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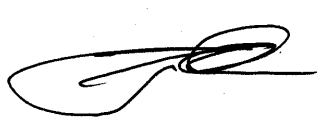
Dear Sir/Madam,

Exposure Draft - Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Thank you for the opportunity for the Australian Bankers' Association (ABA) to comment on the above Bill.

The ABA's submission is attached.

Yours sincerely



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Australian Bankers' Association Inc. ARBN 117 262 978
(Incorporated in New South Wales). Liability of members is limited.

Comments on Exposure Draft: *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*

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Comments on Exposure Draft: Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Chapter 1 – Strengthening the non-binding vote – the 'two-strikes' test

New Law (draft)	Current Law
A 'two-strikes and re-election' process will be introduced where a company faces significant 'no' votes on its Remuneration Report over two consecutive years.	The Corporations Act does not set out any consequences where a Board proceeds with its remuneration policies despite a negative shareholder vote.

ABA position
• Voting threshold should be the level required for an ordinary resolution - 50% • Before implementing a two strikes rule, there must be a review of the range of possible unintended consequences and of the practices of shareholder associations and proxy advisors

Policy intent

Increasing transparency, governance and informed shareholder engagement in relation to remuneration practice and process are fundamental principles of sound remuneration policy and practice. However, it is not clear that the introduction of a "two-strike" rule will have a positive impact on these objectives and in fact there may be negative unintended consequences.

The proposed requirements inappropriately place remuneration issues above other issues the Board must deal with, and the re-election requirements could have the effect of destabilising the Board.

Moreover, the re-election process will be complicated and confusing, in particular to retail shareholders who do not necessarily focus on corporate governance issues as keenly as institutional investors.

Australia's relatively strong economic performance throughout the GFC can be attributed in part to the existing strong governance of our corporations in general and our banks in particular. As an observation, all G20 countries are reviewing governance laws and regulations in the wake of the GFC, however no other country is contemplating the introduction of similar measures at this time.

Threshold

The Remuneration Report is a complex document and a vote against it could be a vote against only one of many elements, but may trigger the extreme outcome of

a Board re-election. It is often not known which aspect shareholders may be opposing. This means it may often be very difficult for the company to know what the concerns were that led to the negative vote and which need to be explained.

The 25% 'no vote' threshold is set too low. It ignores the 75% majority view and can be inflated by the fact that the percentage required is of the votes cast, not total eligible votes, and that it is proposed that undirected proxies held by key management personnel (KMP) will not be able to vote on the Remuneration Report or spill resolutions.

A majority vote is more appropriate. We recommend that the voting threshold be set at 50%, in line with other ordinary Board resolutions.

Prudential regulation

The two strikes rule could potentially damage the intent of APRA's Prudential Standard on Governance, A/G/LPS 510:

> *The Board must ensure that directors and senior management of the regulated institution, collectively, have the full range of skills needed for the effective and prudent operation of the regulated institution, and that each director has skills that allow them to make an effective contribution to Board deliberations and processes. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the regulated institution, including its legal and prudential obligations, and to ensure that the regulated institution is managed in an appropriate way taking into account these risks. This does not preclude the Board from supplementing its skills and knowledge through the use of external consultants and experts.*[1]

By exercising the two strikes rule, the skills, knowledge and experience of existing directors could be effectively nullified by a minority vote, which may also lead to the election of less qualified directors.

Shareholders

There are many scenarios where voting by ill informed or poorly advised shareholders could lead to a "spill resolution" for the Board of a well managed corporation, which in turn could have a negative impact on the share price and the financial stability of the corporation.

The introduction of a two strikes rule, without a critical review of the range of possible unintended consequences and a review of the practices of shareholder associations and proxy advisors, may create more risk of corporate instability rather than less. We submit that it is a disproportionate response.

If the rule were to be implemented, one technical issue to be resolved would be to make sure that directors do not cease to hold office before the meeting, so that the Chairman is available to run the meeting.

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[1] http://www.apra.gov.au/Policy/upload/APS-510-Governance-Nov-2009.pdf

Chapter 2 – Improving accountability on the use of remuneration consultants

New Law (draft)	Current Law
Companies that are a disclosing entity will be required to disclose details relating to the use of remuneration consultants. Remuneration consultants must be engaged by non-executive directors, and must report to non-executive directors or the Remuneration Committee, rather than company executives.	Currently, companies are not required to disclose any details relating to the use of remuneration consultants. In addition, there is no requirement for remuneration consultants to be engaged by, and their advice provided directly to, non-executive directors or the Remuneration Committee.

ABA position
• These changes are not supported • They would capture activities not within the policy intent • Board autonomy would be undermined • Existing regulation is adequate • The required disclosures are excessive

Role of the Board

The role of the Board is to make assessments on information provided to them and to make remuneration decisions based on those assessments, and the role of management is to act as a conduit for this data. Boards should have direct access to the providers of third party remuneration information so that they can question and probe on the data and analysis and make their decisions accordingly.

The proposed changes will reduce the autonomy of Boards and their Remuneration Committees because directors will be required to disclose the nature of any advice they receive from independent remuneration consultants.

The proposals would also force changes to the manner in which companies' HR and remuneration teams currently operate, by effectively requiring all advice relating to the nature and amount/value of KMP compensation to be channelled through the non-executive directors and limiting the scope for direct contact between remuneration consultants and management. This would impose management functions on non-executive directors and is inconsistent with widely accepted views on the appropriate role of non-executive directors for effective corporate governance.

Management would be prohibited from directly engaging external remuneration consultants. This would handicap management and negatively impact the Board's

deliberations, because it would diminish the depth of views presented to the Board on key remuneration issues.

Role of executives

The legislation does not does not address the role of the internal HR and compensation department in the compensation setting process. Neither does it address the role of KMP in setting compensation for those who are not KMP, or indeed the role of the CEO in recommending compensation for their KMP team.

We believe the Bill as currently drafted will result in significant unintended consequences. Management uses consultants for a range of operational advice relating to executives such as cross border taxation advice for expatriates and inpatriates, remuneration benchmarking to support appropriate remuneration at all levels of the organisations, and advice on broad-based reward arrangements applying to both senior executives and other employees, for example superannuation plans, insurance plans and other employee benefits.

Role of advisors

The engagement of remuneration consultants by the Board is an important part of the compensation setting process but it is critical that management is also able to engage consultants.

Global best practice is to have independent and separate remuneration consulting engagements for the Board and for management.

The advisor to management is typically engaged by the HR department and provides the following services.

(1) Market data surveys and analysis relative to positioning of the company's remuneration levels and structures, across all levels within the organization, including KMP.

(2) Advice on remuneration plan design, including the legality of the design, tax implications and accounting treatment.

(3) Advice as required for particular transactions including key hires, mergers and acquisitions and divestments.

Generally, internal control practices ensure that market data, analysis and advice is not shared with the subjects of the advice. For example, the CEO should never see analysis or data on the CEO position, but the CEO should receive data on those positions that report to them. These and other internal control processes for the compensation system are already well established in major corporations.

The advisor to the Board is typically engaged directly by the Board. The services provided by the Board's advisor are different from the management advisor, they include.

(1) Advice to the Board on remuneration policy and practice - the remuneration policy being issued by the Board (not management).

(2) Review and advice to the Board on the remuneration recommendations provided by management. This includes

recommendations of remuneration made by the CEO for the KMP population.

(3) Attending to remuneration governance training programs for Non-executive Directors.

(4) Annual review of the implementation of the Remuneration Policy.

The above practice is consistent with the relationship between external and internal audit departments. Both have a similar role, but the emphasis is slightly different. To have all the advice (for KMP) siloed at Board level would make the role of CEO uncertain as far as control over remuneration is concerned. At the same time the Board needs a strong and independent advisor who can provide competent impartial advice to the Board, who ultimately are responsible for the company's remuneration policy.

Operation of proposed provisions

The draft legislation will include any person (other than an officer or employee of the company) who, under a contract for services with a company, provides "advice relating to the nature and amount or value of remuneration for one or more members of the KMP for a company that is a disclosing entity" (s206K(1)(a)).

ABA understands the provisions are designed to promote independent advice being provided to non-executive directors to enable them to assess remuneration for the CEO and other KMP.

ABA members consider this definition of a "remuneration consultant" to be too broad, potentially capturing external accountants, legal advisers and other consultants engaged by them to advise on issues such employee equity plans or remuneration structures. In the case of legal advisers, the requirement to publish the proposed information is of particular concern, as it may put at risk legal professional privilege in some cases.

The explanatory memorandum states that the key concern is:

> *"that remuneration consultants may be placed in a position of conflict if they are asked to provide advice on the remuneration of officers who might have the capacity to affect whether or not that consultant's services will be retained again."*

The risk arising from any conflict only materialises where the advice is used to provide the non-executive directors with independent advice on remuneration of the CEO and KMP.

ABA considers the requirement for remuneration consultants to be engaged by non-executive directors and provide advice directly to the Remuneration Committee or non-executive directors may create an unintended administrative burden on non-executive directors.

ABA recommends including an explicit provision which allows the Remuneration Committee and non-executive directors to access administrative support from the company when engaging and dealing with remuneration consultants, similar to

the provision in APRA Prudential Practice Guide PPG 511 Remuneration paragraph 15:

> *"The Board Remuneration Committee may rely on administrative support from internal or external parties when conducting reviews. The Committee, in performing its duties, would typically seek information from relevant internal parties including, but not limited to, those responsible for risk management, human resource management and internal audit. APRA expects the Committee to ensure that there are processes in place to ensure advice from such parties is not influenced by conflicts of interest."*

Such a provision would improve the practical implementation of the legislation and not contravene the proposed legislation under Schedule 1, Item 5, sub-sections 206K and 206L, as remuneration consultants would still be required to be engaged and report directly to the Remuneration Committee/non-executive directors.

There is a significant lack of clarity on the practical operation of the proposed provisions. For example, it is unclear whether a remuneration consultant can, on the instruction of the Remuneration Committee, send copies of advice to management which has already been provided to the Remuneration Committee, or discuss same with management.

There is also a lack of clarity on what constitutes advice on the "nature and amount or value" of KMP remuneration. For example, it is not entirely clear whether the proposed provisions would apply to the following forms of advice which would not ordinarily (and probably should not ordinarily) be considered to be 'remuneration advice':

- advice on required disclosures in the Remuneration Report;
- advice on the legal structure of employee equity plans;
- interpretation of clauses under employee equity plan documentation;
- valuations of employee equity incentives under Australian accounting standards; and
- advice on the application of the recently amended termination benefits provisions of the Corporations Act

Existing regulation

ASX principles already provide:

> *"The terms of reference of the Remuneration Committee should allow it to have access to adequate internal and external resources, including access to advice from external consultants or specialists."* (principle 8, rec 8.1 commentary).

The APRA Standard requires:

> *"51. The Board Remuneration Committee, or in the case of a foreign ADI, the senior officer outside Australia, must: have free and unfettered*

access to risk and financial control personnel and other parties (internal and external) in carrying out its duties; and (b) if choosing to engage third-party experts, have power to do so in a manner that ensures that the engagement, including any advice received, is independent." (Prudential Standard APS 510).

APRA Prudential practice guide 511 - Remuneration advises:

*"**Use of external advisers***

19. If a Board Remuneration Committee engages external advisers, the governance standards require that the advisers be commissioned in a manner that ensures that their engagement, including any advice received, is independent. The Board Remuneration Committee will need to exercise its own judgement and not rely solely on the judgement or opinions of others.

20. Where a Board Remuneration Committee chooses to seek advice from a third party, there is a potential for conflicts of interest to arise where the third party provides, or may seek to provide, other remuneration advice or services to the regulated institution or its executives. In engaging an adviser, APRA expects the Committee not to engage an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution in relation to remuneration."

These well established approaches are preferable as they enable the Remuneration Committee to decide how best to commission and receive advice as needed in a particular case, but making sure it is independent.

Disclosures

ABA considers the proposed disclosure requirements to be excessive, even with the assumption that the definition will be narrowed to engagements requested by the non-executive directors. Given that the procedures for engaging the remuneration consultant are designed to ensure their independence, there is no clear reason to require the detailed disclosure of each contract given there are no other equivalent disclosures for other consultants/advisers under the Corporations Act.

The proposals do not adequately clarify the level of detail required in relation to the disclosures provided. The additional requirements will further increase the size of Remuneration Reports, which are already very long, and there are no carve-outs to address confidentiality of services.

ABA recommends that the disclosure provisions operate on an aggregate basis - in a similar way to the current disclosure requirements for auditor's remuneration (e.g. total fees and general categories of services). The level of detail proposed in the draft legislation may further confuse the users of the Remuneration Report because remuneration consultants' advice is only one facet of the decision-making process used for determining KMP remuneration.

Chapter 3 – Prohibiting Key Management Personnel (KMP) from voting on remuneration matters

New Law (draft)	Current Law
Prohibit key management personnel (and their closely related parties) that hold shares from voting on their own remuneration arrangements, as part of the non-binding vote. Prohibit key management personnel (and their closely related parties) from voting undirected proxies on all remuneration related resolutions.	Key management personnel can participate in the non-binding vote, including by exercising undirected proxies.

ABA position
• These changes are not supported • The proposed approach adds complexity, and the prohibitions are too broad

Proxy voting

A person should not be excluded from voting on a resolution merely by virtue of an involvement or connection with the resolution, or matters that are dealt with in the resolution. KMP should be prohibited from voting on resolutions where they have a material personal interest, such as a resolution relating to their individual remuneration arrangements. In those circumstances a person would be excluded from voting under the ASX Listing Rules (listing rule 14.11). A person should not be excluded from voting on a resolution where they do not have a material personal interest in the outcome of the resolution.

The proposals would effectively disenfranchise those shareholders who choose to vote by undirected proxy, who are primarily retail shareholders. The law provides for shareholders to vote by giving undirected proxies. The fact that a shareholder exercises their right to vote in this way should not mean that their vote is then excluded.

ABA suggests that concerns in this regard can be adequately dealt with in a similar way in the Corporations Act as resolutions required by the listing rules are dealt with under ASX listing rule 14.2.3B. Under listing rule 14.2.3 votes cast under an undirected proxy in favour of the Chairman of the meeting in relation to a resolution in which the Chair has an interest will **not** be disregarded where the shareholder acknowledges that the proxy-holder may vote those shares, even where he/she has an interest in the outcome of the resolution. In this way the shareholder is making a conscious choice to appoint the proxy. This approach does not disenfranchise shareholders while taking account of the need to manage any possible conflicts of interest.

Closely related parties

The breadth of the restriction on not voting undirected proxies on any remuneration related resolutions is problematic in relation to the definition of "Closely related parties", which includes a spouse, child, child of spouse, dependant of the member or spouse, and anyone else in the person's family who may influence or be influenced by the person and a company the person controls.

In its final report the Productivity Commission acknowledged that even extension to associates would be impractical and infeasible to administer in practice. The Commission also noted that major company shareholders could be precluded from voting and that extension to closely related parties could "inappropriately exclude relatives of directors or KMP who had independently purchased shares in the company."

Chapter 4 – Prohibiting hedging of incentive remuneration

New Law (draft)	Current Law
Prohibit KMP (and closely related parties) from hedging remuneration that depends on the satisfaction of a performance condition.	KMP can hedge their exposure to remuneration, and must disclose the company's hedging policy in the annual report.

ABA position
Supported, but the approach should be principles-based

ABA believes that a "hedge" should be defined broadly as a principles-based provision (as per 206J(2)), rather than through a prescribed list of arrangements. The evolution of modern financial markets would quickly render a prescribed list redundant.

Arrangements relating to life or income protection insurance, where the insurable risk event relates to the death or illness of the KMP, should be excluded from the definition of a "hedge". However, in the case of insurance contracts where the insurable risk event relates to the financial value of remuneration or equity/equity-related instruments, these insurance contracts should be considered hedges. In other words, the relevant test is the insurable risk event rather than the arrangement or instrument itself.

Chapter 5 – No vacancy rule

New Law (draft)	Current Law
Public companies will be required to obtain the approval of its members for a declaration that there are no vacant Board positions, should the member of Board positions filled be less than the maximum number specified in the	There is no current law equivalent to this provision.

company's constitution.	

ABA position
• Not supported • The rule would add complexity • May result in unqualified candidates being appointed

The proposal changes to the rules regarding 'No Vacancy' are intended to constrain the perceived power Boards have over Board composition. However, the proposed changes may have unintended impacts that will also limit the effectiveness of Boards.

There is a concern that this initiative will encourage or facilitate single issue voters and special interest groups to nominate candidates for election as directors; or lead to some companies appointing more directors up to the maximum limit permitted under the Constitution in order to avoid the risk of unsuitable nominees.

In an extreme example, if a Board had 10 directors, with a Constitution that permitted a maximum of 16, the proposed provisions might encourage a special interest group to nominate 6 nominees for vacancies, giving them a "no cost" opportunity to have a significant amount of material included in the notice of meeting and then dominate the meeting with their platform through various presentations by the 6 nominees.

The proposed change may potentially cause Board instability. Boards with less than the maximum number of directors would have to consider:

- hurriedly appointing more Board-appointed directors to fill positions up to the maximum under their respective constitutions; and/or
- changing their respective constitutions to reduce the maximum number of directors prior to the next AGM.

When combined with a possibility of a spill vote this would also increase the possibility of underqualified directors successfully running for election to fill the greater number of available directorships at the next AGM (when all Board-appointed directors would be required to stand for election).

ABA believes Boards should continue to have the flexibility to determine the appropriate mix of skills and experience for the composition of their respective Boards.

In order to address the above concerns, it is very important that if the no vacancy rule were to be implemented, it be done so in conjunction with a new rule that placed some sensible thresholds that must be met in order for a non-Board endorsed candidate to stand for election, for example that a candidate must be supported by at least 1% of the issued voting capital or at least 100 shareholders.

Chapter 6 – Cherry Picking

New Law (draft)	Current Law
Proxy holders will be required to cast all of their directed proxies on all resolutions.	Proxy holders, other than the Chair, are not required to cast all of their directed proxies on all resolutions, but may choose which proxies to cast.

ABA position
Additional clarification is required to make clear that proposal will not apply to proxies not in attendance at the meeting.

We support the underlying proposition that, where a proxy is in attendance at a meeting, the proxy should be required to vote all proxy votes as directed.

It should be clarified that proxy holders will be required to cast all of their directed proxies in relation to any individual resolution where the proxy holder attends and votes on that resolution at the meeting – such a framework could be easily enforced, and it also takes into account the situation where the shareholder may have to leave before all resolutions have been dealt with for personal reasons, or because the meeting has taken longer than expected to complete, or because they fall ill during the meeting.

Specifically, ABA recommends that if a proxy holder registers as an attendee at a meeting, they should be deemed to have voted their directed proxies; and, if a proxy holder does not register their attendance at the meeting, they should be deemed to have voted their directed proxies. In effect, this converts a directed proxy to a direct vote.

Chapter 7 – Persons required to be named in the Remuneration Report

New Law (draft)	Current Law
Remuneration disclosures will be confined to KMP of the consolidated entity.	Remuneration disclosures apply to KMP of the consolidated and parent entities (and the five most highly remunerated officers, if different).

ABA position
Supported