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6 November 2009

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

By email: exec_remuneration@pc.gov.au

Dear Commissioners

Discussion Draft "Executive Remuneration in Australia"

Please find attached the response by the Australian Institute of Company Directors (AICD) to the Productivity Commission's Discussion Draft "Executive Remuneration in Australia".

We look forward to appearing at the Commission's Sydney Public Hearings on 10 November 2009, and would be happy to discuss any of the points made should this be considered appropriate.

Yours sincerely,

John H C Colvin
Chief Executive Officer

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
ABN 11 008 484 197

Submission by

The Australian Institute of Company Directors

to

The Productivity Commission

in response to its

Discussion Draft "Executive Remuneration in Australia" (September 2009)

6 November 2009

INTRODUCTION

The Australian Institute of Company Directors (AICD) welcomes the opportunity to provide feedback in response to the Productivity Commission's Discussion Draft titled "Executive Remuneration in Australia", which was issued on 30 September 2009 ("the Draft Report").

AICD is the second largest member-based director association worldwide, with approximately 25,000 individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, charities, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

AICD acknowledges the systematic, well researched and consultative approach undertaken by the Productivity Commission. We commend the injection of facts, balance and rationality into the debate regarding executive remuneration, particularly given the sometimes emotive nature of commentary by others on the topic. In particular, we believe the Draft Report has an appropriate balance between recognising, on the one hand, key issues that have arisen in the area of executive remuneration, while on the other hand, problems associated with an overly prescriptive approach.

AICD agrees with the majority of the Productivity Commission's conclusions contained in the Draft Report, including:

- the recognition given to the important and central role of boards in setting executive remuneration;
- rejection of legislatively imposed remuneration caps;
- rejection of the notion that the non-binding shareholder vote on remuneration reports should be made binding;
- the desirability of greater transparency around voting decisions on remuneration issues by institutional owners; and
- the strong case for removing cessation of employment as a trigger for taxation of equity-based payments.

We also note the Commission's findings, in line with the comments we made in our earlier submission[1], that:

- Australia's corporate governance rates well[2]; and
- Australian executive remuneration levels generally remain below those in the United States and the United Kingdom, being more in line with smaller European countries.[3]

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[1]AICD Submission to the Productivity Commission, 29 May 2009.
[2]Draft Report, Overview, page xxiii.
[3]Draft Report, Overview, page xix.

We do have difficulties, however, with a number of positions adopted by the Commission, including:

- the proposal that shareholders must approve the maximum number of directors;
- the "two strikes" proposal;
- mandating remuneration committees with compositional requirements for all ASX300 companies;
- prohibiting the company's appointed representative (usually the Meeting Chairman) from casting undirected proxy votes on remuneration resolutions put to shareholders;
- proposed prescriptive requirements to hedging and expert advice; and
- preliminary views on the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.

For ease of reference, a summary of AICD's responses is included in Table 1.

Table 1 - Summary of AICD Responses

	Productivity Commission Draft Recommendations	AICD Response
1.	The Corporations Act 2001 should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).	**Opposed.** Recommendation is considered to be overly prescriptive and extend beyond remuneration matters. If progressed, the capacity for companies to put in place qualifying conditions regarding director nominations should remain as it is.
2.	A new ASX listing rule should specify that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.	**Opposed.** Considered that this would be more appropriate as an "if not, why not" requirement.
3.	The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a 'comply or explain' recommendation which specifies that remuneration committees: • have at least three members • be comprised of a majority of independent directors • be chaired by an independent director.	**Supported.**
4.	The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration-related resolutions.	**Supported in part,** but concerned about potential disenfranchisement caused by extending the prohibition to "associates".
5.	The Corporations Act 2001 should prohibit all company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks.	**Opposed.** Considered that this is better dealt with as a governance guideline given complexity involved and potential red tape issues.
6.	The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.	**Supported in part,** subject to an exception that the Meeting Chairman be allowed to receive and vote undirected proxies in the Company's best interests. Again, the extension of the prohibition to "associates" is queried.
7.	The Corporations Act 2001 should be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any other remuneration-related resolutions.	**No objection,** subject to the issue of proxy holder consent being addressed.
8.	Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include: • a plain English summary statement of companies' remuneration policies • actual levels of remuneration received by executives • total company shareholdings of the individuals named in the report. Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.	**Supported,** subject to satisfactory clarification of the meaning of "actual" remuneration. Considered that the opportunity should be taken to consolidate and simplify existing requirements.
9.	Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to the key management personnel. The additional requirement for the disclosure of the top five executives should be removed.	**Supported.**
10.	The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.	**Supported in part.** Believe this is more appropriate as a "best practice" guideline, possibly with an "if not, why not" reporting trigger. Recommendation should be limited to advisers on the remuneration of directors and key management personnel.

11.	The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.	**Supported**, but should be limited to advisers on the remuneration of directors and key management personnel.
12.	Institutional investors should disclose, at least on an annual basis, how they have voted on remuneration reports and any other remuneration-related issues. How this requirement is met should be at the discretion of institutions.	**Supported.**
13.	The cessation of employment trigger for taxation for equity-based payments should be removed, with the taxing point for equity or rights that qualify for deferral being at the earliest of: where ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.	**Supported.**
14.	The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.	**Supported.**
15.	The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a 'no' vote of 25 per cent or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why. If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re-election (a 'two strikes' test) at either: • an extraordinary general meeting or • the next annual general meeting.	Disclosure Proposal - **Supported.** A 25% or more "no" vote of total votes cast (including recorded abstaining votes) is an appropriate reporting trigger, subject to refinement in the area of "main stated" concerns by shareholders. "Two Strikes" Proposal - **Opposed.** But, if progressed the trigger for a board spill should be no less than a majority (over 50%) of total votes cast (including recorded abstaining votes) against a remuneration report for two consecutive years.

PART A: COMMENTS ON DRAFT RECOMMENDATIONS

A.1 Improving board capacities

DRAFT RECOMMENDATION 1: ***The Corporations Act 2001 should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).***

The Commission seeks participants' views on:

- *how this draft recommendation should operate in practice, in terms of the two stage voting process*
- *whether there are other 'barriers to entry' to boards that may contribute to a lack of diversity or inhibit renewal.*

AICD does not consider the existing paradigm for board nominations and appointments is "broken"

AICD does not support draft recommendation 1. We understand the underlying rationale for draft recommendation 1, but believe it is overly prescriptive and extends beyond remuneration matters. In particular, we note:

- it is currently within the power of shareholders as a group to introduce a provision into the company's constitution to the effect that the maximum number of directors be set only at a general meeting of shareholders;
- shareholders of listed companies effectively put an upper cap on board size through the director fee pool that they approve[4];
- we do not believe adoption of this requirement would not have much, if any, bearing on remuneration outcomes; and
- boards are in the best position to assess the appropriate number of directors for the company.

Possible unintended consequences include:

- (where the limit is set too tight) reduced capacity for boards to appoint exceptional candidates where opportunities present themselves;
- (where the limit is set too tight) an impediment to boards putting in place arrangements as part of a smooth succession planning process (e.g. the practice of boards appointing new directors in anticipation of an existing director(s) retiring or not standing for re-election); and
- (where the limit is set too high) larger boards than are otherwise necessary.

If such a recommendation is ultimately adopted by the Productivity Commission, greater recognition should be given to the need for companies to continue to have the capability to put in place qualifying conditions for director nominations by shareholders, otherwise there could well be an "avalanche" of nominations by poorly

[4] ASX listing rule 10.17.

qualified candidates (with a potential disruptive effect on shareholder meetings).[5] We also consider that unless companies are able to put in place appropriate checks and balances, boards could become unnecessarily large and "factional" in nature, with adverse implications for board effectiveness and company performance.

We were pleased to see there is recognition in the Productivity Commission's Draft Discussion Report[6] of the potential disruptive impact of unchecked board nominations, and comments to the effect that restrictions on board nominations (e.g. number of signatures needed from other shareholders) should remain a matter for companies and shareholders to resolve.

While AICD supports diversity, it does not agree that "greater diversity" will necessarily result in "better" remuneration decisions

AICD notes that, following on from the recommendations of the Companies and Securities Advisory Committee (CAMAC)[7], there are initiatives under consideration to encourage boards to more closely consider diversity, including gender, backgrounds, skills, experience and perspectives. These include initiatives under consideration by the ASX Corporate Governance Council and AICD.

Having said that, AICD does not consider that greater diversity is necessarily going to make executive remuneration decisions any less difficult or result in different remuneration outcomes. Nor do we consider there exists any systemic "management capture" or "remuneration round robin" problem, as stated by some respondents to the Inquiry. We note:

- All directors, no matter what their background is, will be required to put in place remuneration structures that are in the best interests of the company.
- A director's duty to act in the best interests of the company will override any "community" or vested interest viewpoints that the individual director may have.
- Executive remuneration levels are driven to a large extent by market forces, which are unrelated to issues of board diversity.
- Shareholder concerns with executive pay, where they have existed, have been more prevalent with some ASX100 companies, which often have an international outlook - yet draft recommendation 1 relates to all companies.

A.2 Reducing conflicts of interest

DRAFT RECOMMENDATION 2 - ***A new ASX listing rule should specify that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.***

[5] We note there are already nomination requirements in law, as well as in many company constitutions.

[6] Productivity Commission, Draft Report, final paragraph on page 304.

[7] CAMAC, "Diversity on boards of directors", Report, March 2009.

AICD disagrees with draft recommendation 2 in its current form. We acknowledge there is a listing rule requirement for an audit committee with particular attributes that extends to ASX300 companies, but we consider that the same requirements should not necessarily be applied to remuneration committees. Our reasoning is:

- such a requirement for remuneration committees would extend too far, imposing unwarranted costs on companies at the smaller end of the ASX300 spectrum;
- audit committees require a large time commitment from non-executive directors and those members may not be able to contribute to the remuneration committee (or have the necessary skill set);
- the role of the audit committee is fundamental and goes to the integrity of financial reports upon which company performance is assessed;
- while it is generally accepted as best practice that audit committees be comprised entirely of non-executive directors, we believe there are legitimate situations, depending on a company's circumstances, for an executive (e.g. CEO) to be on a remuneration committee given that such committees often deal with matters in addition to board and executive remuneration and there are obligations under the law relating to the handling of conflicts; and
- the introduction of the audit committee requirement was, in effect, phased in - an "if not, why not" audit committee requirement existed in the listing rules for approximately eight years before audit committees with compositional requirements were mandated for larger companies.[8]

A likely consequence of implementing draft recommendation 2 would be an increase in the size of boards. In some cases this additional cost will not be justified.

For the reasons outlined above, we query whether there is a need for a listing rule of the type proposed; our preferred approach is that the "if not, why not" proposal in draft recommendation 3 (see below) be given time to operate and then be assessed.

If the Commission proceeds with an amended version of draft recommendation 2 we consider that either the recommendation as currently drafted should be restricted to ASX100 companies, or the compositional requirements in draft recommendation 3 be incorporated into draft recommendation 2. The latter would also have the advantage of consistency, recognising that companies may go in or out of the ASX100 group, or the ASX300 group.

[8] On 1 July 1993 ASX introduced a listing rule that required listed companies to state whether they had an audit committee. An "if not, why not" component was subsequently introduced on 1 July 1994. On 1 January 2003 ASX introduced listing rule 12.7 which provided that an entity included in the Standard & Poors All Ordinaries Index (the top 500 companies by market capitalisation) must have an audit committee and that the composition, operation and responsibility of the audit committee must comply with the best practice recommendations of the ASX Corporate Governance Council. The rule was changed on 3 May 2004 to require all companies in the S&P All Ordinaries Index (the top 500 companies) to have an audit committee, and the top 300 by market capitalisation in that index to meet the compositional requirements.

DRAFT RECOMMENDATION 3 - ***The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a 'comply or explain' recommendation which specifies that remuneration committees:***
- ***have at least three members***
- ***be comprised of a majority of independent directors***
- ***be chaired by an independent director.***

The Commission seeks comment on:
- *how the intent of this draft recommendation could be effected in the event that the ASX Corporate Governance Council — which has ownership of its principles and recommendations — does not agree*
- *whether or not draft recommendation 2 should be extended to all listed companies were draft recommendation 3 not adopted.*

AICD supports draft recommendation 3, and endorses an "if not, why not" approach over the mandating of remuneration committees. This is on the basis that there is no "one size fits all", combined with the fact that the bulk of ASX listed companies are not in a position to be able to comply with a requirement which mandates remuneration committees with the proposed attributes.

DRAFT RECOMMENDATION 4 - ***The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration-related resolutions.***

AICD has no fundamental objection to those directors and key management personnel that have their remuneration detailed in the company's most recent remuneration report being prohibited from voting their securities where the resolution relates to *their own remuneration* (including the Remuneration Report) - although, if combined with a "two strikes" requirement, we believe there is a stronger argument that all shareholders (including executives and directors) should be able to vote on the remuneration report (given the potential value destroying effect of a board spill). We recognise that the proposed voting prohibition is consistent with the approach taken in the ASX listing rules where a shareholder stands to benefit in a capacity other than a shareholder if a resolution is passed.[9]

We have some concerns, however, with possible unintended consequences of applying the voting restrictions to "associates" of individuals named in the remuneration report. How is "associate" to be defined? Is it envisaged, for example, that a major shareholder be precluded from voting (disenfranchised) on a non-binding

[9] Refer to ASX listing rule 14.11.

remuneration report resolution because they have a representative on the board who is named in the remuneration report? If so, we would find this a very odd result.

DRAFT RECOMMENDATION 5 - ***The Corporations Act 2001 should prohibit all company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks.***

AICD has no difficulty with the general principle that executives should not hedge unvested equity remuneration (indeed, we espouse this as good practice[10]). We also recognise there may be circumstances where it is inappropriate to hedge vested equity remuneration. It is widely acknowledged that the hedging of securities by directors/executives can lessen the alignment of their interests with those of shareholders.

Having said this, we do not support the proposed amendment to the Corporations Act:

- we believe there are some complex and difficult drafting exercises involved that will result in excessive "red tape" (e.g. the difficulties in defining appropriate "one size, fits all" post-vesting hedging limitations);
- we query the likely effectiveness of black letter law in this area given the various ways in which hedging can be achieved; and
- there are already adequate disclosure-based requirements in place.

As noted by the Productivity Commission[11] there are already requirements relating to the disclosure of a company's hedging policy regarding unvested securities:

- The Corporations Act requires that if an executive's remuneration includes securities (shares or options), then the remuneration report should discuss board policy on the executive limiting exposure to risk (hedging) in relation to those securities and the mechanism to enforce the policy (section 300A(da)).
- The ASX Corporate Governance Council recommends that companies establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy (Recommendation 3.2). In formulating a trading policy, the Council suggests companies consider prohibiting 'designated officers from entering into transactions in associated products that limit the economic risk of security holdings in the company over unvested entitlements' (Box 3.2). The Council also recommends that companies publicly disclose the company's policy on hedging unvested entitlements under equity-based remuneration schemes (Recommendation 8.3).

We also query whether the circumstances where a holding lock could be applied to an executive's securities match the circumstances in which it would be appropriate to

[10] See, for example, "Trading Away Disclosure Responsibilities", Company Director, August 2006, p25.
[11] Draft Report, page 202.

prohibit hedging. Holding locks are designed to prevent transfer of legal title for a variety of reasons.[12] It is our understanding that holding locks are not necessarily a perfect "yardstick" for circumstances where economic hedging and the like would be inappropriate.

DRAFT RECOMMENDATION 6 - ***The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.***
The Commission seeks participants' views on whether this draft recommendation should:
- *be extended to apply to all undirected proxy holders*
- *apply to all resolutions to obviate the potential costs that might arise from a two-tiered approach.*

AICD also has no objection to those individuals that are the subject of the company's most recent remuneration report being, as a general rule, prohibited from voting undirected proxies where a resolution relates to *their own remuneration* - subject to one main exception (see below). Again, we have some concerns regarding the potential ramifications of prohibiting "associates" from voting (e.g. potential disenfranchisement of a major shareholder who has a nominee on the board).

We believe there should be an exception built into draft recommendation 6 for circumstances where undirected proxy votes are given to a nominated company representative. More specifically, the Chairman of a shareholders' meeting in ordinary circumstances should not be precluded from casting undirected proxies, on behalf of the company, in relation to, say, CEO remuneration[13] (e.g. a termination payment), particularly given there is widespread acceptance that they should not be precluded from casting undirected proxies on behalf of the company on other recommendations made by the board (e.g. major capital raising, merger, various related party transactions, etc). In each case, the Meeting Chairman is under a legal duty to act in the best interests of the company when voting the undirected proxies.[14]

In circumstances where the Meeting Chairman is precluded from voting his or her own shares on a remuneration resolution (e.g. non-binding vote on remuneration report, increase in board fee pool), rather than prohibiting the Meeting Chairman from casting undirected proxies, we would suggest requiring the Company to state in the relevant notice of meeting how the holder of the proxies (usually the Meeting Chairman) is likely to cast votes should a poll be called (we presume, usually in favour of the resolution). In this regard, we note that ASX listing rule 14.2.3 already deals with this issue[15]. If considered necessary[16], this could be supplemented by a

[12] Refer to ASX listing rule 8.10.1.

[13] A better alternative would be to require the company to state in the notice of meeting how it is intended that the votes will be (or are likely to be) cast.

[14] Refer, for example, to AICD, "Annual General Meetings: A Guide For Directors", 2009.

[15] ASX listing rule 14.2.3 is mentioned in the Draft Report, page 264.

statement by the Company after the relevant shareholders meeting as to how votes were cast by the Meeting Chair.

In terms of whether such a voting prohibition of the kind proposed in draft recommendation 6 should apply to all resolutions put before shareholders, we would argue that such a question extends well beyond the Productivity Commission's terms of reference. Again, we consider that shareholders should, in the ordinary course, retain the ability to provide undirected proxy votes to, say, the Chairman of the relevant shareholders meeting.

We further note that, in relation to the workability of a "two tiered" regime, there are already voting restrictions in certain circumstances imposed by the ASX listing rules and this appears to be operating without major difficulties (see ASX listing rule 14.11).

DRAFT RECOMMENDATION 7 - ***The Corporations Act 2001 should be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any other remuneration-related resolutions.***

This Commission seeks participants' views on whether this draft recommendation should apply to all resolutions.

AICD has no major issues in principle with this recommendation[17]. Again, we consider the issue as to whether such a requirement should extend beyond remuneration falls outside of the Productivity Commission's terms of reference, and note there have been a number of regulatory proposals in relation to "cherry picking" of directed proxy votes[18].

A.3 Improving relevant disclosure

DRAFT RECOMMENDATION 8 - ***Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include:***

- ***a plain English summary statement of companies' remuneration policies***
- ***actual levels of remuneration received by executives***
- ***total company shareholdings of the individuals named in the report.***

Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.

[16] We note the Commission's comment that "..... there is uncertainty about whether chairs are legally bound to follow boards' voting intentions as stated in proxy forms" (Draft Report, page 308).
[17] We note there are technical issues that need to be addressed relating to the proxy holder having given consent to act as holder of the proxy.
[18] See, for example, the Draft Report, page 266.

AICD supports draft recommendation 8, subject to satisfactory clarification of the meaning of "actual" remuneration. We believe there is merit in initiatives that make remuneration reports less complex, more readable and more understandable. With this in mind we consider the opportunity should also be taken to consolidate and simplify existing requirements.

One of the problems with the current requirements relating to remuneration reports is how these are split (and sometimes duplicated) between the Accounting Standards and the Corporations Law. We believe this current approach is very user-unfriendly and should be re-examined. In particular, it should be explored whether it is possible to consolidate the requirements relating to remuneration reports into the one place. Our current thinking is that the Corporations Law (including Corporations Regulations) is the appropriate place.

DRAFT RECOMMENDATION 9 - ***Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to the key management personnel. The additional requirement for the disclosure of the top five executives should be removed.***

The Commission seeks participants' views on the scope to further improve the readability of remuneration reports and reduce the compliance burden on companies by confining detailed individual disclosure to the CEO and the top key management personnel, with remuneration for other key management personnel reported collectively in bands.

AICD supports draft recommendation 9 on the basis it will help to reduce the complexity and cost associated with report preparation, as well as help the readability of reports.

DRAFT RECOMMENDATION 10 - ***The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.***

AICD supports the principle underlying draft recommendation 10. We note this is consistent with one of the key guidelines included in AICD's executive remuneration guidelines released in February 2009[19]. We do not believe, however, this should be made a "black letter" law or listing rule requirement, particularly if the assessment of "independence" extends to potential conflicts of interest arising from the adviser having been appointed by Management in some other capacity[20]. This is largely

[19] AICD, "Executive Remuneration: Guidelines for Listed Company Boards", February 2009.

[20] We note in the commentary surrounding draft recommendation 10 the Commission states the following. "Conflicts of interest can also arise where a consultant is providing remuneration advice to the board as well as other services to management. The

because "independence" in this context is not always a "black or white" issue and will involve matters of judgement. In this context, what level of interaction by an expert with Management is seen to impact adversely on the independence of advice given? Also, we query the likely consequences of a breach of such a listing rule?

In light of these points we consider the draft recommendation is more appropriately couched as a corporate governance "best practice" guideline, possibly with an "if not, why not" reporting trigger. We are of the view it is best to see how the best practice guideline works in practice given the relatively recent focus on this issue (e.g. AICD released its guidelines on this issue in February 2009). We also consider the recommendation should be limited to advisers on the remuneration of directors and key management personnel.

While it is not included amongst the draft recommendations of the Productivity Commission, we would like to make point that it is not desirable to have draft recommendation 10 applying to all listed companies. Many of the 2000 plus listed companies will have boards comprised predominantly (or entirely) of executive directors. As such the board in many cases will not be independent of Management. These companies also do not appear to have raised many concerns in the executive remuneration context, and if they are fortunate enough to grow into ASX300 companies, they will be subjected to whatever regime that has been put in place (e.g. reporting trigger).

DRAFT RECOMMENDATION 11 - ***The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.***

The Commission seeks comment on whether draft recommendation 10 should apply to all listed companies were draft recommendation 11 not adopted, or whether draft recommendation 11 (if adopted) would be sufficient of itself for all non-APRA regulated entities.

AICD again questions the desirability of, or need for, such a requirement:

- shareholder concerns regarding executive remuneration have mainly been associated with larger companies (where remuneration packages tend to be larger);
- while recognising the requirement has an "if not, why not" element, if any of the advice has privilege, disclosure of the fact that advice has been given may waive the privilege; and

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consultant may naturally feel that remuneration advice unfavourable to executives may compromise access to other, often more lucrative, work" (Draft Report, page 314).

- boards do not necessarily follow advice they have been given (e.g. there may be conflicting advice from different experts), particularly if they consider it is inappropriate in the company's circumstances.

Having said this, if disclosure around expert advisers is considered necessary, we believe an "if not, why not" approach is much better than a more prescriptive approach. The reporting trigger should, however, be limited to those experts advising on the remuneration of directors and key management personnel. Our reasoning is:

- this should be the main focus of interest (e.g. where the potential conflicts of interest are greatest, the greatest potential wealth effect, etc); and
- to go beyond this group would impose an unreasonable regulatory burden and present practical difficulties for companies that engage a range of advisers on different aspects of remuneration, at various levels in the organisation.

DRAFT RECOMMENDATION 12 - ***Institutional investors should disclose, at least on an annual basis, how they have voted on remuneration reports and any other remuneration-related issues. How this requirement is met should be at the discretion of institutions.***

The Commission seeks participants' views on the appropriate mechanisms to achieve the intent of this draft recommendation, such as a voluntary code of practice devised, coordinated and promoted by relevant key industry associations.

The Commission also seeks participants' views on the practice of securities lending in regard to its implications for transferral of voting rights on remuneration matters and the extent to which disclosure would be desirable, and if so, whether mandating this would be necessary.

AICD supports draft recommendation 12. We believe such a recommendation will promote:

- greater engagement; and
- greater accountability.

Many listed companies have made genuine efforts to engage with shareholders, in particular institutional shareholders, on various issues including executive remuneration. However, this is not always a straightforward issue, particularly for larger companies. One of the problems boards have in engaging on issues such as executive remuneration with shareowners is often identifying those parties who decide how to vote on particular issues. This is because investors often choose to hold their shares through a nominee company or some other indirect way. There are also sometimes differences between organisations as to which party in the organisation or its investment chain decides how to vote (directed by the industry super trustee, left to the discretion of the funds manager, etc), which may result in an effective divorce of ownership and voting. Further, even within some big institutional shareholders, there may be various fund managers making different voting decisions in respect of a

particular stock, given possible differing perspectives (long term versus short term horizon, etc). Additional complexity is introduced by the existence of stock lending arrangements.

We note the Investment and Financial Services Association's (IFSA's) "Blue Book" contains a disclosure principle broadly along the lines of draft recommendation 12, although this is limited to aggregate voting behaviour and applies only to IFSA members.[21]

Again, AICD favours a principles-based approach over black letter law. Ideally there would be a wide reaching set of principles, extending to institutional shareholders and any agents they engage to make voting decisions.

A.4 Well-conceived remuneration policies

DRAFT FINDING 1 - ***Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, there are some key dimensions that often warrant being explained clearly to shareholders, and, where appropriate, could usefully be addressed in companies' treatment of their remuneration polices in the remuneration report:***

- ***how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests***
- ***how the mix of base pay and incentives relates to the remuneration policy***
- ***how comparator groups for benchmarking executive remuneration and setting performance hurdles and metrics were selected***
- ***how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price)***
- ***whether any 'incentive-compatible' constraints or caps to guard against extreme outcomes from formula-based contractual obligations apply***
- ***whether alternatives to incentives linked to complex hurdles have been considered (for example, short-term incentives delivered as equity subject to holding locks)***
- ***whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to 'buy out' poorly performing executives in order to avoid litigation***
- ***whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.***

[21] IFSA, "Corporate Governance: A Guide for Fund Managers and Corporations" (the "Blue Book"), June 2009. Guideline 3 states in part that "An aggregate summary of a Fund Manager's Australian proxy voting record must be published at least annually and within 2 months of the end of the financial year."

AICD supports the Productivity Commission's conclusion that the matters listed in draft finding 1 are not amenable to prescriptive direction. We note that most (if not all) of the practices listed are already the subject of industry guidelines.[22]

DRAFT RECOMMENDATION 13 - ***The cessation of employment trigger for taxation for equity-based payments should be removed, with the taxing point for equity or rights that qualify for deferral being at the earliest of: where ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.***

AICD believes the framework (legislative, regulatory, market, corporate, etc) in which remuneration practices are adopted should not, intentionally or inadvertently, promote short-termism. The current taxation requirement referred to in draft recommendation 13 presents a problem in this regard. AICD has been advocating[23] this type of proposed change and as such supports draft recommendation 13. In our opinion, the current taxation laws, which include cessation of employment as a taxation trigger:

- reduce the ability of companies, should it be appropriate in their circumstances, to reward executives and others on the basis of long-term performance (this restriction is at odds with measures aimed at reducing short-termism as a result of remuneration practices); and
- promote lump sum termination payments (larger lump sum payments would seem to be at odds with proposed measures by the Australian Government to reduce large termination payments).

A.5 Facilitating shareholder engagement

DRAFT RECOMMENDATION 14 - ***The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.***

AICD supports draft recommendation 14.

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[22] See, for example, AICD, "Executive Remuneration: Guidelines for Listed Company Boards", February 2009.

[23] See, for example, AICD's letter dated 16 June 2009 to Senator Nick Sherry on the reform of taxation of employee share schemes. Available at www.companydirectors.com.au (in Policy section under 2009 Submissions).

DRAFT RECOMMENDATION 15 -
The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a 'no' vote of 25 per cent or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why.

If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re-election (a 'two strikes' test) at either:
- ***an extraordinary general meeting or***
- ***the next annual general meeting.***

The Commission seeks participants' views on:
- *any issues that may arise with maintaining a 25 per cent threshold for this second stage*
- *whether an election should be held at the next annual general meeting or at an extraordinary general meeting and, if the latter, the timing*
- *the likely consequences of the proposals, including costs.*

No Objection to "25% Threshold" for Further Consideration/Explanation

We have no objection to a 25% "no" vote threshold[24] for boards having to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why. Given there may be a multitude of differing reasons why shareholders as a group vote against a resolution, some of which may not be made known to the company and others not, we suggest the requirement be limited, for example, to the "main reasons" made known to the board. We note, requiring a formal response to shareholders after a 25% "no" vote is merely codifying something many companies already do.

Concerns with "Two-Strikes" Requirement

We have a number of significant concerns with the "two strikes" element of draft recommendation 15, including:

- the potential disruptive effects on the company (remembering that an effective, fully functioning board can take years to build/re-build);
- we do not think this mechanism will satisfy shareholder concerns regarding remuneration levels (see below);
- the fact that it is proposed that all companies which prepare a remuneration report be made subject to a "two strikes" requirement, when shareholder

[24] That is, 25% of total votes cast (including recorded absenting votes).

concerns regarding executive remuneration have tended to relate to some larger (eg some ASX100) listed companies;

- there are already provisions in the law dealing with the removal of directors (re-election process and shareholder authority to remove directors);
- it is arguably inconsistent with the rights afforded to directors in the Corporations Act where shareholders seek to remove a director[25];
- there is disproportionate emphasis being placed on remuneration as a trigger for a board spill (see below);
- there are likely unintended consequences, such as whether executive employment contracts will need to be amended to provide for modification in the event of a "first" or "second" strike - which may result in this additional "risk" being priced into such arrangements (e.g. through a sign-on fee);
- there are practical issues with the "two strikes" requirement (see below); and
- the mechanism could be used as a "stalking horse" for individual shareholders or vested interest groups (see below).

In relation to the thresholds contemplated, we note:

- they are too low (25% in the first year and an as yet unspecified percentage in the second year - possibly 25%); and
- it needs to be remembered that there is rational apathy on the part of a fair number of shareholders (e.g. a large number do not go to the trouble of voting if they are not unhappy) which means a 25% "no" vote could represent considerably less than 25% of the total number of available votes[26].

Shareholder Concerns

We do not believe a "two strikes" requirement will result in remuneration levels that will satisfy the vast majority of shareholders. We say this for a number of reasons, including:

- remuneration outcomes are driven to a large extent by market forces;
- while the board may be "spilled", the underlying remuneration arrangements that may have been considered egregious by some shareholders will in many cases remain in place (resulting in a potential "double whammy" for shareholders); and
- as long as there are equity securities issued as part of remuneration packages, and changing market circumstances (e.g. a market upturn resulting in the rise

[25] Refer to the Corporations Act, sections 203D(2) to 203D(5).

[26] It is not unusual for say 40% of total available votes not to be cast on a given resolution in relation to a listed company (see, for example, the Draft Report at page 253). As such, a 25% "no" vote if based on the total number of votes cast, may be equivalent to, say, only 10% of total possible votes.

in value of shares that are earned), there are likely to be instances of shareholders expressing dissatisfaction with executive remuneration packages (often with the benefit of "20/20 hindsight"), particularly in larger companies which tend to have larger remuneration packages.

Disproportionate Emphasis

We note that while the setting of executive remuneration is an important function of the board, there are other circumstances of equal or more importance that will not have any "board spill" mechanism associated with them. These other circumstances include, for example, a failed major merger and acquisitions transaction, large losses, systemic failure of management oversight, and so on.

We are concerned that the introduction of such a mechanism to the narrow context of executive remuneration, could well lead to a disproportionate emphasis being placed on remuneration issues by both boards and shareholders.

Misuse of Mechanism

While it is questionable, in principle, to single out executive remuneration for "special" treatment over other significant corporate issues, a potentially greater problem is that voting on remuneration matters may in practice be driven by a range of completely unrelated issues.

The current system of non-binding votes on remuneration reports often sees shareholders use this as way of expressing their discontent with the general performance of the company, the share price, strategic decisions by the board and so on. While there are other mechanisms shareholders could conceivably use (e.g. 100 member rule - see below), the non-binding vote on remuneration could be used as a "cloak" for destabilizing the board or company - for reasons unconnected to executive remuneration (e.g. environmental issues).

Such a mechanism could also give a greater, and inappropriate, degree of power to shareholders with a large, but still minority, stake in a company[27]. You do not have to think too long about what would happen, for example, if there was a takeover in play.

"Board Spill" Threshold

Whilst we do not support the "two strikes" requirement, should it be progressed we note that the proposed threshold is too low. A board spill being triggered by as low as a 25% "no" vote on a company remuneration report for two consecutive years is inappropriate and would run contrary to the existing law regarding the election of directors by giving a relatively small minority considerable control over the board and the company's fate. This not only disenfranchises a majority of shareholders who vote in favour of the remuneration report – up to 75 per cent depending on the "second strike " threshold ultimately decided upon - it is also potentially open to abuse and manipulation (see above).

[27] Consider the case of a company with an individual shareholder who owns say 19.9% of ordinary voting shares. If only 60% of total votes are typically cast, this shareholder will have effective voting power of 33%.

We note that for a director to be elected or re-elected to the board, a majority of votes must be in favour of the resolution. Further, there are provisions in the Corporations Act dealing with the ability of shareholders to a requisition meeting to remove directors for whatever reason. Such a meeting could be requisitioned by as little as 100 shareholders or shareholders who collectively own at least 5% of voting shares[28]. A resolution to remove the entire board could be passed by a simple majority of votes cast[29].

We consider the hurdles for a full board spill, given the potential harmful impact on the company, should be set higher than the current legal threshold for the removal of an individual director. We propose the relevant threshold should be no less than a majority (over 50%) of the total votes cast (including recorded abstaining votes) in relation to the remuneration report were against the report. For a board spill to be caused this majority vote should occur for the past two consecutive years. If the threshold is reached the directors would need to either stand down, or put themselves up for re-election at the next AGM or special meeting of shareholders. This would not, of course, prevent shareholders representing a majority of votes from removing individual or multiple directors from office in the interim, if this was considered necessary.

Practical Issues

There are a host of practical issues associated with a "two strikes" requirement. For example:

- who will identify new director candidates after a board spill if there are no board members left?
- who will appoint directors to fill casual vacancies if there are no board members left?
- what will be the impact on executive directors of a board spill?
- is a managing director required to submit himself or herself for re-election by shareholders as a director when they are not usually appointed by shareholders in the first place? [30]
- how will this impact other stakeholders? (e.g. preference shareholders with limited voting rights)
- what of new directors who were appointed between the first and second "two strikes" results?
- what of directors who might be elected or re-elected at the same shareholders' meeting that gives rise to the second "strike"?

A.6 General

Participants' views are sought on the potential for any adverse consequences to arise from the interactions across and between the various elements of the Commission's

[28] Corporations Act, section 249D(1).
[29] Corporations Act, section 203C and 203D.
[30] Corporations Act, section 201J.

suite of draft recommendations.

Some of the Commission's draft recommendations involve amendments to the Corporations Act 2001 and also the ASX listing rules. While these are judged appropriate within the current regulatory and institutional settings, the Government has signalled changes to the balance between the Australian Securities Exchange and the Australian Securities and Investments Commission, and the potential for additional entities to operate in competition with the Australian Securities Exchange. Participants' views are sought on the implications of these developments for the Commission's regulatory proposals.

AICD considers that, in general, the Productivity Commission has the balance of proposed "black letter" law, listing rule and "if not, why not" requirements about right. We note, however, there are a few of instances where we consider a "best practice" guideline is far more preferable than a requirement prescribing particular structures or practices:

- the use of remuneration committees that meet various compositional requirements (draft recommendation 3);
- hedging of unvested and certain vested equity remuneration (draft recommendation 5); and
- the use of expert advisers (draft recommendation 10).

In the first case we are concerned largely about the cost-benefit aspects of a mandated requirement for companies. In the other two cases, we consider the issues are complex and lend themselves much better to a "if not, why not" model.

PART B: OTHER MATTERS

B.1 Termination Payments

We disagree with the Productivity Commission's preliminary views expressed in the Draft Report that reduction of the threshold for shareholder approval of termination benefits from seven years' of annual remuneration to one year's base pay, as proposed in the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 (hereafter "the Termination Payments Bill"), is "unlikely to have significant adverse effects"[31].

AICD accepts that a reduction in the current shareholder approval threshold for termination payments is warranted. We consider, however, that a reduction to one year base, with a pro-rata calculation applying in the first year of a contract, is too severe. A threshold level of two years total remuneration is much more appropriate, possibly stepping down over time to one year base pay.

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[31] Draft Report, page xxv.

AICD has expressed strong concerns about the Termination Payments Bill.[32] These include the following points.

- A one year base pay approval threshold for termination payments is materially lower than approval thresholds in comparable jurisdictions overseas. Australian companies will be at a distinct disadvantage in the market for executive services compared to companies domiciled overseas or local subsidiaries of foreign companies (which may only need to go through the formality of obtaining the approval of a foreign parent, as opposed to the parent's shareholders). In other words, Australian companies will be put at a competitive disadvantage both overseas and in the domestic market.

- A one year base pay threshold is at odds with common practice by large Australian companies (see below).

- A one year base pay threshold will have unintended effects (e.g. distortions in other elements of executive pay), particularly for large companies that compete in the global market for executive services and corporate groups that have a large number of subsidiaries.

- We are concerned that the reduction in approval threshold will apply to unlisted companies, with unintended consequences. We have seen no evidence of shareholder concerns about the level of termination payments in these companies. Further, we believe there is a good chance, given the severity of the proposed reduction in approval threshold, that unlisted companies may inadvertently breach the new requirements.

- We maintain it is inappropriate for a breach of the termination provisions to give rise to a strict liability offence (in relation to either listed or unlisted companies), particularly in light of the proposed tightening of requirements. It follows that we also do not support the proposed increase in fines and a potential jail term of up to 6 months, for what, in effect, will usually be a red tape issue. The existing law that the Termination Payments Bill seeks to amend is inherently complex and ambiguous. There is no evidence the existing provisions have been breached, that warrants increased penalties. The proposed liability and penalty regime seems totally out of proportion, particularly in the case of charities, school boards, not for profit companies, etc.

<u>The proposed reduction in approval threshold is too large</u>

To illustrate the severity of the proposed reduction in approval threshold it is worth considering an example where a CEO's total remuneration for a particular year is $400,000, which includes base pay of $200,000.[33] Under the current law, the existing maximum threshold for shareholder approval of a termination payment is $2.8 million. We agree a reduction in this threshold is appropriate, but under the proposed

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[32] See AICD's submission to the Senate Economics Committee dated 16 July 2009 on employee share schemes. Available at www.companydirectors.com.au (in Policy section under 2009 Submissions).

[33] We note the Draft Report (page xvi) refers to the smallest listed companies having average CEO remuneration of around $180,000.

legislation, the maximum threshold for approval is $200,000. This represents a reduction in the approval threshold of approximately 93 percent.

The situation is worse if the contract is terminated during the first year

It should also be recognised that under the proposed amendments the one year base pay threshold is applied on a pro-rata basis during the first year of employment. So, if the CEO's contract is terminated after 6 months (e.g. as a result of a merger), the threshold for shareholder approval using the example above, is only $100,000. After three months, the threshold would be $50,000.

It would appear to be the case that if there is a termination of an executive's contract prior to the executive commencing work (e.g. because of a takeover), the approval threshold could be zero. This would appear to be a bizarre result and not in accordance with sensible or rational outcomes.

A flat approval threshold, with a pro-rata increase during the first year, is inconsistent with the common "step down" approach for potential termination payments

A CEO contract is often relatively short term (e.g. three to five years), and the entering into an employment contract with a new employer can represent a reasonably "high risk" for the CEO concerned - both in terms of the potential reputational damage and the opportunity cost to the CEO if the contract is ended prematurely by the company. This risk, and the potential cost, to an incoming CEO is greatest at the start of the contract. It is therefore common practice, in order to entice a CEO to join a company, for there to be a relatively high potential termination payment in the early part of a contract (typically expressed as a notice period), should a company terminate the contract. This potential payment often "steps down" as the remaining contract period decreases. The contract may provide, for example in an overseas hire, that a company give an executive 18 months notice of contract termination (or payment in lieu of notice) in the first year of a five year contract, 12 months notice for the following 2 years, 6 months notice in the fourth year and no notice at the expiration of the final year. There will also often be provisions dealing with the treatment of unvested short term and long term incentive payments on termination.

There are also issues associated with restraint of trade payments

Consider a situation where a CEO is entitled to a payment of one year base salary in lieu of notice (a situation that is not unusual) and that the individual is so integral to the company that it is considered in the company's best interests to continue to make monthly payments for 12 months after the CEO leaves in exchange for the CEO not working with a competitor. We query whether this should be subject to a shareholder approval requirement.

The proposed threshold for shareholder approval should be increased

For the reasons outlined above, and contained in the attached submission, we continue to maintain that the approval threshold in the Termination Payments Bill should be two years total remuneration. If this level is considered too high (we maintain it is not), then there should at the very least be provision made for a threshold of two years

total remuneration in the first year of a contract, with a stepping down in potential termination payments over time.

B.2 Taxation measures

We draw to the Productivity Commission's attention to two aspects of recently stated taxation changes which we consider will have an adverse impact on companies:

- the bringing forward of the taxation point of shares obtained by non-executive directors (NEDs) through means of a fee sacrifice will materially reduce the use of such arrangements, notwithstanding they are generally viewed favourably by shareholders as a means of incentive alignment[34].

- the bringing forward of the taxation point for options granted to executives and other employees from the time of exercise to the time when options become exercisable will have a material adverse consequence on SMEs, in particular[35].

If the Productivity Commission agrees with these points, we believe this warrants mention in its final report. We note, for example, that the Commission accepts that "...fee sacrifice schemes help to mitigate potential conflicts of interest, while still retaining an appropriate alignment of interests between NEDs and the company."[36]

B.3 Guidance issued by AICD

We suggest that changes be made to the Table on page 128 of the Draft Report to reflect the fact that AICD has, in addition to the matters listed, provided guidance on the following:

- shareholder engagement on remuneration reports[37]
- shareholder engagement on termination payments[38]
- NED remuneration - linking to performance[39]
- Non-recourse loans - linking to performance.[40]

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[34] See, for example, AICD's submission dated 16 July 2009 to the Senate Economics Committee's Inquiry into employee share schemes. Available at www.companydirectors.com.au (in Policy section under 2009 Submissions).

[35] See, for example, AICD's submission dated 16 July 2009 AICD submission to Board of Taxation on employee option schemes. Available at www.companydirectors.com.au (in Policy section under 2009 Submissions).

[36] Draft Report, page 176.

[37] See, for example, AICD, "Shareholder Consideration of the Annual Remuneration Report of a Listed Company; A Guide for Consideration of the Issues", 2004 and AICD, "Executive Remuneration: Guidelines for Listed Company Boards", February 2009.

[38] See, for example, AICD, "Executive Remuneration: Guidelines for Listed Company Boards", February 2009.

[39] See, for example, AICD, "Remuneration of Non-Executive Directors, Position Paper", October 2008.

[40] See, for example, AICD, "Non-Recourse Loans Provided to Executives, Position Paper", May 2008.