



**SUBMISSION TO
PRODUCTIVITY COMMISSION ENQUIRY
ON DIRECTOR AND EXECUTIVE REMUNERATION
IN AUSTRALIA**

November 2009

Table of Contents

| | |
|------------------------------------------------------------|----|
| Introduction..... | 3 |
| Draft Recommendation 6..... | 3 |
| Draft Recommendation 8..... | 3 |
| Draft Recommendation 12..... | 5 |
| Draft Recommendation 15..... | 5 |
| Egan Associates Research – Remuneration Report Voting..... | 8 |
| Votes cast..... | 8 |
| ‘No’ vote distribution..... | 8 |
| ‘No’ vote distribution modified | 8 |
| The voting influence of the ‘Top 20’ shareholders..... | 9 |
| The voting influence of the ‘Top 3’ shareholders..... | 9 |
| Observations | 9 |
| Voting patterns illustrated..... | 10 |

Introduction

The recommendations issued by the Productivity Commission for comment may appear straightforward, but their implications are extremely complex. This submission seeks to outline these complexities and realities of shareholder voting and the dynamics which may result from their adoption in the current form.

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.

This recommendation undermines the democratic rights of shareholders. When shareholders give undirected proxies to Board members they are signalling their trust in those members to apply the underlying votes in the interest of the company. There has been no evidence that undirected proxies are being used for improper purposes.

It could be suggested that this is a superficially easy way to appear to deal with a problem while it is in reality taking away a shareholder's right.

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.

Emphasis on valuation of grants of equity which are the subject of performance hurdles and those where the level of reward are geared to a future level of performance (conditional grants) contributes to the misinformation surrounding the management of reward.

There is no way of knowing whether most recipients will receive the underlying shares, hence we question the purpose of requiring an estimate to be made of the value of the undelivered equity. A much more serious result of the complexity of this requirement is that incentive plans are being designed where participants are being promised rewards often expressed as percentages of fixed annual remuneration or salary but there is a significant disconnect between the promise and the delivery.

In these plans, the number of shares to be delivered is calculated using the value of a hurdle-encumbered option or right at the date of grant, resulting in a number of options or rights being issued. If the hurdle is satisfied at the end of the performance period, it is to be expected that the share price (ie, the value of the share) will have risen and the benefit delivered is considerably more than the percentage of fixed salary promised at the date of grant. However, this historic perspective reflecting improved share value has not been delivered in a number of vested awards in the recent market downturn. This has raised the question of rewarding improved shareholder outcomes as distinct from relative

performance. This question has had a flow-on impact on the rewards of investment managers.

With performance hurdles primarily requiring a relative improvement in total shareholder return, many well managed companies meeting their business plans within defined parameters of risk have not rewarded their management, either due to the market's generalised sentiment in relation to their sector and until recently the market's higher risk appetite. In this context there has been poor alignment with shareholder expectations and reward outcomes.

Under governance and accounting standards securities issued have been expensed to the profit and loss account, though in a substantial proportion of cases no value has been delivered to management. The incentive value delivered to managers has equally been highly variable, a modest proportion reflecting the board's intent in relation to an award for achieving business plans, however in recent times, though not the past twelve months, reward has substantially exceeded reward intent under many long term incentive plans reflecting an extended period of a bull market.

If it is the intent of the Rudd Government or the Productivity Commission to bring about reform in executive remuneration a key area for that reform is the management and application of equity based incentives. Increasingly boards in their transparent disclosure of remuneration intent express their plans having regard to their expectation of the level of reward which executives would receive if the company meet their business plans and strategies and meet performance hurdles demanded by investors.

The lottery effect of these performance hurdles have clearly in the immediate past led a number of companies to taking investment risks which have been inconsistent with long term sustained performance as the only way in which executives were rewarded was to out-perform a marketplace defined, for example, as the ASX 100 or the ASX 200. The lottery effect comes from the fact that this market expresses returns across a significant diversity of industries where companies have an engagement across highly varied geographies and economies.

As revealed in an earlier submission, adopting a theoretical allocation of \$100,000 in value using a valuation tool regarded as appropriate in accordance with accounting standards has led to a substantial number of companies, many performing consistently in relation to growth in shareholder value at many multiples of consumer price movement, not being rewarded and others being rewarded broadly in alignment with the remuneration intent, though where the average reward delivered was more than seven times the disclosed remuneration intent and in some cases more than twenty times. Given this circumstance, a problem clearly exists.

In remuneration parlance a long term incentive simply reflects a requirement for sustainable and improved performance. If that is to be set at 30% of an executive's fixed remuneration, say \$200,000, it would be appropriate for shareholders to anticipate that where the company or the executive met the plan set they would receive an incentive in the form of equity equivalent in value to \$200,000, not say \$1,500,000, or where the company significantly out-performed expectation they might receive a benefit of double the remuneration intent for on-plan performance.

By way of illustration and reflective of an average performance on the ASX, the following sets out disclosures and average outcomes.

Executive salary: \$400,000
Incentive proposal: 50% of salary = \$200,000
Share price at grant date: \$5
Disclosed valuation of share right at grant date subject to hurdle: \$4
Number of rights issued using the above valuation: 50,000
Share price at the date of vesting: \$8 (17% compound share price growth: hurdles met)
Value of rights on exercise: \$400,000

Assuming the issued rights were amortised over a three year period and a similar proportion of rights were allocated to the nominal executive annually, then disclosed value of the long term incentive would be \$200,000. The realised value in the above example was twice the disclosed value on a marked to market basis. This example does not represent an extreme position but rather a modest outcome during the bull market era.

While Egan Associates support the Commission's recommendation we believe that the Government's initiatives in the area of share plan participation require more thoughtful consideration if genuine reform in employee and executive reward is to be achieved for the long term benefit of all stakeholders. This extends beyond disclosure of realised outcomes but a statement as to the alignment of reward intent and realised outcomes, an appropriate taxation regime which enables companies to require senior staff to hold shares in the company and thus continue their alignment with shareholders whose support is essential for their competitive rewards and to also allow deferment of annual incentive benefits subject to sustainable performance.

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.

See comments on Recommendation 15 below.

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.***

25% of votes cast?

The first aspect of this requirement is that the recommendation refers to 25% being voted against the Remuneration Report. The recommendation does not say what this 25% refers to – the votes cast or the total votes available (ie total number of ordinary shares in the company). The Corporations Act requires that a special resolution should be voted for

by 75% of the votes cast to be carried. It would appear that the Commission's recommendation would also refer to votes cast.

If that is the case, it raises several problems. Our analysis shows that in the top 200 companies, at the median, 54% of available votes are cast. On that basis, the 25% of votes cast would represent 13.5% of the total shareholdings in the company. We doubt that most shareholders want their companies managed in that way.

In 2008, the top three shareholders in the top 200 companies held, at the median, 39% of the shares. There is the potential for 13.5% of the total shareholdings to vote against the remuneration report at two meetings and trigger an election for the whole board. This reflects neither democracy nor good governance.

Egan Associates Research

We have attached to this submission summaries of our research including short commentaries which describe the realities of both shareholding and voting patterns across Australia's top 200 listed companies.

The data which appears in this research provides a stark picture of the current reality in our market and the influence of the large shareholders ie the institutional shareholders.

On the basis of our research it is evident that a small number of shareholders can achieve a higher than 40% vote against a Remuneration Report. In this context we also note the increasing influence of proxy advisers in recommending votes for and against aspects of executive reward which are brought to shareholders for a binding or non-binding vote. While we accept that the remuneration adviser and the proxy adviser have valuable roles to fulfil, it would be our judgement that the shareholder with least influence is the retail shareholder and the shareholder with potentially undue influence is the major shareholder, which in many instances would be representing a significant number of superannuants whose collective investment places them in a position of significant influence.

It would be our assessment that the retail shareholders' clout is minimal, albeit organisations such as the Australian Shareholders' Association are a conduit for their voice. It would also be our judgement, based upon our general reading, that a significant vote against a Remuneration Report may often be influenced by other concerns of significant shareholders.

The engagement and voting 'reality' – what role for proxy votes and corporate governance?

The questions that emerge surrounding boards and companies managing the relationships with the major institutional shareholders in the context of the 2 strikes rule are;

1. Is it appropriate that boards continue to direct proxy votes in regard to the remuneration report, or should any vote capable of being directed by the chairman now be excluded on the basis that board tenure is impacted by the vote (related party)?
2. Recognition that the fundamental principles of corporate governance are challenged by the inequality of the stakeholder relationships and voting behaviours.

The proposed remedy raises even more problems

The recommendation proposes that the votes of a small cadre of the total shareholders should be able to unseat the board. This means that small groups of major shareholders may have control over the survival of many of the boards of the major companies in the country. See the charts attached.

The recommendation proposes that all the board be required to stand for re-election. This is despite the likelihood that the decisions being voted against were prepared and submitted to the board by the remuneration committee who would have the detailed knowledge of what was proposed. Is it reasonable to penalise all the board if the decisions of part are questioned? And why is there no mechanism for consultation with the Chairs of the board and the committee before such a radical step is taken? Many concerns brought to the forefront of disclosure relate to decisions or agreements entered into years earlier, often under the stewardship of different directors.

There is no indication as to when the enforced election should take place. Would this be at a special general meeting or at the next annual general meeting? If the former, this entails additional expense for the company, or in the latter a board, knowing that their entire board must stand for re-election, though in the meantime they are accountable to provide effective stewardship of the company for the following year.

There is an even more important reason and precedent why the whole board is not required to stand for election at the one meeting. The re-election and appointment of directors is a staggered process by design as a board of directors is an accumulation of company knowledge, individual director expertise, networks and commercial savvy. To ask any company to risk the destruction of such an important team is most prejudicial.

Good governance and advisers

In our previous submission, we emphasised the importance of the independence of the advisers to the board. The recommendation makes no reference as to whether the vote on the remuneration report is well-advised or not. There are times when boards must make unpopular decisions for the continuing good and sustainability of the company.

In the face of such complexity, extreme caution and extensive market analysis may be necessary.

Egan Associates Research – Remuneration Report Voting

Votes cast

In relation to published annual reports and published outcomes of companies whose financial year ended in calendar year 2008 reveals the following.

1. The average percentage of shareholders voting among the top 200 companies was 54%, and
2. The maximum vote cast was 88% of potential shareholders.

Percentage of votes cast in 2008 reporting season

| | 75 th Percentile | Median | 25 th Percentile | Average |
|------------|-----------------------------|--------|-----------------------------|---------|
| Top 25 | 59% | 52% | 46% | 55% |
| Top 50 | 65% | 58% | 48% | 57% |
| Top 100 | 68% | 59% | 46% | 57% |
| Top 200 | 66% | 54% | 43% | 54% |
| Second 100 | 63% | 50% | 37% | 52% |

'No' vote distribution

In relation to the distribution of shareholders voting against the remuneration report the table below reveals that the average negative vote in the top 200 companies was 10%, with the smallest negative vote among the top 25 companies. The table below sets out the percentage of those shareholders voting at the 2008 annual general meetings who voted against the remuneration report.

Percentage of 'No' votes cast in 2008 reporting season

| | 75 th Percentile | Median | 25 th Percentile | Average |
|------------|-----------------------------|--------|-----------------------------|---------|
| Top 25 | 8% | 4% | 2% | 8% |
| Top 50 | 9% | 4% | 2% | 11% |
| Top 100 | 9% | 5% | 2% | 10% |
| Top 200 | 11% | 4% | 2% | 10% |
| Second 100 | 14% | 4% | 2% | 10% |

'No' vote distribution modified

If we assume that those shareholders who did not exercise their right to vote were either positive or neutral and the negative vote was assessed having regard to the expressed concern of all shareholders, the table below reveals that the average negative vote among all shareholders recorded (though not necessarily voted) in respect of the top 200 companies stood at 5%.

'No' votes in 2008 reporting season – modified.

| | 75 th Percentile | Median | 25 th Percentile | Average |
|------------|-----------------------------|--------|-----------------------------|---------|
| Top 25 | 3% | 2% | 1% | 4% |
| Top 50 | 5% | 2% | 1% | 6% |
| Top 100 | 5% | 2% | 1% | 6% |
| Top 200 | 6% | 2% | 1% | 5% |
| Second 100 | 6% | 3% | 1% | 5% |

The voting influence of the 'Top 20' shareholders

In reflecting upon Recommendation 15 and our observations as to what factors might contribute to a negative vote in relation to the remuneration report, but which might stand outside the content of the remuneration report, we also explored the proportion of total shareholders represented by the top 20 shareholders and observed that the average holding of the top 20 shareholders among the top 200 companies was 65% of all shareholders. See table below.

'Top 20' as a proportion of total shareholder in 2008 reporting season

| | 75th Percentile | Median | 25th Percentile | Average |
|------------|-----------------------------------|---------------|-----------------------------------|----------------|
| Top 25 | 77% | 63% | 50% | 60% |
| Top 50 | 79% | 72% | 53% | 64% |
| Top 100 | 81% | 74% | 56% | 66% |
| Top 200 | 81% | 72% | 53% | 65% |
| Second 100 | 81% | 69% | 52% | 64% |

The voting influence of the 'Top 3' shareholders

In order to explore the potential influence of the top three shareholders we also considered their shareholding as a proportion of a company's total shareholding and note that among the top 200 companies the top three shareholders have an average holding of 40% of the company. We also observe that the maximum holding across all categories reported in the table below was 88%, being least substantial among the top 25 companies where it stood at 69%.

'Top 3' as a proportion of total shareholder in 2008 reporting season

| | 75th Percentile | Median | 25th Percentile | Average |
|------------|-----------------------------------|---------------|-----------------------------------|----------------|
| Top 25 | 55% | 42% | 35% | 43% |
| Top 50 | 55% | 46% | 35% | 43% |
| Top 100 | 53% | 45% | 35% | 43% |
| Top 200 | 52% | 39% | 30% | 40% |
| Second 100 | 47% | 37% | 26% | 38% |

Observations

In the above context we acknowledge that many significant financial institutions act as nominees for shareholders whose identity is not always directly revealed. Our research does, however, highlight the fact that in the era that sponsored the Government's enquiry into executive remuneration the median negative vote among the top 200 companies stood at 2% of total shareholders and the average 5%.

It would be our judgement in this context that there was not widespread disquiet in the 2008 reporting season, although we readily acknowledge that in a small number of companies shareholders express significant concern in relation to the level of executive remuneration or proposed contractual arrangements, particularly in relation to the issue of shares, options or share rights.

Voting patterns illustrated

In our final illustrations we reveal the percentage of total shares voting on the remuneration report compared to the shareholding of the top three shareholders and the percentage of votes against the remuneration report compared with the shareholding of the top three shareholders.

