

9 November 2009

Mr Gary Banks
Chairman
Executive Remuneration Inquiry
Productivity Commission

By email: exec_remuneration@pc.gov.au

Dear Commissioner Banks

Regulation of Director and Executive Remuneration in Australia

The Australian Council of Super Investors (ACSI) welcomes the opportunity to respond to the draft recommendations proposed by the Productivity Commission draft report on executive remuneration.

ACSI commends the Productivity Commission for the analysis and well considered draft recommendations. In our opinion these recommendations represent constructive reforms. As shareholders we rely on boards of listed companies to be effective in the way they go about determining executive remuneration policy. We also believe that it is important for shareholders to have appropriate rights available in order to effectively monitor how Boards discharge their responsibilities.

ACSI therefore considers that the draft recommendations enhance Board accountability and transparency on executive remuneration.

In broad terms, we believe that the recommendations do not unduly tip the balance in remuneration setting and monitoring nor do they impose unnecessary requirements that are likely to result in negative unintended consequences for companies.

Key remuneration and governance position

Outlined below are our specific observations with respect to each of the recommendations. Our perspective is derived from our member superannuation funds who as long term investors have become more active participants on corporate governance issues that arise in the companies in which they invest. Our overriding commitment in this area is predicated on a view that any improvements should ultimately strengthen the integrity of executive pay decisions by Boards and encourage effective shareholder oversight.

ACSI has identified two draft recommendations contained in the report that appear to have raised more significant debate amongst various stakeholder groups, individuals and commentators in the community.

The two recommendations relate to the proposed cessation of the “no vacancy” rule and the introduction of a whole Board election in the event of a remuneration report eliciting “two strikes” from shareholders.

We support these recommendations in principle and propose to provide additional feedback aimed at facilitating the implementation of these recommendations.

We wish at the outset to clarify our view in relation to the issue surrounding Listing Rule 10.14.

Listing Rule 10.14

A key premise of the Commission's review is to find ways to strengthen Australia's corporate governance framework and to ensure that executive remuneration is aligned to shareholder interests.

To this end we feel that we need to reiterate our concern with the ASX Listing Rule 10.14. The Commission has correctly noted that prior to an ASX Listing Rule amendment in 2005, Listing Rule 10.14 required shareholder approval for a director to acquire securities under an employee incentive scheme. Following the review by the ASX, the rule was amended to exempt securities purchased on-market from requiring shareholder approval.

We agree with the Commission's observation concerning the history of Listing Rule 10.14 and the review leading up to the amendment of the Listing Rule. At the time of review, the main concern was protecting bona fide salary sacrifice arrangements in which the purchase of shares on market was not dilutory and therefore did not adversely affect the interests of other shareholders.

As you correctly pointed out, the reference to salary sacrifice arrangements were omitted in the final version of Listing Rule 10.14.

ACSI's submission proceeds from a concern that the Listing Rule provisions as they currently stand can be open to some uses for which they was never intended.

As shareholders we are concerned with the quantum and terms of incentives, especially long term incentives. Where new shares are proposed to be issued, shareholders must be given a **binding vote** on the proposal which enables them to evaluate:

- The number of shares proposed to reward performance;
- The terms under which performance is to be measured; and
- Vesting arrangements.

Equally where share options are to be granted, shareholders must be given a binding vote on the number, the price, the performance hurdles and the vesting arrangements.

Listing Rule 10.14 however has emerged as a loophole. Boards wishing to avoid binding votes on their long term reward system can by using shares bought on market to avoid a binding vote on:

- The number of shares;
- The terms under which performance is to be measured;
- The vesting arrangements.

This was not, and should not be a function of the operation of Listing Rule 10.14.

We do not seek a return to the pre-2005 position where shareholder approval was required for a director to acquire securities under an employee share ownership scheme.

Nor do we wish to be utilising a vote against a remuneration report every time a company utilises the Listing Rule provisions and we remain concerned about the hurdles underpinning a share based incentive.

ACSI reiterates that that the Listing Rule 10.14 should be restricted to the purpose for which it was originally introduced, that is to facilitate 'bona fide' salary sacrifice.

We acknowledge the fungibility of executive pay. We note that there are currently no statutory restraints on companies rewarding executives with cash bonuses and that boards can exercise their discretion in setting remuneration, and we believe they get it right in the majority of cases.

Whether long term incentive schemes reward executives with shares bought on market, newly issued shares or options, in each case they require the use of shareholder capital and should be subject to an equal suitable level of shareholder scrutiny.

In our opinion, amending Listing Rule 10.14 should cover all equity based long term incentives to directors. ACSI agrees with the preservation of its use in relation to bona fide salary sacrifice, that is sacrificing fixed salary.

Board Capability

Recommendation 1: End the 'no vacancy' rule

ACSI supports the proposal to end the 'no vacancy' rule.

ACSI believes that shareholders should ultimately determine the number of board positions that should be filled on the basis of advice from a company board.

Company constitutions outline the endorsed view of shareholders on the size of a company board. It is our view that in circumstances where a board believes that the number of board seats filled should vary with the number specified in a company's constitution, then shareholder endorsement for a variation should be sought.

This can either be effected through an alteration to the Company's Constitution or alternatively through a mechanism as suggested on page 145 of the draft report.

Either way this would allow a board to submit a resolution to shareholders of its preferred number of board positions and, where such a measure is not supported by shareholders, it could subsequently allow non-board endorsed candidates to seek to run for board vacancies up to the maximum number of seats that are stipulated in the company constitution.

We recognise that the draft recommendation could lead to a greater possibility for non-board endorsed candidates having an input into the Board nomination and appointment process.

In these circumstances a non-board endorsed candidate would still require a majority vote (not an insignificant task in the Australian market) without potentially competing against an incumbent director or Board nominated candidate. Therefore the impact of removing the "no vacancy" rule could facilitate easier access for non-Board endorsed nominees to seek election for Board positions.

We make the observation that to date, the significant majority of non-board endorsed candidates have sought election to raise a grievance with the incumbent board and/or company performance, or as a representative of a sectional interest. There has not been a significant push by shareholders to utilise provisions to seek election to a company board. It has been more common, although generally infrequent until recently, for shareholders to lodge a vote "against" the re-election of a director.

Whilst ACSI endorses the removal of the "no vacancy" rule on the basis of shareholders having the ultimate say on numbers of board seats and the potential flow on impacts of removing a potential barrier to entry, we remain unsure whether this measure will in itself promote greater board diversity.

We believe that the listed companies need to step up with concrete strategies to introduce 'new blood' on boards and senior executive levels, by tapping into the talent pool of skilled and highly credentialed men and women that operate across many spheres of public and professional life.

In our opinion a range of measures and initiatives are required by company boards in order to lift the levels of skills on boards as well as diversity.

As investors, we are increasingly interested in how boards identify what strategies, if any, they have to promote effective board succession planning that addresses a range of skill, experience and diversity objectives. We believe that such strategies should also be disclosed to shareholders.

In the absence of improvements in the area of succession planning underpinned by strategies to enhance board skills and diversity, we remain unsure whether the most talented and effective individuals are in fact being appointed to company boards.

We would question whether some boards have in fact genuinely taken into account factors relating to skills, despite the fact that they profess to want to have highly skilled directors on their boards. There is a strong perception that females have to jump through a higher skills 'hoop' than their male counterparts in order to grab the attention of prospective boards. There are situations that arise where boards look for new talent and the specificity of the skills required may potentially exclude female candidates.

We recognise that these issues can be complex and require boards to do some 'heavy lifting' to address their collective skill and composition issues in light of their strategic objectives.

Measures such as skills matrices and voluntary targets endorsed by boards may promote more concrete objectives with respect to skills and diversity without being perceived to be addressing these issues in a tokenistic manner. In this regard, we also recognise the integral role of company nomination committees that should be encouraged to include in their terms of reference and deliberations consideration of these issues.

Conflicts of Interest

Recommendation 2: Ensure remuneration committee independence – ASX 300

ACSI supports the draft recommendation that the Listing Rules should require larger companies to have a remuneration committee consisting exclusively of non-executive directors with the chair and the majority of members being independent directors.

Whilst we do support the Listing Rule threshold applying to companies in the ASX 300 as recommended, should the Productivity Commission be minded to amend its position in this regard, we would also support the threshold applying at the ASX 200.

We do not believe this will represent a major resource imposition on these companies.

We recognise that smaller companies may have resource and personnel challenges to meet such requirements and accordingly support a pragmatic approach to the application of the listing rule.

ACSI supports the non-conflicted consideration of executive remuneration by board remuneration committees.

Whilst boards remain ultimately responsible for setting executive remuneration policy, they do rely on remuneration committees for more extensive considerations and recommendations on these issues.

Those companies with remuneration committees that have no executive director representation can and do seek the opinion of executive and managing directors in circumstances where further information and advice is required.

Whilst we recognise that currently executive directors who participate on remuneration committees may step aside during deliberations on setting their own pay, an executive director can still influence the remuneration outcomes of their direct reports and thereby establish a platform on which their own remuneration arrangements are based.

We do however recognise that remuneration committees that are technically independent and devoid of representation of executive directors can still be influenced by executives and remuneration consultants. This is why we emphasise the importance of ensuring that directors on remuneration committees are not only independent but also have the necessary skills and capacity to deal with these sometimes complex issues.

In summary we support the Commission's view that executive directors of larger companies should not be members of the remuneration committee due to the conflicts of interest that can arise.

Recommendation 3: Promote remuneration committee independence- comply or explain

As a member of the ASX Corporate Governance Council, ACSI supports recommendation 3 that would elevate the existing provisions on the composition of remuneration committees from a "suggestion" into a "comply or explain" recommendation.

In our opinion the ASX Corporate Governance Council Principles have provided companies with a clear outline of shareholder and stakeholder expectations on a range of important governance matters and provide sufficient flexibility to companies to explain their divergences from agreed principles.

Recommendation 4: Prohibit executives and directors voting on remuneration

ACSI strongly supports amendments to the Corporations Act that would prohibit company executives identified as key management personnel from voting on remuneration and remuneration related matters.

We unequivocally believe that in order to have a clear understanding of shareholder views of a remuneration report or remuneration related resolution, then all key management personnel should not participate on such a vote. Conflicts of interest arise where directors and executives who are the direct beneficiaries of a remuneration resolution are able to vote, thereby resulting in a higher "approval" vote on the remuneration report that may not be indicative of overall shareholder sentiment.

ACSI therefore welcomes the Commission position that acknowledges the importance of having a 'true litmus test' of shareholder views on voting issues that apply to executive remuneration by removing such a conflict of interest.

Recommendation 5: Prohibit executives hedging

ACSI supports an unambiguous prohibition of hedging unvested equity remuneration and vested remuneration subject to holding locks by company executives. It is our longstanding view that the alignment of executive and shareholder interests through incentives is diminished if executives are allowed to hedge their incentive entitlements prior to vesting or where vested incentives are subject to holding locks.

Companies should not allow their executives to remove the risk associated with share options in their remuneration packages through hedging. This practice also negates the purpose and existence of variable remuneration schemes when executives have contributed to above average corporate performance.

Recommendation 6: Prohibit executives and directors voting undirected proxies on remuneration matters

ACSI supports the amendment to the Corporations Act and ASX Listing Rules to prohibit company executives identified as key management personnel and all directors from voting undirected proxies on remuneration reports and other remuneration related resolutions.

We concur with the observation from the Commission that a contradiction could arise in practice where directors and executives are prohibited from voting on remuneration but, however, the chair can vote undirected proxies on the same resolution to influence an outcome on a remuneration related resolution.

Recommendation 7: Oblige all directed proxies to be cast

ACSI supports the amendment of the Corporations Act to require proxy holders to cast all directed proxies on remuneration reports and remuneration related resolutions.

In our opinion, such an amendment should apply to all resolutions and not just remuneration related resolutions, in order to minimise the risks of 'cherry picking'.

Disclosure

Recommendation 8: Improve information content and accessibility of remuneration reports through amendments of section 300A of the Corporations Act 2001

Plain English disclosure of remuneration reports

ACSI supports the proposal to improve information content and accessibility of remuneration reports through amendments made in section 300A of the Corporations Act 2001. A plain English outline can be a useful tool for a company to articulate in summary their approach on these issues.

However an initiative that introduces 'plain English' summaries should not compromise the provision of sufficiently detailed reports, to enable those shareholders who are interested, to make an informed view about the design, detail and intended impact of board policy on executive remuneration. The provision of greater details should not be an inhibitor for a company to provide a 'narrative' about the objectives of a company's endorsed remuneration policy.

ACSI supports the inclusion of plain English disclosures to explain remuneration policies, disclosure of actual realised pay received by executives and total company shareholdings of individuals named in the report in Section 300A of the Corporations Act 2001.

Method of disclosure

ACSI supports the disclosure of fair valuation methodologies of equity rights for executives in financial statements, while still continuing to disclose the actual fair value for each executive in the remuneration report.

Short term incentive disclosure

We reiterate an observation made in our submission dated 3 June 2009 to the Commission with respect to Section 300A(1)(ba) (1) of the Corporations Act 2001 (cth) which requires companies to disclose in remuneration reports a "detailed summary" of the performance conditions applying to performance-based pay.

These provisions have been inadequately addressed by companies. We do not believe that there needs to be an amendment to the law on these issues, but rather more effective enforcement of these requirements. We recognise that in many instances the metrics underpinning short term incentives are aligned to the achievement of internal organisational or financial criteria coupled with the application of board discretion. In some instances, there are companies that consider this information to be 'commercial in confidence' therefore resulting in negligible disclosure to shareholders of benchmarks for payment of short term incentives. Therefore shareholder concerns that short term incentives may not be underpinned by a sufficiently 'stretching criteria' is exacerbated by the lack of disclosure in this regard.

ACSI has supported many companies disclosing the broad parameters of relevant short term incentive performance hurdles or the retrospective disclosure of short term incentive hurdles in order to overcome potential shareholder concerns. By doing so, boards raise the confidence of shareholders that short term incentives are being paid on the basis of reasonable performance expectations and are not necessarily being utilised by boards to placate executives who have been unable, for whatever reason, to achieve their long term incentive hurdles.

Termination pay

ACSI refers to section 300A(1)(e)(vii) requirements for remuneration reports to disclose the term of service contracts with KMPs including entitlements that relate to termination.

We reiterate that there should be improvement in the way companies disclose the amounts actually paid to departing executives thereby overcoming some of the perceptions of the true size of termination payments as referred to in the media and provide a more accurate outline termination payment outcomes to shareholders.

Recommendation 9: Remove superfluous disclosure – KMP only.

ACSI recognises the arguments for rationalising references to the five highest paid executives in company reports to 'key management personnel' in accordance with Australian Accounting Standards Board standard 124 (being individuals who may be able to influence their own pay or materially affect the management of the company). We would however make the observation with respect to some financial services companies, the highest paid executives may not necessarily be regarded as a KMP in accordance with this definition. Therefore the definition of Key Management Personnel may be too narrow in this regard to some companies.

Recommendation 10: ASX Listing Rules 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.

Recommendation 11: Remuneration advisers should be commissioned by, and their advice provided directly to, the remuneration committee or Board, independent of management. ASX Corporate Governance Council recommends that companies disclose expert advisers used in relation to remuneration matters; Require remuneration advisers to be disclosed – 'comply or explain'

As a member of the ASX Corporate Governance Council, ACSI endorses the approach outlined by the Council that recommendations 10 and 11 be dealt with in the form of Council Principles and recommendations with associated commentary.

We would however support constructive moves to monitor how companies respond to these provisions in order to get satisfactory compliance in this regard. In the absence of effective responses from ASX Listed companies within two years, we would support these provisions being included in the ASX Listing Rules in the future.

In summary, ACSI supports the proposition that remuneration consultants be independent of management. This is consistent with APRA guidelines for financial institutions that propose external advisers be commissioned by and provided directly to the remuneration committee and Board. ACSI acknowledges the importance of external expert opinions on remuneration and information that assists boards to make informed decisions, as long as there is separation between consultants and management. The ASX Corporate Governance Principles should therefore provide that companies disclose information about who has commissioned external remuneration consultant, who the consultant is, the nature of services provided and outcomes proposed.

Recommendation 12: Institutional investors to disclose their voting on remuneration reports and any securities lending activities that impact on voting

ACSI supports the recommendation that institutional investors should disclose their voting on remuneration reports to support transparency of institutional investors including 'pooled funds'. However we would recommend that the timing and the methodology should be left to investors so as not to create a compliance burden.

ACSI believes that institutional investors should disclose their voting position on all general meeting matters in which they have voted. Accordingly, it would then be clearer as to who is not voting their shareholdings.

With respect to superannuation funds undertaking stock lending in order to earn additional income from the securities they hold in conventional long portfolios, we are aware that many superannuation funds lend securities to (or through) their custodians on a fully secured basis and they generally provide for the recall of their securities for any vote required. An improved disclosure regime on voting should accordingly provide a clearer picture as to which funds were exercising their vote.

Remuneration Principles

Recommendation 13: Remove taxation point impediment to deferred equity

ACSI supports the removal of taxation point impediment to deferred equity. Taxation legislation should strengthen the alignment between executives, shareholder interests and company performance to ensure that both appropriate tax concessions and adequate employee ownership policies are in place.

Shareholder Engagement

Recommendation 14: Confirm allowance of electronic voting

ACSI supports the inclusion of electronic voting without the need for constitutional amendments, as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.

ACSI considers this measure to be an effective mechanism to improve the integrity of voting processes through the assurance of documentation trail as well as increase shareholder engagement and participation with companies.

Recommendation 15: 25 per cent 'no' vote on remuneration report triggers formal explanation and response/Substantial 'no' vote on two consecutive remuneration reports trigger Board spill and call for election

ACSI supports the proposal that calls for greater accountability and potential Board re-election if there are at least 25% of 'no' votes on a remuneration report in the first year and at least a 50% 'no' vote in the second year.

We believe that these provisions would, for the majority of companies in the ASX 200, remain largely irrelevant and would only act as deterrent for recalcitrant companies that continue to ignore shareholder concerns on remuneration. We consider this mechanism to provide a potential consequence for 'inaction' on the part of companies who do not seek to engage with shareholders on substantive remuneration issues.

The Productivity Commission seeks comment on the following aspects of this recommendation:

- The validity of keeping the 25% threshold for the second stage of the two-step approach.
- The appropriate timeline for election in the event of a second vote of no confidence.

ACSI believes that the introduction of the non-binding shareholder vote on remuneration has been one of the major catalysts for engagement between institutional shareholders and company Boards. We have however come across companies that have sought to 'tough it out' and ignore the underlying message arising out of a non-binding vote and have taken no concrete steps to address reasonable shareholder concerns.

ACSI supports a 25% threshold in the first instance with the view of increasing the threshold in the second year to 50% given the consequences of a second vote triggering a whole board election.

We believe that the 25% trigger is high enough to send out an unequivocal message to a board that it should proceed with a rethink on substantive remuneration matters and to work with shareholders on further improvements.

In the event where shareholder concerns have remained unaddressed, a 50% vote against would represent an extraordinarily high, and serious, trigger to a board. Such a high threshold would require widely held shareholder concern. Companies that have done nothing to deal with substantive shareholder concerns and attract a 50% vote against deserve to be subject to a higher level of scrutiny through a spill of board positions.

We would encourage the Commission to consider requiring companies to achieve a 75% level of shareholder support for a remuneration report in circumstances where there was a 50% vote registered against a remuneration report in the preceding year. Our experience would indicate that a high vote against a remuneration report that reflects fundamental shareholder concerns with a company's approach would require fundamental review by a company. Securing just over 50% support for a remuneration report in a second year is hardly a strong endorsement of a company's remuneration report.

We believe that it would be highly unlikely that shareholders would want to vote out a whole board should a 'spill' be triggered. Institutional shareholders would be reluctant to hand over power to executives who may themselves be the recipients of remuneration arrangements that have been the subject of controversial reactions. We should also remind the Commission that there already exists a mechanism for shareholders to requisition a meeting to remove a whole board. Such a mechanism has been scarcely utilised in the Australian context.

We believe that a vote on the re-election of the whole board should proceed soon after the general meeting that resulted in the second trigger being evoked. In circumstances where a director is re-elected, their cycle for future re-election should revert to the pre-existing cycle of three year terms.

Conclusion

ACSI reiterates its support of the approach and general substance of recommendations made by the Commission.

We look forward to amplifying any issues at the hearing scheduled for 13 November 2009.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ann Byrne', with a large, stylized flourish at the end.

ANN BYRNE
Chief Executive Officer