholder voting and ensure directed proxies are voted on all resolutions.

We note that the Productivity Commission's draft report refers to Treasury proposals under the *Corporations Amendment Bill (No. 2) 2006* to address concerns over 'cherry-picking' of proxy votes across all resolutions. While the proposed amendments have not been put to Parliament, they appear to address concerns over proxy holders being appointed unknowingly or unable to vote while also removing any potential for conflict of interest.

[1] See page XXVIII of the Overview section of the Report.

Consequently, we believe that Treasury's proposed amendments to subsections 250A(4) and 250A(5) of the Corporations Act 2001 appear reasonable and should be considered in any future reforms to enhance shareholder voting.

Recommendation 8

IFSA is supportive of changes to the Corporations Act 2001 that result in an improvement in the readability of remuneration reports and a reduction in the compliance burden for companies.

However, given the prescriptive list of requirements in Section 300A of the Corporations Act 2001 and the fact that failure to comply has criminal liability implications for directors, IFSA believes that there is scope to review its operation as part of a broader process seeking to simplify and improve the readability of remuneration reports.

Recommendation 8 (b)

IFSA supports the intent behind the Commission's recommendation for companies to disclose more meaningful remuneration details. Importantly, care will be needed in relation to how 'actual' or 'realised' remuneration is defined to ensure consistent application between companies.

For example, 'actual' remuneration, if interpreted as cash received by an individual during the reporting year, could include the following:

- Base salary
- Short-term incentives awarded in respect of the current year paid in cash (i.e. those not deferred)
- Payment in cash of deferred short-term incentives awarded from a prior year (note that these may include awards over multiple years depending on the vesting scale)
- Exercise of vested long-term incentives (noting that these may include awards over multiple years due to overlap of exercise periods and/or re-testing policies)

A different interpretation of 'actual' remuneration could result in long-term incentives being the value "accrued" over the year adjusted for share price movement and progress towards meeting the performance hurdle.

Without a clear definition of 'actual' remuneration, there is a risk that total 'actual' remuneration reported may be very difficult to reconcile to company performance, may not necessarily be comparable year-on-year, and may not allow comparison between companies on a like-for-like basis.

Recommendation 8 (c)

IFSA supports the recommendation to include company shareholdings of individuals named in the remuneration report noting that many companies already adopt this approach and that the financial statements already include this requirement.

Recommendation 9

IFSA supports the recommendation to align the Corporations Act with the accounting standards so that individual remuneration disclosures are confined to the key management personnel.

Recommendation 10

IFSA supports the principle that external advisers be engaged by and provide their final advice to the remuneration committee (or, where there is no remuneration committee, the full board).

However, IFSA acknowledges that executives may also have a need to engage such experts to design the remuneration policies for other company employees. As such, care needs to be taken as to how this recommendation is implemented to ensure that the company is not precluded from engaging multiple external advisers if necessary or desirable.

Given the complexities in this area, IFSA prefers that this recommendation be incorporated into the ASX CGC Principles where guidance can be provided to minimise any unintended consequences from the proposal.

Recommendation 11

Given our views on recommendation 10, IFSA supports Recommendation 11 on the basis that it will provide a more holistic approach to external advisers under the framework of ASX CGC Principles and therefore should deliver a better outcome for shareholders and companies.

Recommendation 12

IFSA members are already required to comply with IFSA Standard No.13 Proxy Voting. Should the Committee consider further guidance is required, IFSA would be pleased to discuss possible improvements to the Standard.

Proxy voting transparency

Under Standard No.13 Proxy Voting, IFSA members are required to: [2]

- have a formal Proxy Voting policy approved by their Board that sets out the principles and guidelines under which proxies are voted;
- vote on all Australian company resolutions where they have the voting authority and responsibility to do so; and
- publish an aggregate summary of their Australian proxy voting record at least annually and within 2 months of the end of the financial year. It is common practice for these records to be publicly available on member websites.

As part of the guidance provided to IFSA members under the Standard, they are encouraged to provide additional information in respect of their Proxy Voting record covering, for example, explanations of votes on contentious or material issues; where they have abstained from voting; or delegated the voting of non-contentious issues to the Chair of the meeting.

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[2] See IFSA Standard: http://www.ifsa.com.au/documents/IFSA%20Standard%20No%2013.pdf.
See also examples of proxy voting disclosure: http://www.ampcapital.com.au/_pdf/governance/2009-August_Corporate-Governance.pdf?DIRECT (AMPCapital Investors), http://www.cfsgam.com.au/uploadedFiles/CFSGAM/About_Us/Responsible_Investment/090708_CG-update.pdf (Colonial First State Global Asset Management).

Securities lending

IFSA supports the practice of securities lending as it contributes to the liquidity and efficiency of the market. Importantly, IFSA has had a long held policy of not supporting differential voting shares or vote renting activity.

Under IFSA Guidance Note No. 2,[3] fund managers are advised to discuss and develop policies dealing with securities lending arrangements, including the circumstances and procedures for ensuring all securities lending activity is lawful and that all voting entitlements are exercised appropriately.

This may include working closely with superannuation clients and custodians to increase the information and transparency surrounding securities lending.

Recommendation 13

IFSA strongly supports removing the trigger for taxation of equity-based payments on cessation of employment, though acknowledges that the Government has proceeded with the introduction of new legislation on taxation of employee share schemes on the existing basis.

Importantly, removing cessation of employment as a taxing point aligns with the principles of APRA and the Financial Stability Board in promoting remuneration structures that take account of sound risk management. The existing tax laws do nothing to encourage deferrals and longer-term alignment beyond tenure.

Recommendation 14

IFSA strongly endorses this recommendation. Over a number of years, IFSA has been spearheading a move towards electronic proxy voting, as evidenced by our submission to the 2007 Parliamentary Joint Committee on Corporations and Financial Services into shareholder engagement and participation.

For the Committee's benefit, we have reproduced below the key issues covered in our submission dealing with the inadequacies of the current proxy voting system.

Paper based weaknesses of the present system

There are elements of the present proxy voting system that are largely paper based and consequently manually intensive. The current process requires the lodging of institutional proxy forms by fax with authenticated signatures and those instructions are typically re-keyed by registry staff as part of the counting process. The cumbersome nature of this process has resulted in a number of cases of votes not being correctly counted or lodged.

It is important to note that it is currently not possible to determine the exact number or proportion of lost votes due to the lack of an effective and accurate audit trail whenever votes are lodged.

Indeed, as an example, AMP Capital Investors was only able to ascertain that "votes had gone 'missing' when reviewing a small sample where the 'against' or 'abstain' instructions lodged by AMP Capital, on the shares held in portfolios under our management, exceeded

[3] See:
http://www.ifsa.com.au//2009%20Documents/2009_0703_June%202009%20Blue%20Book%20FINAL.pdf

the number of such votes recorded by the company and disclosed to the ASX after the company meeting".

In AMP Capital's case, after conducting a further review of circumstances where they had instructed in the proxy to either vote 'against' or 'abstain from voting', they determined that voting instructions had been "lost" in over 4% of instances.

The increasing reliance on 'Schemes of Arrangement' to effect takeovers also highlights the importance of complete integrity in the proxy voting system. Changes of control (and consequent compulsory acquisition of minority interests) take place as a consequence of shareholder votes. All investors need to have confidence that vote counting systems in close votes, such as in the recent contested Scheme involving Rebel Sport, were beyond scrutiny.

Given these weaknesses, the investment and superannuation industry believes there is a clear need to establish an effective electronic proxy lodgement system that is capable of providing a meaningful audit trail and removing cumbersome paper based mechanisms from the process.

Recommendation

Superannuation trustees and investment managers should immediately commence requesting issuers in which they hold shares to receive proxy instructions by electronic means as a matter of course at all members' meetings.

Following the publication of this submission, IFSA, on behalf of willing Roundtable members, will prepare an open letter to all S&P/ASX 300 companies requesting that they put appropriate electronic proxy voting arrangements in place as soon as possible.

Clarification of company constitution to facilitate electronic proxy voting

The Corporations Act does not mandate that listed entities must provide for electronic lodgement. Consequently, we are aware of a widespread belief that companies are unable to offer electronic lodgement unless it is provided for in their constitution.

As it is not clear whether all company constitutions require amendment to facilitate electronic lodgement, Roundtable members suggest that ASIC consider issuing a Policy Statement or 'no action position' letter clarifying that any issuer that accepts electronic proxies without a relevant constitutional change will not be taken to have breached the relevant sections of the Corporations Act.

In the event that such a statement is unable to be provided by ASIC, Roundtable members recommend that, given their level of institutional ownership of S&P/ASX300 listed entities, companies seek to amend their constitutions at the next members' meeting to explicitly provide for electronic lodgement if this is not already provided for in their constitution.

Recommendation

We request that the PJC recommend that ASIC issue a Policy Statement or 'no action position' letter clarifying that any issuer that accepts electronic proxies without a relevant constitutional change would not be taken to have breached the relevant sections of the Corporations Act.

Alternatively, in the event that such a statement is unable to be provided by ASIC, Roundtable members recommend that companies seek to amend their constitutions at the

next members' meeting to explicitly provide for electronic lodgement if this is not already provided for in their constitution.

Lack of an audit trail

A major issue raised at the initial Roundtable was the lack of an audit trail under the present system. At present, no confirmation is received by a custodian, superannuation fund or investment manager from issuers or their share registrars as to the number of votes lodged and subsequently voted as well as the manner in which they were voted.

In effect, this means that a superannuation fund or investment manager is unable to confirm whether their voting instructions have been accepted by share registry service providers.

This is also the case with existing "online" voting facilities offered by some share registry service providers which do not provide a receipt or confirmation as to the number of votes lodged and subsequently voted as well as the manner in which they were voted.

Increasingly, fund managers and superannuation trustees are being more transparent and reporting openly to their constituents about their proxy voting activity. This process will have more meaning where the existence of an audit trail from the issuer back to the lodgement agent (e.g. a custodian) is in place.

Recommendation

An electronic proxy voting capability needs to be developed that will provide a meaningful audit trail from issuers & their registrars to shareholders so that superannuation funds, investment managers and other appointed proxies are able to confidently declare how they voted in any instance.

The audit capability should allow for acknowledgement within 24 hours of the record cut-off date for any proxy instruction submitted electronically.

Institutional investors recognise that moving to an electronic proxy voting system that provides this level of functionality and audit capability will require an investment by issuers and share registry service providers. However, the industry is prepared to discuss mechanisms to allow issuers and share registry service providers to recoup these costs by charging a fee (based on cost-recovery) for using such a system.

The Roundtable is aware of discussions that are underway between market participants and the ASX regarding the possible use of CHESS to facilitate such a system. While the Roundtable is not opposed to a CHESS based system, it is concerned at the possible delays that may arise from the creation of such a system and the risk that it may be superseded by international electronic proxy voting messaging standards currently being tested and refined by SWIFT. Such international messaging standards are also likely to facilitate cross-border voting.[4]

The Roundtable therefore supports the implementation of the most effective, efficient and timely electronic solution that is most likely to result in widespread adoption.

Time pressure to reconcile votes lodged against entitlement to vote

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[4] See: http://www.swift.com/index.cfm?item_id=63149

For the appointment of a proxy and accompanying voting instructions to be effective, there are two critical timeframes that must be observed:

- Under section 250B(1) of the Corporations Act 2001, a proxy appointment must be received by the company at least 48 hours before the meeting (proxy appointment cut-off date); and
- Under regulation 7.11.37(3) of the Corporations Regulations 2001, the convenor of a meeting must determine the entitlement to vote at the meeting based on those persons who were shareholders of the company not more than 48 hours prior to the meeting (record cut-off date).

The time pressure caused by the co-existence of these cut-off dates inevitably results in last minute reconciliations by share registry service providers of the number of votes lodged against actual holdings at the record cut-off date – increasing the likelihood of errors in the process.

Critically, the proxy appointment cut-off date can be extended beyond 48 hours, allowing investment managers and superannuation funds to provide earlier notification of a proxy appointment and voting instructions.

The record cut-off date, however, is fixed at not more than 48 hours, meaning that the issuer must reconcile the number of votes lodged against the actual entitlement not more than 48 hours prior to the meeting – effectively removing the flexibility provided by the more flexible proxy appointment cut-off date.

This record cut-off date presents unique challenges for custodians and share registry service providers when an Annual General Meeting (AGM) is scheduled on a Monday or after a public holiday or series of public holidays for example.

It is interesting to note that in the US and Canada, the record date is normally 60 days prior to the meeting. It would therefore not seem to pose any serious market risks if the record date were moved out to "5 business days before the meeting".

Consequently, for the reasons outlined above, the Roundtable recommends an amendment to regulation 7.11.37(3) of the Corporations Regulations 2001 to extend the record cut-off date to "5 business days before the deadline for receipt of proxy appointment set by the company". The Roundtable also supports the adoption of the ASX Listing Rule definition of "business day" for this purpose.

This will provide sufficient time for the reconciliation process to occur such that a more effective audit can be undertaken between the registered holder (custodian) and share registry service provider to ensure that all votes lodged are received and voted as instructed.

In the event of any discrepancy or uncertainty, this will also allow for the relevant share registry service provider to contact the registered holder (custodian) and for the custodian to then contact the relevant clients who provided the voting instructions.

Issuers should also give careful consideration to the difficulties posed by holding an AGM on a Monday or after a public holiday or series of public holidays.

Roundtable participants acknowledge that an electronic proxy voting capability should facilitate a more timely reconciliation process and remove, to a significant extent, manually intensive aspects of the vote lodgement and reconciliation process by allowing for a "straight through process" that is effectively automated once the votes are lodged.

Nevertheless, Roundtable participants are of the view that in order to comprehensively address the risks posed by a record cut-off date of "not more than 48 hours prior to the meeting", an amendment to the Corporations Regulations 2001 is necessary to extend the time period as suggested above.

Recommendation

Regulation 7.11.37(3) of the Corporations Regulations 2001 should be amended to extend the record cut-off date to "5 business days before the meeting". The Roundtable also supports the adoption of the ASX Listing Rule definition of "business day" for this purpose.

Such a timeframe will provide more time to reconcile votes lodged against actual holdings and will significantly address issues that currently arise where the AGM is scheduled for a Monday or after a public holiday.

Once a well functioning electronic proxy voting system with a high take-up is operating in the market, these dates can once again be reviewed by ASIC if there are concerns about the time between the record and appointment cut-off dates.

Exercise of discretion by share registries and/or issuers

Roundtable participants also noted that there is currently a lack of consistency between share registry service providers' and/or issuers' approaches to determining how they will deal with:

- unclear proxy appointment forms; or
- cases where the votes lodged by the proxy appointment cut-off date do not reconcile with the number of votes entitled by that proxy holder immediately before the meeting (the record cut-off date).

While the exercise of some discretion may be necessary at times, Roundtable participants strongly support an approach which ensures the boundaries around the exercise of that discretion are well defined and appropriate.

Indeed, it was noted at the Roundtable that there have been cases where a discrepancy in the shareholding has led a share registry service provider to disregard the voting instructions entirely, rather than reduce the number of shares to be voted so that only the actual entitlement is voted.

Recommendation

Issuers should, as soon as practicable, make publicly available on the corporate governance part of their websites a clear policy surrounding how they will deal with unclear proxy forms and cases where the votes lodged do not reconcile at the proxy appointment cut-off with the shares actually held by that registered shareholder at the record cut-off date.

It is strongly advised that the policy provide that in cases where there is a discrepancy in the shareholding, the company will direct its share registry service provider to conduct a reconciliation process so that the correct entitlement is voted as opposed to disregarding the entire number of votes.

In all cases, proxy forms rejected must be advised before the proxy cut-off to ensure there is an opportunity to resolve any confusion or uncertainty.

Standardising the disclosure of proxy results to the ASX

Roundtable attendees also noted that there is no standardised format for disclosure of proxy results by issuers being made to the ASX.

Section 251AA (2) of the Corporations Act and ASX Listing Rule 3.13.2 require listed entities to disclose the results of resolutions passed at member meetings, including the total number of proxy votes validly appointed, the number of proxy votes cast for, against, abstain etc.

However, a listed entity is not required to disclose the percentage of the issued capital voted (in total) and the percentage of the issued capital voted for, against, abstain etc.

Such disclosure would provide improved transparency of the outcome of votes at company meetings. The ASX is represented on the Roundtable and has indicated that it is willing to consider recommendations that arise out of the Roundtable process.

Recommendation

The Roundtable will continue to work with the ASX to develop a template to facilitate standardised disclosure in this area. The template could include details of the number of votes lodged for/against/abstain for each resolution including as a proportion of issued capital. We seek the support of the PJC in this area.

Recommendation 15

IFSA has strong concerns about the unintended consequences of the proposed "two strikes" rule outlined in the Draft Report.

In our view, the current non-binding vote on the remuneration report has generally worked well. Our experience suggests that Boards take shareholder concerns seriously and more importantly, have generally sought to rectify any major areas of concern in subsequent Reports.

Additionally, in our experience, requiring a Board to formally explain and respond to shareholders after a 25 per cent 'no' vote – the 'first strike' – is primarily codifying something that most Boards already undertake.

However, the introduction of a 'two strikes' approach would make a second vote against the remuneration report effectively a vote against the entire Board and could give that power to a minority of shareholders. Depending on the required voting level set for the second trigger, this could in effect disenfranchise the majority of shareholders who may have voted in favour.

Such a proposal would therefore allow the remuneration report to be used as a mechanism to trigger disapproval with a wide range of unrelated issues and interests – totally unrelated to remuneration.

There are also considerable practical issues associated with this proposal. The effect of removing the Board following a second strike could be significant on shareholder value and could create a significant disruption to the operation of the company.

IFSA therefore believes that this proposal needs to be significantly refined if it is to be incorporated into the Corporations Act.