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General Manager
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: executiveremuneration@treasury.gov.au

Dear Sir/Madam

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

We are writing in response to the consultation on the above Bill on behalf of Australian Foundation Investment Company Limited (AFIC), Australia's largest listed investment company. AFIC is a listed company with over 92,000 (predominantly retail) shareholders, and has been a long-term investor in Australian companies for over 80 years. We are the owner of shares in 78 ASX listed companies with a market value of $4.95 billion as at 31 December 2010. As such, we believe AFIC is well placed to comment on these issues regarding the governance of listed companies.

AFIC is very concerned at the practical effect of a number of the proposals in the Bill. We think that as currently drafted, the provisions may weaken the governance of listed companies and even disenfranchise shareholders, particularly retail ones. In considering these matters, it is very important that the respective roles of the Board and management are kept clear and separate. The role of management is to deal with the day to day operations of the company. The role of the Board is to set objectives and goals for the operation of the company, to oversee management, to regularly review performance and to oversee a company's affairs in the best interests of shareholders. We do not believe it is the role of Boards to take on detailed operational responsibilities, including HR matters.

The focus of AFIC's response to the consultation is to highlight what we see as being the main deficiencies with the proposed changes.

Use of remuneration consultants

Our understanding of current practice for determining the remuneration of key management personnel (KMP) is for appropriately qualified members of management (normally the HR function) to design the often complex incentive systems for executives, with the assistance of external consultants who advise on technical, legal and accounting matters in light of developing best practice aspects of remuneration.

Management then make recommendations to the Board (or Board Remuneration Committee) who often take their own expert advice to determine whether the incentive systems proposed are appropriate for the organisation in question.

The Productivity Commission's recommendations with respect to the use of remuneration consultants were designed to ensure that where Boards (or Board Remuneration Committees) took their own advice from remuneration consultants, that advice was independent and free from conflicts of interest.

In our view, the draft legislation misunderstands the Productivity Commission's recommendations and as currently drafted, would completely change, in a detrimental fashion, the way in which remuneration for KMP is determined in corporate Australia.

The Bill prohibits management from commissioning or receiving any external advice whatsoever in relation to remuneration matters which may involve KMP. Any advice to management more generally would be caught by the legislation in relation to any incentive system that covers many employees, if it included a single member of KMP.

In addition, CEO's will not be able to commission or receive advice in relation to the remuneration of their direct reports and responsibility for the design of incentive systems for KMP will rest squarely on the shoulders of non-executive directors. Non-executive directors, while being qualified to judge whether particular remuneration systems are appropriate for an organisation, should not be involved in day to day issues of resolving details of remuneration systems for each and every KMP. This proposal forces non-executive directors to take on management responsibilities, and blurs the respective roles of the Board and management.

In our view, the current proposals are untenable in practice and will not assist in the desired outcome of ensuring KMP incentive systems are appropriate for the company and are also aligned with the interests of shareholders.

AFIC recommends that the draft legislation be amended to give effect to the Productivity Commission's original recommendations on the use of remuneration consultants and its associated disclosure.

The proposed "two-strikes" rule

It is AFIC's view that this controversial proposal will be of no additional benefit to shareholders or the governance of listed companies and insufficient consideration has been given to the practicalities of implementing it.

Shareholders already have the power by ordinary resolution to remove directors and it would only require the support of 100 shareholders or shareholders representing at least 5% of the issued capital of a company to put such a resolution to a general meeting for shareholders to vote on.

Moreover, the responsibilities of Directors are not confined to deciding KMP remuneration matters. Directors have other important responsibilities including amongst other things approving corporate objectives and strategies and monitoring the financial and non-financial performance of the company.

As an institutional shareholder, it is puzzling to us why the remuneration of KMP has been singled out as the only issue deemed important enough by the legislators to provide for a possibility of the whole Board being spilled.

The practical impact of the proposals will likely be that shareholders (particularly institutional ones) will be more hesitant to vote against remuneration reports, as they will not want a company's focus to be turned away from the business of creating shareholder value because of the prospect of potentially facing a Board spill resolution. In addition, by having a minority threshold of 25%, the concern we have is that this will be an avenue that could be exploited by special interest groups or even hostile takeover bidders as a tactic to create instability in a company over matters completely unrelated to remuneration.

The proposals also have a number of practical difficulties in respect of the implementation of the "two-strikes" rule. In calculating the 25% threshold, the proposals do not take account of the traditional form of voting at Annual General Meetings on a show of hands, which is preferred by retail shareholders and it is not clear how the 25% threshold should be counted and recorded with accuracy in such a situation.

Practical difficulties also arise if the legislation is amended to mandate voting by poll on the resolution to adopt the remuneration report. As noted above, this is not the preferred method of voting by retail shareholders. In addition, results of polls are often not known until after the meeting has ended, in order for them to be counted and the results audited and advised to the market.

The situation of an AGM where a company has received a first strike (i.e. a greater than 25% vote against the remuneration report) the year before will be particularly complex.

At the second year's AGM, dealing with the remuneration report will require two resolutions. First the normal resolution to adopt the remuneration report. Secondly, a contingent resolution will also be required as to whether there should be Board spill meeting. If the voting is conducted by a show of hands, the above comments about uncertainty regarding how it is assessed would apply. If conducted by a poll, again the outcome is significantly delayed until the votes are counted and the results audited. Shareholders attending the meeting will most likely not know the outcome of these matters until after the meeting has closed when the company advises the market of the results of the voting.

The uncertainty even has the potential to effect trading in the company's shares during the delays while the results of these resolutions are being determined, because a potential spill of the Board is a material matter.

We have been concerned for sometime that retail shareholders are increasingly discouraged from attending AGMs because of the formal technicalities surrounding them.

Due to the practical effects and complexities of the proposals outlined above, we believe that while the AGM as a mechanism for voting will remain important, the AGM as an event to be attended by shareholders to find out about the operations of a company will even further diminish in value.

AFIC strongly believes this proposal should not be adopted. However, if the legislature insists on these proposals going ahead, they need to consider the practical issues we have outlined in much greater depth. Before implementation, the high level of uncertainty that exists around how the proposals will work in practice must be resolved.

Voting of discretionary proxies

In companies with a large proportion of retail shareholders, it can be observed that those companies receive a higher proportion of proxy votes that provide the proxy with the discretion how to vote, as their relationship with the company is more personal in nature and most of them appoint the Chairman as their proxy. In AFIC's case, for the 2010 AGM, 36% of all proxies received on the remuneration report were discretionary, with the vast majority of them appointing the Chairman as proxy.

Notices of meeting already set out Board recommendations regarding voting on each resolution. They also detail how the Chairman intends to vote in the situation where a shareholder has appointed the Chairman as proxy and given him/her the discretion how to vote. Those votes to the Chairman are with full disclosure of how the Chairman intends to vote them. It is a misnomer that proxies that grant the Chairman the discretion of how to vote are described as "undirected".

Without extensive publicity and shareholder education, the practical effect of the proposal to bar KMP, including the Chairman, from voting discretionary proxies will be to disenfranchise a large number of retail shareholders.

It is AFIC's view that this proposal should be removed from the draft legislation.

Cherry picking of proxies

While AFIC is supportive of the general principle that proxies should be required to vote "directed proxies", we are strongly of the belief that the legislation should explicitly provide an exception to this rule (and it should be an explicit exception to the rule, rather than a defence to a breach of the rule) for those that are not aware that they have been appointed proxy or if they are not present at the relevant general meeting.

Effective abolition of the "no-vacancy" rule

The previous practice by Boards of invoking the "no vacancy rule" had the practical and beneficial effect of discouraging individuals without much shareholder support from standing for election as a director.

As an institutional shareholder, AFIC is concerned that there could be a number of undesired consequences, should the "no vacancy rule" be effectively abolished as currently proposed. This includes encouraging single issue special interest groups or even those involved in litigation against the company to nominate a number of candidates for election because there are vacancies. This would provide them with a low cost opportunity to dominate the meeting and the meeting materials with their issues without any genuine commitment to serving the interests of all shareholders by being Board members.

In order to combat that risk, it could also lead some companies to either appoint more directors up to the maximum limit permitted under their constitution or to put up proposals to reduce the maximum size of the Board allowed under their constitution.

We believe the ability of Boards to appoint additional directors when they become available is an important part of the process for orderly Board succession and renewal. This would require a company to have unfilled vacancies on the Board from time to time. In our view, a Board should not be discouraged from having unfilled vacancies for this purpose.

If the Government were to continue with the current proposals, AFIC would be supportive of the insertion of amendments to the Corporations Act to introduce minimum shareholder support requirements before an outside individual can stand for election as a director. As mentioned earlier in this response, other types of resolutions can be put to shareholders if they have the support of 100 shareholders or shareholders representing at least 5% of the issued capital of a company. This may be a useful starting point.

We would be happy to discuss AFIC's views with you in more detail should you have any questions.

Yours faithfully

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