

27 January 2011

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

By email: executiveremuneration@treasury.gov.au

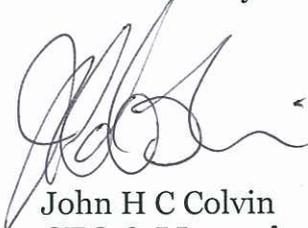
Dear sir

Enclosed is a submission by the Australian Institute of Company Directors (Company Directors) in response to the Exposure Draft of the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011*, released by the Federal Government on 20 December 2010. In providing our views, we hope to assist Federal Treasury and the Federal Government with their deliberations.

You will see from our submission that we have a number of major concerns with the proposed legislative changes. We urge the Federal Government to reconsider its proposed heavy-handed black letter law approach to executive remuneration and other governance issues. This is unwarranted, will have negative consequences and create unnecessary red tape for Australian businesses, and is at odds with the overall corporate governance framework in Australia, which has served our nation well.

Company Directors would be happy to elaborate on any of the points made in our submission should this be required.

Yours sincerely



John H C Colvin
CEO & Managing Director

cc. Hon David Bradbury MP, Parliamentary Secretary to the Treasurer

Enclosure – Submission by the Australian Institute of Company Directors to Federal Treasury in response to the Exposure Draft of the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Submission by

The Australian Institute of Company Directors

to

Federal Treasury

in response to the

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

27 January 2011

Introduction

This submission sets out the views of the Australian Institute of Company Directors (Company Directors) on the Exposure Draft of the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* (“the Draft Bill”) and accompanying Explanatory Memorandum, released by the Federal Government on 20 December 2010.

The Australian Institute of Company Directors is the second largest member-based director association worldwide, with approximately 28,000 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 policy debates.

Company Directors welcome full and proper consultation on proposed legislative and other requirements impacting on the governance of companies. We note with disappointment, however, there has been an on-going trend for some key consultations to occur over the Christmas and new year holiday period. We also note that consultation periods on some significant issues have in recent times been inadequate. Both of these attributes are present with the current consultation (including only one month consultation), and could lead one to conclude it has not been a genuine attempt at obtaining feedback and represents poor practice for law reform.

We are grateful for being granted a one week extension of time from 20 January 2011 to 27 January 2011 to respond to the Draft Bill, although we note that this has still only given us five weeks in total, including the Christmas and New Year breaks, to prepare this submission. We consider at least 2 months, preferably 3 months, would have been an appropriate consultation period given the magnitude and significance of some of the changes and associated detailed drafting issues.¹

Company Directors would like to emphasize that we consider the approach to reform being adopted in the Draft Bill is excessive and fundamentally flawed. Much of the public debate around executive remuneration has been emotionally and politically charged, and ill-informed. The result is now a set of heavy-handed proposed reforms that will do very little, if anything, to address the issues companies and their boards face, and instead are likely to unduly hamper efforts to create value for shareholders and a long-term rational approach to executive remuneration.

The proposed requirements will impact adversely on thousands of companies notwithstanding that, in practice, concerns over executive remuneration issues have tended to relate to a very small minority of companies. Moreover, the measures will harm Australian companies through creating instability and reducing flexibility, which in turn will disadvantage corporate stakeholders (including employees and

¹ We refer to the Business Checklist for Commonwealth Regulatory Proposals, which has support from a number of leading associations, representing some diverse member interests. Available at - http://www.companydirectors.com.au/NR/rdonlyres/F20F97AA-BC68-4779-B51D-A97F6C43D9C5/0/BusinessChecklistforCommonwealthRegulatoryProposals_1352007.pdf.

shareholders) and others who benefit indirectly from a prosperous business sector (including Governments and welfare recipients, who rely heavily on business-generated revenues).

As a matter of general principle, there should be a compelling case before new laws are introduced. Laws should also be proportionate to the issue at hand, and if applied generally should be appropriate for the majority rather than a small minority of instances. To do otherwise results in an excessive amount of legislation and red tape - a problem which is well documented.² It can also create considerable difficulties for advisers and for courts.³ This further increases unnecessary costs for businesses.

We note the Productivity Commission in its review of executive remuneration did not identify any systemic failings in the approach to executive remuneration taken by Australian companies. Rather, the key measures proposed were aimed largely at reinforcing the role of the board in executive remuneration setting. The current set of proposals, in some important respects, go beyond what the Productivity Commission recommended and are markedly more heavy-handed. What's more the Federal Government has chosen not to adopt one of the most helpful recommendations of the Productivity Commission which had almost universal support from respondents – relating to the taxation trigger points for equity-based incentive schemes.

We believe the material presented in the Explanatory Memorandum and Regulatory Impact Study accompanying the Draft Bill does not provide a sufficient case for law reform, and that the measures proposed are far in excess of what is needed or desirable. In particular the Regulatory Impact Study does not adequately examine the potential disruptive effects of the two-strikes and board vacancy requirements. Nor does it consider the relative merits of alternative approaches, such as an “if not, why not” regime.

Having said that we have reviewed the Draft Bill with a view to providing constructive feedback. Our ability to provide detailed drafting comments has been hampered by the timing and short length of the consultation, as has our ability to consult with our policy and legal contributors. As such the comments provided should not be regarded as exhaustive.

Given the potential significant and negative impacts of the “two strikes and re-election” process and “board vacancy” proposals, we consider they should, if progressed as black letter law requirements, include a 5 year sunset clause⁴ and another round of consultation on the exact wording of the sections.

A summary of the changes put forward by Company Directors is set out in Table 1.

² Refer, for example, to the Productivity Commission, *Rethinking Regulation*, January 2006 and the Business Council of Australia, *Business Regulation: Action Plan for Future Prosperity*, 2005

³ We note recent comments by the Chief Justice of the Federal Court on the difficulty for Courts in have to deal with complex legislation. Refer to James Eyres, “Top judge hits out at federal laws”, *Australian Financial Review*, 21 January 2011, at pages 1 and 14.

⁴ By this we mean the requirement should automatically cease to operate and be deleted 5 years after commencement unless Parliament considers, after proper consultation, it should be continued.

Table 1 : Summary of Changes to the Federal Government’s Proposal put forward by Company Directors

Government’s Proposal	Main Changes Put Forward by Company Directors
<p><i>A “two-strikes and re-election” process be introduced where a company’s remuneration report receives a “no” vote of 25% or more it must explain whether shareholders concerns have been taken into account, and either how they have been taken into account or why they have not been taken into account. If the company’s remuneration report subsequently receives a “no” vote of 25% or more at the next AGM, shareholders will vote at that AGM to determine whether the directors need to stand for re-election within 90 days. If this resolution passes with 50% or more of eligible votes cast, then the “spill meeting” will take place within 90 days.</i></p>	<p>The disclosure requirement relating to an initial 25% or more “no vote” should be couched in terms of “actions taken” by the board (if any) in response to receiving a “strike” rather than “shareholder concerns” raised “at” the relevant AGM.</p> <p>The board spill mechanism should be removed given the potential disruptive effects and possible unintended consequences.</p> <p>If the “two-strikes and election” process proposal is pursued:</p> <ul style="list-style-type: none"> • Key Management Personnel and closely related parties should not be prohibited from voting on the spill resolution; • it should be deferred until the existing remuneration reporting requirements have been overhauled; and • it should include a 5 year sunset clause.
<p><i>Companies that are a disclosing entity be required to disclose details relating to the use of remuneration consultants.</i></p>	<p>Given the likely negative consequences, this proposal should be couched as an “if not, why not” requirement. We note this was the preferred approach of the Productivity Commission.</p>
<p><i>Remuneration consultants must be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.</i></p>	<p>This proposal is unworkable in practice. If pursued this should be couched as an “if not, why not” requirement.</p>
<p><i>Key Management Personnel and their closely related parties that hold shares be prohibited from voting on their own remuneration arrangements, as part of the non-binding vote.</i></p>	<p>Care needs to be taken to ensure the definition of “closely related parties” does not extend, for example, to major shareholders with board nominees.</p>
<p><i>Key Management Personnel and their closely related parties be prohibited from voting undirected proxies on all remuneration related resolutions.</i></p>	<p>In circumstances where the Meeting Chairman is precluded from voting his or her own shares on a remuneration resolution, rather than prohibiting the Meeting Chairman from casting undirected proxies, we suggest requiring</p>

	<p>the Company to state in the relevant notice of meeting how the holder of the proxies is likely to cast votes should a poll be called (we presume, usually in favour of the resolution). If considered necessary, this could be supplemented by a statement by the Company after the relevant shareholders' meeting as to how votes were cast by the Meeting Chair.</p>
<p><i>Key Management Personnel and their closely related parties be prohibited from hedging the Key Management Personnel's incentive remuneration.</i></p>	<p>We believe it will be extremely difficult to provide a clear definition of what constitutes hedging. Our preferred approach is to introduce a requirement in the ASX listing rules that is analogous to the approach taken in relation to director share trading policies, supplemented by guidelines in the ASX Corporate Governance Council <i>Corporate Governance Principles and Recommendations</i>. As was the case with director share trading policy requirements, the process could begin as an ASX Corporate Governance Council recommendation, with a move to a specific listing rule over time, if deemed necessary.</p>
<p><i>Public companies be required to obtain the approval of their members for a declaration that there are no vacant board positions, should the number of board positions filled be less than the maximum number specified in the company's constitution.</i></p>	<p>This proposal has nothing to do with remuneration and should not be made black letter law. No real justification has been provided, If, despite our concerns, the proposal is progressed it should be couched as an "if not, why not" requirement.</p> <p>If the proposal is progressed as black letter law it should include a 5 year sunset clause.</p>
<p><i>Non-Chair proxy holders be required to exercise all directed votes subject to certain defences.</i></p>	<p>Provision should be made to ensure that proxy holders are not subject to sanction when they are unaware of their appointment, have not consented to serve as a proxy holder, or are unable for legitimate reasons to attend the relevant shareholders' meeting.</p>
<p><i>Individual remuneration disclosures in the annual remuneration report be confined to the key management personnel of the consolidated entity.</i></p>	<p>We suggest that this relief be made available for annual reporting periods ending on or after 30 June 2011.</p>

“Two strikes and re-election process” requirement

Government’s Proposal: *A “two-strikes and re-election” process be introduced where a company’s remuneration report receives a “no” vote of 25% or more it must explain whether shareholders concerns have been taken into account, and either how they have been taken into account or why they have not been taken into account. If the company’s remuneration report subsequently receives a “no” vote of 25% or more at the next AGM, shareholders will vote at that AGM to determine whether the directors need to stand for re-election within 90 days. If this resolution passes with 50% more of eligible votes cast, then the “spill meeting” will take place within 90 days.*

Requirement to explain whether “shareholders concerns have been taken into account” is impractical

Company Directors have no objection to a 25% "no" vote threshold for boards having to report back to shareholders in the subsequent remuneration report, explaining what actions have been taken by the board in response and, if there have been no actions, the reason(s) why. We note this occurs in practice already. There are likely to be a multitude of different (and potentially conflicting) reasons why shareholders as a group vote against a resolution, some of which may be made known to the board at the relevant AGM or outside the meeting. In this regard, if key institutional shareholder raise concerns, this usually occurs prior to the AGM, but rarely “at” the AGM.

To require companies to disclose whether they have taken into account shareholder concerns raised “at” an AGM, no matter, for example, the merits of the concern or how many shares an individual holds, is an overly simplistic approach and potentially counterproductive, particularly if those concerns are driven by individual ideologies or personal agendas that have little or nothing to do with the “correctness” of the remuneration decisions made (e.g. individuals or groups with social reform agendas unrelated to the company, disgruntled former workers, etc).

Concerns with the "Two-Strikes and Re-Election Process" Requirement

Company Directors are opposed to the proposed board spill mechanism being introduced in connection with remuneration reports. A board “spill” is arguably one of the most significant corporate governance actions that can occur. To our knowledge there is no comparable requirement to that proposed either abroad or in connection with other corporate activities.

While there are provisions in the Draft Bill that are intended to serve as “stabilisers” these are insufficient for that purpose⁵, and there is no escaping the fact that a board spill can do material and long-lasting damage to a company’s reputation and performance. While the loss of any one director can normally be mitigated through appropriate succession planning, if an entire board is replaced it can take some years before an equilibrium is restored; not only in terms of how board members interact with one another and as a team, but also in terms of how the Chairman and the board

⁵ Consider, for example, a circumstance where all non-executives directors view the spill as a vote of non-confidence and resign, resulting in the need to quickly “throw together” a board, or a hostile takeover bid being announced immediately following a board spill.

interact with the CEO and executive team. This includes loss of corporate memory, including in relation to past remuneration deliberations and issues.

Company Directors have previously expressed significant concerns regarding a "two strikes" requirement. These concerns have included the following.

1. *Disruptive effects.* We are concerned that the introduction of such a mechanism to the narrow context of executive remuneration, will lead to an overemphasis on remuneration issues by both boards and shareholders. The corollary to this is that attention will be taken away from issues that are more significant from a value creation perspective, such as the company's strategy, revenue generating potential or other sustainability issues.
2. *Requirements extend too far.* We consider it poor law reform practice to require all companies which prepare a remuneration report to be subject to a "two strikes" requirement when shareholder concerns regarding executive remuneration have tended to relate to a small minority of companies – typically, some larger listed companies. We note there is **no** other jurisdiction that has a "two strikes and re-election" process requirement and given Australia's excellent corporate governance standing we do not believe this is warranted or appropriate.
3. *Shareholder democracy issues.* The Productivity Commission has attempted to address shareholder democracy concerns that some respondents (including Company Directors) had with its original "two strikes" proposal, by adding an ordinary resolution that must be passed before a board spill meeting is required. However, Company Directors still have an issue from a shareholder democracy perspective that a small minority of shareholders, which could represent say 10% of the total number of voting shares on issue⁶, can cause such a potentially disruptive resolution to be tabled.
4. *Alternative mechanisms for board shake-ups exist.* There are already provisions in the law dealing with the removal of directors which could be employed if there is dissatisfaction with a board's handling of remuneration issues, including the requirement that directors periodically put themselves up for re-election if they wish to continue to serve on the board, and rights afforded to shareholders to remove directors in particular circumstances (e.g. the 100 member rule – see sections 249D and 203D of the Corporations Act).
5. *Disproportionate emphasis by policymakers on remuneration.* Policymakers are placing a disproportionate emphasis on remuneration as a trigger for a board spill. Company Directors 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 specific "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.

⁶ 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. 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. The total percentage will be even lower when the votes of Key Management Personnel and closely related parties are excluded.

6. *Will not achieve desired outcomes.* Company Directors do not believe a "two strikes" requirement will result in demonstrably *lower* remuneration levels. We note:
- remuneration outcomes are driven to a large extent by market forces;
 - if the requirements achieve an "artificial" cap on remuneration levels, it will make it more difficult for mid-sized and large Australian companies to retain executives or attract executives from overseas, remembering there is a large contingent of ex pat Australians living abroad;
 - while the board may be "spilled", the underlying remuneration arrangements that may have been considered egregious by some shareholders will in many cases remain contractually in place (resulting in a potential "double hit" 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 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.
7. *Unintended consequences.* There are likely to be unintended consequences associated with the proposed requirements, 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 or larger fixed remuneration); and
 - the proposed requirements could simply serve as a "lightning rod" for other (non-governance) issues to the detriment of corporate governance and the sustainability of companies generally (see below).
8. *Practical issues remain.* There remain practical issues for companies with the "two strikes" test and board re-election proposal. For example:
- what happens to directors who are elected or re-elected at the same AGM that gives rise to the need for a board spill meeting?
 - what happens in terms of on-going governance procedures and board nominations if the non-executive directors view a forthcoming spill meeting as a vote of no confidence and resign shortly after the most recent AGM?
 - as non-executive directors are expected to all step down before the spill meeting, who is expected to run the spill meeting?

- what do boards need to be doing from a succession planning perspective in the lead up to a potential second strike given the short period between the AGM and when the notice of meeting for the spill meeting will need to be despatched?
 - given the potential consequences for a company of two strikes and a spill meeting, how does the company establish that eligible votes have been cast when it is unclear who is voting shares (e.g. given use of nominee companies) and who is a closely related party? (see below)
9. *Unnecessary red tape.* The proposed requirements will create unnecessary complexity at AGMs.
10. *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 (noted above), 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).

Key Management Personnel and closely related parties should be entitled to vote on the spill resolution

While we understand the rationale for prohibiting Key Management Personnel and closely related parties from exercising advisory votes on a remuneration report (as an indicator of the level of satisfaction by "other" shareholders with remuneration arrangements), we consider that this prohibition should not extend to the spill resolution. The passing of a spill resolution could have a material effect on a company's operations, and Key Management Personnel and closely related parties should not be denied the ability to vote their shares, for the same reason they are not denied a say in the election or removal of directors in other circumstances, or major corporate transactions. We consider this to be a matter of fairness given a board spill could substantially reduce the value of their shares, which could represent one of their major assets or a substantial portion of their superannuation funds.

Introduction of a two strikes requirement if pursued further should be deferred

Another issue with the proposed two strikes requirement is that it presumes shareholders will be provided with clear and meaningful information concerning remuneration afforded to Key Management Personnel. Current remuneration reporting requirements do not deliver this information, and are unintelligible and in need of an overhaul.⁷ We note that the Corporations and Markets Advisory Committee (CAMAC) has been tasked with making recommendations designed to improve remuneration reports but at the time of writing we understand CAMAC is

⁷ Company Directors' recommendations for reform are set out in its Position Paper No. 15, "Remuneration Reports", June 2010. Available at - <http://www.companydirectors.com.au/Representation/Policies+And+Papers/2010/Position+paper+no.+15+-+Remuneration+reports.htm>

still in the process of completing its report. We attach our submission to CAMAC dated 13 August 2010.

Remuneration Consultants

Government's Proposal: *Companies that are a disclosing entity be required to disclose details relating to the use of remuneration consultants.*

Company Directors remain unconvinced that disclosure around the use of experts in the context of Key Management Personnel remuneration will lead to the outcomes intended by the legislation; namely “better” remuneration decisions and greater transparency regarding remuneration decisions. Not only will such disclosure add to existing red tape (in an already “cluttered” area) and potentially confuse the situation (e.g. the board may not have relied on all or any of the advice, or obtained conflicting advice from two experts), it may well also result in increased expert fees if disclosure of details around engagements is expected. There is also an issue around loss of legal professional privilege should the board disclose publicly that legal advice on remuneration issues has been obtained in respect of a particular employment agreement, which may cause detriment to the company if there is a legal dispute (e.g. with an executive disputing termination of an employment contract or remuneration received).

In addition, the proposed requirement, particularly disclosure of “other” fees, will act as a powerful disincentive for certain professional services firms, particularly large multi-service, multi-jurisdiction firms, to continue to offer remuneration services for boards relating to Key Management Personnel. This is likely to have a number of consequences:

- boards having less choice when seeking remuneration advice (being limited to boutique service providers);
- loss of possible synergies arising from receiving advice from providers that offer a portfolio of services (e.g. remuneration, taxation, accounting, overseas experts) caused by a narrowing of services offered by remuneration consultants; and
- over time increased dependency by remaining remuneration consultants undertaking work on Key Management Personnel issues under board engagements as their major source of revenue, with possible ramifications for independence.

We note that the proposed black letter law approach is against the recommendation of the Productivity Commission that:

The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.⁸

⁸ Productivity Commission Inquiry Report, *Executive Remuneration in Australia*, 19 December 2009, at page xxxix.

Other issues include:

- draft section 300A(1)(h) potentially captures not only “remuneration consultants” proper but also lawyers giving advice on employment contracts and/or accountants performing present value calculations for reporting purposes and the like, creating huge difficulties; and
- we consider draft sections 300A(1)(h)(ii) and (iii) are unnecessary given the prohibitions in sections 206K(2) and 206L(4).

Should the current proposal be pursued we believe an “if not, why not” regime provides a more appropriate mechanism for dealing with circumstances where companies may be unduly harmed by disclosure related to advice obtained.

Government’s Proposal: *Remuneration consultants must be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.*

Company Directors have significant concerns with the proposal in its current form and believe it is unworkable in practice.

There is no evidence of problems in practice that would justify such a heavy-handed approach to dealings with remuneration consultants. Rather, we consider that the mistake is being made of trying to convert something that may make a good *aspirational* standard into an inappropriate black letter law requirement.

There is no other type of engagement or other contract that is subject to the same stringent requirements that are being proposed for remuneration consultants. We note that there are a multitude of other contexts in which consultants might be engaged that have greater potential to destroy shareholder value (e.g. mergers and acquisitions, financing, audit, strategy, large legal actions).

Again, the Federal Government is seeking to go much further than what the Productivity Commission recommended:

The ASX listing rules should require that, where an ASX300 company’s remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company’s remuneration report.⁹

We question why, the current proposed requirements should burden all 2000-plus listed entities, when shareholder concerns regarding executive remuneration have mainly been associated with a relatively small minority of companies (usually larger companies with complex activities). Particularly if, as proposed by the Federal Government, shareholders will have the ultimate say on the appropriateness of remuneration arrangements, including the company’s approach regarding remuneration consultants, through a two strikes and re-election process.

⁹ Productivity Commission Inquiry Report, *Executive Remuneration in Australia*, 19 December 2009, at page xxxix.

An effect of this change will be that non-executive board members who engage remuneration consultants must take a more active role in contract negotiations, renegotiations and terminations than many currently do. To require non-executive directors to take on direct responsibility for seeking all remuneration advice for all Key Management Personnel is too extreme and unrealistic given non-executive directors may only meet during one or two days each month. As a result of the current proposal, non-executive directors will be drawn further into the day-to-day activities of companies, which will provide upward pressure on director fees, and over time possibly (when combined with other increased responsibilities) impact on their independence if they are compelled to devote greater time to fewer directorships.

We further note that some members of Management (for example, the Human Resources Manager and the Company Secretary) can and do play important time saving, advisory and execution roles for the board, under board supervision¹⁰. They can also serve as an important check on whether the advice given takes account of the circumstances of the company and is workable. Another result of the current proposal will be that the quality of the advice provided to boards is likely to suffer.

At a time when boards should be encouraged to seek expert advice in appropriate circumstances for remuneration issues, some perverse outcomes of the proposed requirements relating to remuneration consultant engagement and disclosure, especially the strict liability offences that apply for non-compliance, are likely to be that boards are less prepared to engage external remuneration advisers, and professional services firms are less likely to want to continue providing advice on Key Management Personnel remuneration (see above). Another perverse outcome we expect is that this requirement will mean it is less likely that companies with executive boards will appoint, or can attract, an appropriate non-executive director given the additional red tape, responsibilities and legal liability.

We note that the proposed requirements are also likely to interfere with optimal working arrangements between the CEO and his or her direct reports, with a negative impact on company performance. In many cases at present it will be the CEO negotiating pay with his or her direct reports, with oversight by the remuneration committee or full board. This is usual and appropriate as the CEO is being held responsible for the overall performance of the company and the management team. Non-executive directors will need on occasion to have greater oversight of remuneration negotiations for individuals reporting to the CEO, but this will depend on the circumstances.

Other issues include:

- draft section 206K potentially captures not only “remuneration consultants” proper but also lawyers giving advice on employment contracts and/or accountants performing present value calculations and the like, creating huge difficulties; and
- there is no definition provided for “executive director”.¹¹

¹⁰ Refer to Australian Institute of Company Directors, *Executive Remuneration Guidelines for Listed Company Boards*, February 2009, at pages 13 -14.

¹¹ As a consequence there is also no definition of a director who is not an executive director (i.e. a non-executive director).

If the current proposal is pursued we believe it is better as an “if not, why not” disclosure requirement in the remuneration report, relating to whether the company has in place procedures such that external advice on executive remuneration is provided independently of the relevant executives, rather than black letter law or a listing rule, particularly given possible unintended consequences. It is far more preferable to first see how this proposal would work as a good practice guideline given the relatively recent focus on this issue. We note that Company Directors released guidelines covering this issue in February 2009¹².

Voting on Remuneration Matters

Government’s Proposal: Key Management Personnel and their closely related parties that hold shares be prohibited from voting on their own remuneration arrangements, as part of the non-binding vote.

Company Directors accept the principle underlying this proposal, although we note that care needs to be taken in how far the definition of “closely related parties” extends, so as not to include, for example, major shareholders with board nominees¹³.

We also note that there will be practical issues for companies in establishing the number of eligible votes cast (e.g. given the possible use of nominees, not knowing who might be a closely related party).

Government’s Proposal: Key Management Personnel and their closely related parties be prohibited from voting undirected proxies on all remuneration related resolutions.

Company Directors have no in-principle objections to this proposed requirement, however we believe there should be an exception for circumstances where undirected proxy votes are given to a nominated company representative. More specifically, we consider 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 remuneration-related resolutions, 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, 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 is likely to cast votes should a poll be called (we presume, usually in favour of the resolution). In this

¹² Australian Institute of Company Directors, *Executive Remuneration: Guidelines for Listed Company Boards*, February 2009.

¹³ We noted this in our submission to the Productivity Commission dated 6 November 2009 (at page 9). Available at - <http://www.companydirectors.com.au/Representation/Submissions/2009/2009-34+AICD+submission+on+Productivity+Commission+Discussion+Draft+on+Executive+Remuneration.htm>.

¹⁴ Refer, for example, to the Australian Institute of Company Directors, *Annual General Meetings: A Guide For Directors*, 2009.

regard, we note that ASX listing rule 14.2.3 already deals with this issue by requiring a notice of meeting in certain circumstances (where a voting exclusion statement is required) to include a statement of the Chairman's voting intentions as well as a statement to the effect that if a shareholder does not wish to direct their proxy they should include a mark in a box on the form, with the wording "By marking this box, you acknowledge that the Chairman may exercise your proxy even if he has an interest in the outcome of the resolution and votes cast by him other than as proxy holder will be disregarded because of that interest". If considered necessary, this could be supplemented by a statement by the Company after the relevant shareholders' meeting as to how votes were cast by the Meeting Chair.

Without this exception, the proposal will serve to potentially disenfranchise rather than empower shareholders and reduce flexibility. The ability to provide an undirected proxy vote to a nominated company representative is a benefit for shareholders who want to vote and be guided by the Meeting Chair. A shareholder also has the alternatives of voting directly for or against a resolution, or not at all.

Prohibiting hedging of incentive remuneration

Government's Proposal: Key Management Personnel and their closely related parties be prohibited from hedging the Key Management Personnel's incentive remuneration.

Company Directors have no objection in principle to the prohibition on hedging by Key Management Personnel of unvested incentive-based remuneration, however it has concerns with the possible range of activities that may be caught by draft section 206J(1):

206J No hedging of remuneration of key management personnel

(1) A member of the key management personnel for a company, or a closely related party of such a member, must not enter into ***an arrangement (with anyone)*** that has the ***effect of limiting the exposure*** of the member to risk relating to an element of the member's remuneration [emphasis added]

Care needs to be taken to ensure that the prohibition is not drafted so widely as to catch legitimate private dealings of Key Management Personnel or closely related parties¹⁵, particularly if breach of the prohibition results in a strict liability offence. To the extent the prohibition on hedging is considered, for example, to extend to the purchase of securities as part of a portfolio that historically happen to have a negative correlation with the company's securities, this could well have the effect of further distorting remuneration packages (e.g. away from market-based incentive elements) and work against the main objective the proposed change is seeking to achieve (incentive alignment between executives and shareholders).

We believe it will be extremely difficult to provide a clear definition of what constitutes hedging. Our preferred approach is to introduce a requirement in the ASX listing rules that is analogous to the approach taken in relation to director share trading policies¹⁶, supplemented by guidelines in the ASX Corporate Governance

¹⁵ We do not believe, for example, that the prohibition should extend to income protection insurance that covers the possibility that an individual is unable to work due to disability.

¹⁶ See ASX listing rule 12.9.

Council *Corporate Governance Principles and Recommendations*. This will enable companies to put in place contractual arrangements that are appropriate for their circumstances, rather than a heavy handed “one size, fits all approach”. As was the case with director share trading policy requirements, the process could begin as an ASX Corporate Governance Council recommendation¹⁷, with a move to a specific listing rule over time, if deemed necessary.

Ability to declare “no board vacancy”

Government’s Proposal: *Public companies be required to obtain the approval of their members for a declaration that there are no vacant board positions, should the number of board positions filled be less than the maximum number specified in the company’s constitution.*

Company Directors do not support this proposed change. We note:

- the proposal is unwarranted, not justified and will make it harder for boards to govern effectively;
- the connection between the “no vacancy” proposal and executive remuneration is tenuous at best and we do not believe adoption of this requirement would have much, if any, bearing on remuneration outcomes;
- 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 approve¹⁸;
- boards are in the best position to assess the appropriate number of directors for the company; and
- it is unlikely that boards will seek shareholder approval to declare that there are no vacant board positions given that each director’s personal recommendation regarding the resolution must be included in the relevant notice of meeting (draft section 201Q(a)).

A possible unintended consequence includes larger boards than are otherwise necessary.

While Company Directors support diversity, it does not agree that “greater diversity” will necessarily result in “better” remuneration decisions

No evidence has been provided of a link between “board no vacancy” practices and better remuneration decisions, or for that matter between “more diverse boards” and better remuneration decisions. Company Directors do not consider that greater

¹⁷ We note that by virtue of ASX listing rule 4.10.3 and Recommendation 8.4 of the ASX Corporate Governance Council’s Principles and Recommendations, listed companies are required to provide on an “if not, why not” basis, “a summary of the company’s policy on prohibiting entering into transactions in associated products which limit the economic risk of participating in unvested entitlements under any equity-based remuneration schemes”. Box 8.1 under Recommendation 8.3 provides guidance that “The terms of [equity based remuneration] schemes should clearly prohibit entering into transactions or arrangements which limit the economic risk of participating in unvested entitlements under these schemes”. We consider there is scope for a separate recommendation on this topic, with expanded guidance.

¹⁸ See ASX listing rule 10.17.

diversity is necessarily going to make executive remuneration decisions any less difficult or result in different remuneration outcomes. We note:

- There are market led diversity initiatives already underway, including those by the ASX Corporate Governance Council and Company Directors.
- All directors, no matter what their backgrounds are, 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 this proposal relates to all public companies.

The proposed legislative change may well impact adversely on board diversity efforts

Rather than promote greater diversity, we consider the proposed change could, perversely, undermine current efforts to promote board diversity. Consider a common example where a company has a current board size that is less than the maximum board size provided for in its constitution. An understandable response to the proposed change is for the company to reduce the maximum board size to align with the current board size. The resultant loss of board size flexibility may well reduce the prospect of boards seeking to put in place arrangements that are designed to increase board diversity.

We consider that while the grounds for the proposed change are spurious for listed companies, they are virtually non-existent for non-listed public companies (remembering there are close to 10,000 of these).

Further, if the proposed change is pursued we believe it is much better implemented as an "if not, why not" requirement. For example, the ASX Corporate Governance Council could be asked to publish a recommendation along the lines that companies obtain the approval of their members for a declaration that there are no vacant board positions, should the number of board positions filled be less than the maximum specified in the company's constitution. ASX listed companies would be required to state annually whether they have followed the recommendation. If an ASX listed company has not followed the recommendation it must explain why not. This approach allows boards to assess what is in the best interests of the company, and provide justification to shareholders if they consider the recommendation is inappropriate in the company's circumstances.

“Cherry picking” Votes

Government’s Proposal: *Non-Chair proxy holders be required to exercise all directed votes subject to certain defences.*

Company Directors expressed support for the Productivity Commission’s recommendation in this area, subject to the issue of proxy holder consent being addressed. The Productivity Commission’s recommendation was:

The Corporations Act 2001 should be amended to require proxy holders, except in exceptional circumstances, to cast all of their directed proxies on remuneration reports and any resolutions related to those reports.¹⁹

We further note that the Productivity Commission commented “Provision could be made to ensure that proxy holders were not subject to sanction where they have not consented to, or were unaware of, their appointment”.²⁰

Company Directors are opposed to the proposal as currently drafted on the basis that it would be unduly harsh in circumstances where an individual is unaware of his or her appointment as proxy holder, has not consented to serve as a proxy holder, or is unable for legitimate reasons to attend the relevant shareholders’ meeting.

Persons required to be named in the remuneration report

Government’s Proposal: *Individual remuneration disclosures in the annual remuneration report be confined to the key management personnel of the consolidated entity.*

Company Directors support this change on the basis it should reduce the complexity and costs associated with report preparation, as well as help the readability of reports. We suggest this relief be made available to companies for annual reports ending on or after 30 June 2011.

Other Issues

Taxation Changes

Company Directors remain extremely disappointed that the Federal Government has not included in its proposed executive remuneration changes the Productivity Commission’s recommendation that:

The Australian Government should make legislative changes to remove the cessation of employment trigger for taxation of equity or rights that qualify for tax deferral and are subject to risk of forfeiture. These equity-based payments should be taxed at the earliest of: the point at which ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.²¹

¹⁹ Productivity Commission Inquiry Report, *Executive Remuneration in Australia*, 19 December 2009, at page xxxviii.

²⁰ Productivity Commission Inquiry Report, *Executive Remuneration in Australia*, 19 December 2009, at page 373.

²¹ Productivity Commission Inquiry Report, *Executive Remuneration in Australia*, 19 December 2009, at page xxxix.

Implementation of this widely supported change would remove a barrier to structuring deferred remuneration, and thereby encourage alignment of long-term shareholder and executive interests. We consider this change would have a more productive effect in terms of aligning executive and shareholder interests than the proposed requirements relating to board spills and the handling of board vacancies.

Definition of Key Management Personnel

We believe that rather than the Corporations Act defining Key Management Personnel indirectly by reference to Accounting Standards, a full definition should be inserted. Further, while Company Directors accept that the *content* of the current definition of “Key Management Personnel” includes the key people within the company in whose remuneration shareholders are most interested, it has reservations about the *title* of the definition. The definition of Key Management Personnel includes directors (whether executive or otherwise). In a practical sense, including directors under a definition labelled “Key Management Personnel” conveys a misleading impression that the role of the director is managerial. A director would not have a “managerial” role with the company unless he or she is also a member of the executive team (for example, a CEO/Managing Director). As directors perform oversight and strategic functions for the company and are not usually involved in the day to day operations of the company, the use of the word “management” to encompass both roles is incorrect, misleading and creates confusion.

In our view, the most appropriate mechanism for achieving clarity in the Act and ensuring consistency with the Accounting Standards is to use the term “Key Senior Personnel” in the Remuneration Report and to insert a definition of “Key Senior Personnel” into section 9 of the Corporations Act²². Company Directors recommend, however, that the wording of this definition mirror the current definition of “Key Management Personnel” in the Accounting Standards/International Financial Reporting Standards. The advantages of inserting such a definition into the Act itself are fourfold. It would:

- make clear that the Remuneration Report includes the remuneration details of both the board and the executives/managers and that these personnel perform different functions;
- maintain the consistency between the content of the two definitions and ensure that the remuneration information about the same key people is included in both the financial statements and the Remuneration Report;
- reduce the fragmentation of the existing requirements (given that preparers would not need to refer to the Accounting Standards to determine whose remuneration information should be included in the Remuneration Report of disclosing entities that are companies); and
- ensure that any future changes to the definition would be the subject of a legislative review (at present any amendments made by the Australian Accounting Standards Board/International Accounting Standards Board to the definition of Key Management Personnel could occur without considering the impact of such a change on provisions throughout the Act).

²² Company Directors’ recommendations for reform are set out in its Position Paper No. 15, “Remuneration Reports”, June 2010, at pages 9 and 10. Available at - <http://www.companydirectors.com.au/Representation/Policies+And+Papers/2010/Position+paper+no.+15+-+Remuneration+reports.htm>

Strict Liability

Company Directors maintain that strict liability should not apply to the provisions contained in the Draft Bill. We believe such an approach is too heavy handed and inappropriate particularly as the proposed legislation is open to differing interpretations. We note, in particular, the lack of clarity regarding the provisions relating to engagement of remuneration consultants and hedging of incentive remuneration.

We further note there are more than 700 State and territory laws which impose personal liability on individual directors for corporate misconduct. That is, directors are liable simply because they are a director, even where they may not have had any personal involvement in a breach. Evidence has been provided elsewhere that the burden of legal risk being confronted by Australian directors is leading to an overly cautious approach to decision-making, focussing directors' minds excessively on risk avoidance rather than on ways to add value, and discouraging talented people from taking up or holding directorships.²³

oOo

²³Federal Treasury survey of ASX 200 directors released in late 2008 referred to at <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1387> and Company Directors, "Impact of Legislation on Directors" November 2010 available at <http://www.companydirectors.com.au/Media/Media+Releases/2010/Liability+laws+damaging+the+economy+director+survey+reveals.htm>.