

# Australian Shareholders Association Submission: Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

20 January 2011

## Background

The Australian Shareholders Association (**ASA**) has promoted stronger corporate governance in the area of directors and executive remuneration, on behalf of shareholders, since its inception in 1960. Specifically, the ASA has long campaigned for greater accountability of boards when executive remuneration has not reflected long term performance.

In more recent times, the proliferation of executive pay structures and levels that allow executives to receive entrepreneurial levels of reward, in a relatively short time frame, with little or no downside risk, remains an ongoing concern. History has shown that pay structures which encourage excessive short term risk taking result in poor outcomes for shareholders. The ramifications of poorly designed remuneration arrangements leading onto inappropriate risk taking can be seen at the global level. The current European financial sector crisis and the preceding global financial crisis are both largely born out of private sector banking systems and financial institutions, partially fuelled by flawed remuneration arrangements.

The ASA is pleased to see the proposed Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 (the **Bill**) will implement some of the Productivity Commission's recommendations which ASA mainly supported. The proposed Bill contains tangible measures that should lead to improved transparency and accountability in executive remuneration matters, and we hope subsequent improvements in the alignment of remuneration and performance.

The significant number of 'no' votes directed at remuneration reports in the 2010 Annual General Meeting reporting season indicates that many stakeholders share the ASA's concerns. The ASA expects increasingly to see shareholders using their voice when companies' remuneration practices reflect an underlying culture

of being managed for the managers rather than for the owners. Whilst the proposed measures in the Bill go some way to addressing these concerns, there are other key reforms supported by the ASA from the original Productivity Commission report that have not yet been adopted.

The ASA made two written submissions to the Productivity Commission (PC) inquiry and appeared at both the initial hearing and the hearing in response to the Commission's discussion draft. In addition, the ASA has made a written submission to the Corporations and Markets Advisory Council (CAMAC) with regards to the disclosure issues surrounding executive remuneration and continues active involvement in that process.

## **About the ASA**

The ASA is a not-for-profit organisation formed to represent, protect and promote the interests of investors in shares, managed investments, superannuation and other financial investments. The purpose of ASA is to be the leader for organised representation, advocacy, education and engagement of individual shareholders and investors.

The ASA company monitoring program monitors the performance and corporate governance of most of the ASX 200 companies in Australia. In addition, the ASA accepts appointments as proxy from many retail investors, ASA members and others, at the meetings of those companies it monitors. In 2010, the ASA held proxies for approximately \$4 billion worth of shares, and in many instances held proxies equivalent to a top ten to twenty shareholder. As a holder of open proxies, the ASA decides how to vote those open proxies in accordance with its policies.

The ASA encourages companies to adopt market leading corporate governance practices, on behalf of investors, as a part of their long term strategy to ensure sustainable performance.

Through its policy program, company monitoring and proxy voting activities the ASA will continue proactively to seek improved alignment outcomes in relation to executive remuneration, which will benefit all shareholders of listed companies.

The ASA membership base comprises mainly long term investors who rely on the income and capital growth opportunities that listed companies offer in order to meet their wealth creation and retirement

needs. Our membership base shares these basic financial objectives with every Australian who participates in the superannuation system.

## **Key measures Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 ('Bill')**

### **Measure 1 – Strengthening the non binding vote – the two strikes test**

The ASA strongly supported the recommendations on this measure as originally proposed by the Productivity Commission and we support the proposed measures under the Bill.

The ASA considers that the current system which permits shareholders to make a non binding vote has fostered improved engagement by boards with shareholders. By taking the non binding remuneration vote a step further it will become an even greater catalyst for further engagement between boards and shareholders, further enhancing levels of accountability and transparency.

The ASA view is the current non binding vote does not go far enough in allowing shareholders to hold boards accountable for their decisions when there are clear signs of board complacency. For example, there are a number of publicly listed companies that have received a no vote of greater than 25% in two consecutive years, and yet this clear signal of shareholder disquiet was ignored by the boards, demonstrating our concerns with board complacency.

The ASA view is the proposed new legislation, which provides for a first and a second strike when a company receives a no vote of more than 25% for two years running, will enhance the responsiveness of public companies to shareholders' concerns about remuneration quantum and structure.

The major critique of the two strikes approach, that it will allow a minority of shareholders to destabilise companies, is unfounded for two reasons. First, the company has to remain unresponsive for two consecutive years. Second, the resolution requiring directors to stand for re-election requires a majority of 50% of the eligible votes cast, not the 25% 'no' vote required to trigger a spill in the first instance.

## Measure 2 – Improving accountability on the use of remuneration consultants

The ASA broadly supported the original recommendations proposed by the Productivity Commission with regards to the use of remuneration consultants; however, some of the prescriptive measures proposed under the new Bill may be counter-productive.

The ASA has long held concerns that boards have at times shielded themselves with ‘independent’ experts’ reports, when it was apparent to many observers that the consultants engaged were anything but independent. Under the current law, shareholders have no way to determine who appointed the remuneration consultant, who the advisers are, who they report to, how much they are paid and whether they are independent or subject to conflicts of interest.

The proposed legislative amendments to require remuneration consultants to be engaged only by non executive directors, rather than company executives, ought to foster the independence of those from whom company boards receive remuneration advice. The proposed requirement to disclose any unrelated work and other details of the remuneration consultant should serve to improve shareholders’ ability to determine the degree of independence of the remuneration advice the board receives.

However, the ASA has concerns about some of the detailed prescriptive provisions in the Bill. ASA concerns involve whether these provisions may prevent a chief executive officer/managing director from seeking advice about the remuneration of his or her direct reports. ASA concerns extend to whether these provisions may also prevent company human resources operatives from commissioning and receiving advice about any matters relevant to remuneration including not just short term and long term incentive plans, but also taxation, superannuation contributions, retirement benefits, and other remuneration matters. If the Bill operates effectively to require non executive directors to commission and receive any advice a company wishes to commission and receive on remuneration matters affecting key management personnel, this could see non-executive directors and boards bogged down in the operations of their companies. These provisions need to be revised to ensure their intent is effective but that they do not prevent the normal operations of companies.

### **Measure 3 – Prohibiting key management personnel ('KMP') from voting on remuneration matters**

The ASA supported the original recommendations proposed by the Productivity Commission with regards to prohibiting KMP and their closely related parties from voting on remuneration matters, and we support the measures proposed under the Bill.

The ASA believes that a conflict of interest does exist for KMP who are also shareholders in regards to voting on remuneration matters. It is inappropriate for the directors and executives engaged in the design of remuneration arrangements to be allowed to vote on their ratification, using either their own or undirected votes held by proxy. Minimizing conflicts of interest is a cornerstone of good corporate governance. The ASA agrees with the Bill's proposed prohibition on voting by KMP on remuneration matters, with regards to their own and undirected proxies. It would be contradictory to disallow KMP to vote on remuneration resolutions, and then allow undirected proxies, held by KMP, to be voted on these same resolutions.

The Bill provides ASIC with the ability to provide relief from the prohibition where it would cause unfair prejudice to the interests of any shareholder, which the ASA agrees is necessary to prevent any unintended side effects of the prohibition.

### **Measure 4 – Prohibiting hedging of incentive remuneration**

The ASA supported the original recommendations proposed by the Productivity Commission with regards to prohibiting hedging of incentive remuneration, and we support the measures proposed under the Bill.

The ASA's view is that the incentive component of executive remuneration should be linked to performance. Structuring remuneration schemes to encourage executives to take inappropriate risks with little or no downside risk to themselves, is not aligned with the long term sustainable growth of the company. If declines in share price do not affect the executive's wealth, the incentive component of the payment disappears. The ASA does not support the hedging of unvested equity that has been awarded to an executive as part of their incentive pay. The ASA would prefer to see vested equity that is subject to holding locks remain unhedged and 'at risk' until such time as the holding locks expire.

The ASA is not in favour of any arrangement (including income protection insurance if it relates to incentive pay) that in substance transfers the risk of incentive payments away from the executive, as such arrangements run counter to shareholder alignment and decrease transparency in remuneration.

## **Measure 5 – Requirement for shareholder approval for the board to invoke the ‘no vacancy rule’**

The ASA supported the original recommendations proposed by the Productivity Commission with regards to requiring shareholder approval to invoke the no vacancy rule, and we support the measures proposed under the Bill.

Boards have invoked the ‘no vacancy’ rule in order to deter the election of candidates who may otherwise have had a beneficial effect on the company’s affairs from a minority shareholder’s perspective. Where there has been a history of mismanagement and an impregnable ‘closed shop’ board, the proposed measures provide shareholders with a mechanism to restore their legitimate rights. The ‘no vacancy’ rule has been invoked in circumstances to deny shareholders the opportunity to vote for a more suitable candidate who may not be board endorsed.

ASA believes it is appropriate for boards who wish to invoke the ‘no vacancy’ rule to explain the reason why and seek shareholder approval to do so.

The changes should encourage more board nominations, greater board diversity and increased board accountability to shareholders. The proposed new measures should facilitate proper shareholder oversight of company boards in special circumstances, whilst leaving the power for determining the most appropriate overall board composition and size ultimately with the board.

## **Measure 6 – Cherry Picking**

The ASA supported the original recommendations proposed by the Productivity Commission with regards to cherry picking of voting intentions, and we support the measures proposed under the Bill.

The ASA agrees non chair proxy voters, of which the ASA is one, should be required to exercise all directed votes given to them, rather than just the ones which accord with their view. If a shareholder has given a proxy a directed vote, it seems clear that the shareholder wishes their shares to be voted in that manner by

the proxy holder, regardless of the proxy holder's own views. The ASA supports the extension of this concept to all resolutions rather than just remuneration matters.

## **Measure 7 – Persons required to be named in the remuneration report**

The ASA did not support the original recommendations proposed by the Productivity Commission with regards to limiting remuneration disclosures to KMP, rather than also including the top 5 highest paid executives, and we do not support the measures proposed under the Bill.

The ASA's concern is that there may be circumstances under which a company's highest paid personnell's remuneration details are not disclosed to shareholders. In the ASA's view the current status quo was unlikely to result in any significant additional compliance burden, and it provided an additional safety net.

## **Board Accountability - Simplifying the incentive components of executive remuneration and increasing the performance period**

ASA's view is that boards, in seeking to improve their accountability, should voluntarily elect to simplify their remuneration arrangements, and that the necessary taxation reforms (as proposed by the Productivity Commission) be enacted by the Australian government to make this a more realistic alternative. A simple approach such as providing executives with a cash and equity component with straightforward, transparent, appropriate hurdles and long term holding locks may achieve reasonable alignment and free up company resources from managing complex remuneration structures.

The underlying issue is that the size and structure of executive remuneration packages can combine to provide a backdrop of limited personal downside financial risk. In these circumstances, the ASA's view is that long term corporate and individual performance should be measured over a 4 to 10 year time span, with incentive rewards over and above base pay held in escrow over this time frame.

Executives in publicly listed companies receive a level of pay many times, in some cases hundreds of times, in excess of average earnings. The hurdles and holding locks implemented by boards to allocate this level of remuneration can afford to be, and should be, reflective of the long term consequences of decisions taken and their lasting impact on shareholders' financial futures.

The ASA expects boards to take full responsibility for ensuring they provide fair and balanced reporting on their stewardship of the business, including details of how they have executed their accountability for implementing long term, transparent, performance driven remuneration schemes.