20 January 2011

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Via email: executiveremuneration@treasury.gov.au

Dear Geoff

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

Thank you for the opportunity to comment on the exposure draft of this Bill and the accompanying explanatory memorandum. This submission addresses only three of the areas identified in the explanatory memorandum:

(1) Two strikes rule (chapter 1); and

(2) Remuneration consultant provisions (chapter 2).

I have referred to some of the other proposed amendments where these impact upon these two key policy initiatives.

My submission concludes with some comments on particular drafting issues in section three.

1 Two strikes rule

Ensuring a coherent suite of amendments

As noted in the Productivity Commission's report, it is not possible to tell whether executive remuneration has been set appropriately by boards.[1] This would indicate that, to date, the CLERP 9 reforms of a remuneration report and advisory vote have not clearly achieved their stated goals: enhancing transparency and accountability in relation to decisions surrounding executive remuneration.[2]

I note there are two further initiatives relating to executive remuneration currently on the drawing board: the government's referral to the Corporations and Markets Advisory Committee on executive remuneration in May 2010 on simplifying disclosure in the remuneration report as well as simplifying the incentive components of executive remuneration; and the Treasury consultation on

[1] Productivity Commission, *Executive Remuneration in Australia*, Inquiry Report no 49 (2009), XXIII.

[2] Corporations Law Economic Reform Program (Audit Relief and Corporate Disclosure) Bill 2003 (Cth), Explanatory Memorandum, 166.

clawback. While the CAMAC report has not yet been made publicly available (as at 20 January 2011), it will make recommendations on reforms to the remuneration report (disclosure) in keeping with the Minister's reference. It would be appropriate to consider these recommendations along with the current proposals.

The current bill seeks to improve accountability of directors for the remuneration decisions they make. However, accountability is not an end in and of itself. In this context, improved board accountability is ultimately about improved remuneration practices within listed companies because boards make 'better' remuneration decisions under a credible threat of removal from office by the company's shareholders. To understand how it might achieve this ultimate goal of improved remuneration practices, it is important to appreciate the current limits within the enforcement pyramid for good remuneration practice.

The enforcement pyramid for good remuneration practice

The enforcement pyramid devised by Ayres and Braithwaite[3] in which a regulator has an array of mechanisms that can be deployed to achieve compliance or enforcement must be modified to explain the regulatory space for executive remuneration. It is, however, a useful tool to compare the variety of mechanisms that may be used in encouraging responsive regulation; that is enforcement that responds to the level of compliance or non-compliance exhibited by the regulatee. The advantage of the enforcement pyramid analysis is that it emphasises 'a dialogic regulatory culture' in which conversations between the regulator and the regulatee are pivotal. It is this aspect which makes this model particularly pertinent to an analysis of the regulation of executive remuneration via 'say on pay' as illustrated by the regulated remuneration cycle.[4] That the advisory vote on the remuneration report has increased the level of engagement between company boards and shareholders appears widely accepted. What is also apparent is that it has not ensured better remuneration practices.

Figure 1 below represents the current enforcement pyramid for good executive remuneration practices in Australia. Neil Gunningham notes that the enforcement strategies available must be able to gradually escalate and, furthermore, there must be a credible 'top strategy' or tip of the pyramid 'which, if activated, will be sufficiently powerful to deter even the most egregious offender.'[5] This lack of enforcement options, in particular, the lack of a 'peak' that sufficiently deters the remuneration committee from making poor remuneration decisions, may be an inherent weakness in the existing regulation of executive remuneration. The amendments to the termination provisions in 2009 substantially increased the penalties to be applied to breaches. [6]

[3] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992), 39.

[4] Kym Sheehan, 'The Regulatory Framework for Executive Remuneration in Australia' (2009) 31 *Sydney Law Review* 273.

[5] Neil Gunningham, *Smart Regulation: Designing Environmental Policy* (1998), 396.

[6] *Corporations Act 2001* (Cth), ss 200C(1) and 200D(1) are offences attracting a fine of up to 180 penalty units, or 6 months imprisonment or both.

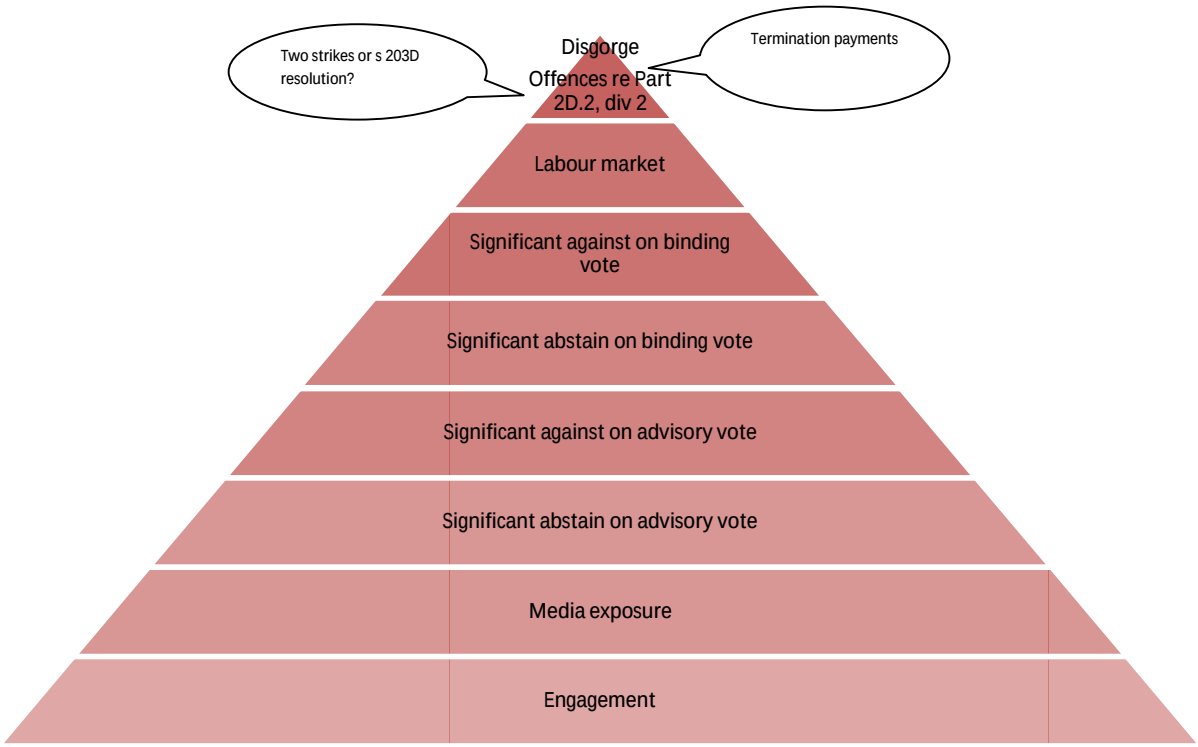

Figure 1: The Enforcement Pyramid for Good Remuneration Practices[7]

Looking at the pyramid, it is clear that the proposed 'two strikes' mechanism could operate as a credible 'peak' for directors, although the current s 203D procedure is likewise a credible peak.

Policy goals

According to the Explanatory Memorandum (EM) accompanying the exposure draft of the Bill, the two strikes test will strengthen the non-binding vote by 'setting out the consequences in the event that shareholders vote against the company's remuneration report.'[8] While the *Corporations Act 2001* (Cth), s 203D provides a mechanism for shareholders of public companies to requisition a meeting to remove a director from office, despite anything in the company's constitution, the EM notes that '*this is a somewhat extreme response, particularly if the director is having a positive impact on the value of the company*'.[9]

The same could be said of the two strikes rule which seeks to give shareholders the right to vote to spill the board (spill resolution in proposed s 250V(1)) should the board fail to respond adequately to shareholders' concerns following two consecutive votes[10] of at least 25% against the remuneration report resolution required by s 250R(2). While the spill resolution must be passed as an ordinary

[7] Kym Sheehan, Regulation of Executive Remuneration: An Empirical Study of the First Three Years of a 'Disclosure and Voting' Regime in Australia and the UK, PhD Thesis, University of Melbourne, p. 105.

[8] Explanatory Memorandum, Corporations Amendment (Improving Accountability on Executive Remuneration) Bill 2011, [1.2] (hereafter 'EM').

[9] EM, [1.4].

[10] It is important to note how proposed s 250U will operate to determine when the second strike and hence the spill resolution must be put to the meeting.

resolution (given no different level of voting is specified in the exposure draft), it can be seen that the spill resolution too will be an extreme response because, if passed, it will require the company to, firstly hold a general meeting within 90 days of the AGM (proposed s 250W(2)), with all of the company's directors at the time of the spill resolution ceasing to hold office immediately before the spill meeting (proposed s 250W(3)).

In practical terms, of course, it is likely that should the company be enjoying a period of strong growth reflected in profits, share price improvements and dividend distributions, the likelihood of shareholders taking an 'in principle' stance to not vote in sufficient numbers to pass the spill resolution diminishes. However so doing will begin the strike count again in the following year,[11] as demonstrated below in Figure 2:

Year 1 AGM	Year 2 rem report	Year 2 AGM	Year 3 AGM	Year 4 rem report	Year 4 AGM	Year 5 AGM	Year 6 rem report	Year 6 AGM	Year 7 AGM
≥25% vote against RRV		≥25% vote against RRV	≥25% vote against RRV		≥25% vote against RRV	≥25% vote against RRV		≥25% vote against RRV	≥25% vote against RRV
	explanation of response to year 1 vote	vote in favour of spill resolution: NOT CARRIED BY REQUIRED MAJORITY		explanation of response to year 3 vote	vote in favour of spill resolution: NOT CARRIED BY REQUIRED MAJORITY		explanation of response to year 5 vote	vote in favour of spill resolution: NOT CARRIED BY REQUIRED MAJORITY	

Figure 2: Proposed two-strikes process recommences with failure of spill resolution to carry at AGM

A company can continue to receive votes of 25% or more against the remuneration report vote year after year without the directors ever facing a spill meeting. In my view, this undermines the purpose of the advisory vote on the remuneration report as a signal that engagement between shareholders and the board, typically conducted behind the scenes, has failed to come up with remuneration acceptable to those shareholders involved in the engagement.

It is also not clear from the EM whether it is understood that it will remain possible for shareholders to resort to s 203D after one vote of 25% of more against the remuneration report, without waiting to wait and see what the company will do in response. There are clear advantages to shareholders in doing so. It takes fewer resolutions; the process to replace the directors can begin the next day provided the company receives a written request under s 203D to do so and a separate written requisition to call a meeting of members under ss 249D(1), s 249E(1) and s 249F(1), depending on shareholdings in the company; there is a shorter period for directors to engage in efforts to argue for their retention; and unless they resign before the meeting, the directors remain as directors until the end of the meeting (assuming the resolutions calling for their removal are passed). Figures 3 and 4 below illustrate the vastly different time frames to replace directors.

To achieve what s 203D can achieve in one resolution for each director at a general meeting will instead, under the proposed two strikes provisions, take several resolutions over a period of about 15 months (between first strike AGM and second strike AGM) to potentially not achieve the result of holding the board of directors accountable for their remuneration decisions.

[11] Per proposed s 250U(c).

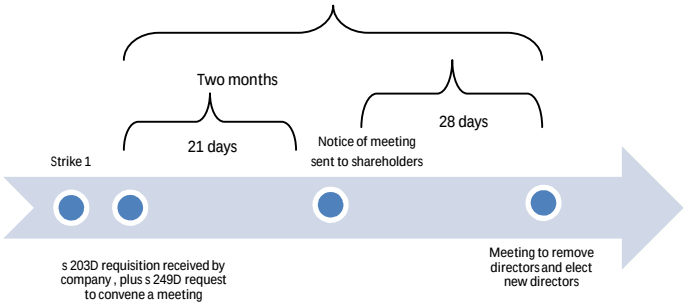

Figure 3: 62 day process to replace directors following first vote of ≥ 25% against the remuneration report, using s 203D and s 249D[12]

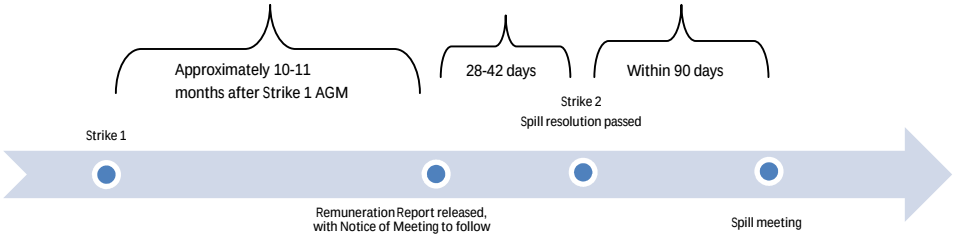

Figure 4: 455 day process to replace directors using two-strikes process, including spill meeting

The EM is correct in identifying the difficulties with making the vote on remuneration binding, with the current resolution 'to adopt the remuneration report' too ill-defined to be a binding resolution. However, *a number of the difficulties highlighted with moving to a binding resolution are also equally applicable to the proposed two-strikes process*: 'it could potentially be disruptive to the operation of the company, particularly if a deadlock arose between shareholders and management regarding the appropriate levels of remuneration;'[13] and would 'absolve directors of their responsibility to shareholders on this issue, and would also undermine their capacity to make key decisions affecting the performance of the company.'[14]

I also disagree that achieve 'greater certainty' for executives about the *levels* of remuneration[15] is an appropriate consideration for regulation of executive remuneration. If the government is serious about encouraging a performance culture amongst listed companies and senior executives, with a strong link between the performance achieved and pay outcomes for executives, there should

[12] Section 203D(2) requires at least two months notice of the meeting but the company can call the meeting within the two months provided it gives proper notice per s 249HA (listed company). Section 249D requires the directors to convene the meeting within 21 days, but can hold the meeting no later than two months after the request is given to the company.

[13] EM, [1.5].

[14] EM, [1.6].

[15] EM, [1.6].

always be an element of uncertainty, so that effort is applied to achieving the performance outcome.

Conclusion on policy goals

The government is advised to revisit the policy goals for regulating executive remuneration in light of the ultimate goal of regulating executive remuneration via levers to improve accountability and transparency: 'good' remuneration practice outcomes are observed because boards of directors make good remuneration decisions.

Impact of s 1322 on procedural irregularities

The remuneration report resolutions required under s 250R(2), together with the 'spill resolution' proposed in s 250V(1) and the subsequent 'spill meeting' proposed in s 250W(2), together with the proposed amendments to s 249L(2A) – and proposed s 250A(5A) have both procedural and substantive aspects.[16] Thus it is important to consider how s 1322 might impact on the operation of the proposed provisions.

Section 1322(2)

Failure to comply with either the timing[17] or notice of meeting requirements[18] might attract s 1322(2) to automatically validate the proceedings because a defect, irregularity or deficiency of notice or time is a 'procedural irregularity' per s 1322(1)(b). While there is no clear identification of standing to bring an action in s 1322(2),[19] it requires an application to the Court to declare the proceedings to be invalid and the Court to form the opinion that the irregularity has caused or may cause substantial injustice that cannot be remedied by any order of the Court. Case law suggests that courts are pragmatic in examining whether substantial injustice has occurred and will examine the evidence to see if the procedural irregularity itself caused substantial injustice, not the fact that the outcome of the irregularity caused an injustice.[20]

Failure to comply with the voting exclusion requirements proposed in ss 250R(4)-(5) that apply to the spill resolution[21] and spill meeting, will not attract s 1322(2) because of the intention evident in proposed s 250R(10): that these provisions will have effect despite anything else in the *Corporations Act 2001* (Cth). It also appears from the case law that 'the thing to be done' is the admission of valid votes, so admission of invalid votes would be a substantive irregularity, not a procedural irregularity.[22]

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[16] *Cordiant Communications (Australia) Pty Ltd v The Communications Group Holdings Pty Ltd* (2005) 194 FLR 322, [85]-[112].

[17] Proposed s 250W(2).

[18] Proposed s 294L(2A).

[19] *Cf* s 1322(3).

[20] *Powlika v Heven Holdings Pty Ltd* (1992) 10 ACLC 641, 651; *MTQ Holdings Pty Ltd v RCR Tomlinson Ltd* [2006] WASC 96, [110]-[116].

[21] Proposed s 250V(2).

[22] *MTQ Holdings Pty Ltd v RCR Tomlinson Ltd* [2006] WASC 96, [100].

Section 1322(4)

The interaction of this section with the above provisions needs also to be considered, given s 1322(4) is applicable 'without limiting the generality of any other provision of this Act'. It is likely that directors and other persons would seek to rely on the Court's power to make an order relieving them from civil liability[23] arising out of a breach of proposed s 250R(7) and s 250W(5). This section might apply to proposed ss 250R(4)-(5) notwithstanding the intent expressed in proposed s 250R(10).[24]

However, if failure to comply with the notice and timing requirements for the spill resolution and spill meeting can be somehow construed as a substantive irregularity, unable to be cured by s 1322(2), then s 1322(4)(a), (c) and (d) might all be brought into play. The Court must not make an order unless it is satisfied of the various requirements in s 1322(6) as they might apply for an application under s 1322(4)(a),[25] s 1322(4)(c), and in every case, 'that no substantial injustice has been or is likely to be caused to any person.'

Conclusion

It is recommended that the government take steps to ensure that the relationship of s 1322 and the proposed amendments is clear in light of its policy goals. Section 1322 should be allowed to operate, with any intention to exclude its operation being carefully considered in light of ensuring a balance is achieved between these resolutions and other meeting resolutions and proceedings under the Act that can attract the protection of s 1322.

Voting levels for directors elected at the spill meeting

As currently drafted, s 250X(3) provides for directors to be elected to the board even though the resolution to appoint them was not passed by a simple majority (as an ordinary resolution). This is contrary to the current process for electing directors by a simple majority. The proposed s 250X(4) allows the managing director (who would not face re-election under the spill resolution and hence be on of 'the directors who hold office apart from this subsection') to determine which of 2 or more persons having the same proportion of votes should be appointed as a directors.

Both proposals are contrary to the notion of shareholder democracy where the majority of shareholders in general meeting can pass a resolution to elect the company's directors.

Offences and sanctions

Should the company fail to conduct spill meeting within 90 days of the spill resolution being passed at the company's AGM and directors at the time of the spill resolution have not since resigned: every

[23] Section 1322(4)(c).

[24] Section 1322(5).

[25] Per s 1322(6)(a) notes three requirements: the act, matter or thing or the proceeding is essentially of a procedural nature; that the person or persons to the contravention acted honestly; OR it is just and equitable that the order be made.

person who is a director of the company at the end of those 90 days commits an offence[26] of strict liability,[27] attracting a sanction of up to 10 penalty units[28] or $1,100.[29]

A more substantial offence will exist for key management personnel voting in contravention of s 250R(4),[30] with a sanction of up to 200 penalty units or imprisonment for five years or both.[31]

These sanctions appear out of line with other sanctions that apply for other remuneration issues or more broadly, the penalties or sanctions that can apply in other 'conflict of interest' situations (including the proposed remuneration consultant provisions and the hedging provisions in the current exposure draft) as demonstrated below in Figure 5.[32]

Schedule 3 item number	Section/ proposed section CA 2001	Penalty units	Term of imprisonment	Both?	Is it a civil penalty provision?[33]	Pecuniary penalty limits	Compensation	Disqualification order?[34]
	ss 180(2) or (3)				yes: s 1317E(1)(a)	person: pecuniary penalty of up to $200,000 body corporate: up to $1 million[35]	yes	ASIC can seek[36]
30	s 184	2,000	5 years	yes				Automatic upon conviction per s 206B(1)(b)(i) irrespective of sentence imposed. Sentence imposed will be relevant for determining period of disqualification under s 206B(2)
32	s 191(1)	10	3 months	yes				Not automatic: strict liability offence per s 191(1A) so dishonesty is not an element of

[26] Proposed s 250W(5).

[27] Proposed s 250W(6)

[28] Current value per Crimes Act 1914 (Cth), s 4AA(1) as $110.

[29] Proposed item 70A in Schedule 3 to the *Corporations Act 2001* (Cth).

[30] Proposed s 250R(7).

[31] Proposed item 68AB in Schedule 3 to the *Corporations Act 2001* (Cth).

[32] This table is not meant to be exhaustive but rather to show a range of different sanctions either current or proposed for comparative purposes.

[33] A breach of the civil penalty provisions listed in s 1317E(1)

[34] In setting out the possibility of seeking a disqualification order, I have distinguished between offences listed as items in schedule 3 with a term of imprisonment and those without. For the situation where the offence is punishable by imprisonment for more than three, but less than 12 months and dishonesty is not an element of the offence (and thus would not attract an automatic disqualification under s 206B(1)(b)(ii)), I have highlighted the fact that a person might attract s 206E and show this as 'Might attract...'. Where the offence is not punishable by a term of imprisonment, I have *assumed*, for the purposes of this table, that it is unlikely ASIC would seek a disqualification order for repeated breaches. I therefore show this as 'Query...'

[35] Section 1317G(1B).

[36] Section 206C(1) and for repeated contraventions of the Act: s 206E(1)(a).

Schedule 3 item number	Section/ proposed section CA 2001	Penalty units	Term of imprisonment	Both?	Is it a civil penalty provision?[33]	Pecuniary penalty limits	Compensation	Disqualification order?[34]
								the offence (thus not s 206B(1)(b)(ii)) Might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
33	s 195(1)	5	-					No Prescribed offence[37] Query whether repeated contraventions would attract s 206E(1)(a)(ii)
35	s 200B(1)	180	6 months	yes				Not automatic: strict liability applies to the circumstance per s 200B(1A) so dishonesty is not an element of the offence (thus not s 206B(1)(b)(ii)) Might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
36	s 200C(1)	180	6 months	yes				Not automatic: strict liability applies to the circumstances so dishonesty is not an element of the offence (thus not s 206B(1)(b)(ii)) might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
37	s 200D(1)	180	6 months	yes				might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
39A	ss 201R(2), (3) and (4)	5	-					No Prescribed offence[38] Query whether repeated contraventions would attract s 206E(1)(a)(ii)
41	ss 203D(3) and (4)[39]	5	-					No

[37] Corporations Act 2001 (Cth), s 1313(8); *Corporations Regulations 2001* (Cth) r 9.4.01.

[38] Corporations Act 2001 (Cth), s 1313(8); *Corporations Regulations 2001* (Cth) r 9.4.01.

Schedule 3 item number	Section/ proposed section CA 2001	Penalty units	Term of imprisonment	Both?	Is it a civil penalty provision?[33]	Pecuniary penalty limits	Compensation	Disqualification order?[34]
								Prescribed offence[40] Query whether repeated contraventions would attract s 206E(1)(a)(ii)
	s 209(2)				yes: s 1317E(1)(b)	as above		ASIC can seek[41]
49A	ss 206J(3), (5) and (6)	60	-					Not automatic might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
49B	s 206K(2)	60	-					Not automatic might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
49C	s 206L(3) and (4)	60	-					not applicable as the offence as currently drafted applies to the remuneration consultant not the directors
50	s 209(3)[42]	2,000	5 years	yes				Automatic upon conviction per s 206B(1)(b)(i) irrespective of sentence imposed. Sentence imposed will be relevant for determining period of disqualification under s 206B(2)
66A	s 250A(5B)	200	5 years	yes				Automatic upon conviction per s 206B(1)(b)(i) irrespective of sentence imposed. Sentence imposed will be relevant for determining period of disqualification under s 206B(2)
68AA[43]	s 250R(2)	5	-					No

[39] These provisions relate to informing the director of the notice and circulating the director's written statement. Note there is no offence currently created should the company not respond promptly to the request, as the drafting of s 203D(2) requires 'at least 2 months' notice' be provided by the member. The offences in section 249E(3) and (4) (when the company fails to call the meeting) attract a sanction of 5 penalty units.

[40] Corporations Act 2001 (Cth), s 1313(8); *Corporations Regulations 2001* (Cth) r 9.4.01.

[41] Section 206C(1) and for repeated contraventions of the Act: s 206E(1)(a).

[42] Dishonest involvement by a person in a public company's breach of the related party transaction requirements in s 208(1).

[43] This amendment is to correct a current anomaly in schedule 3 which shows two separate items 68A. The penalty is unchanged.

Schedule 3 item number	Section/ proposed section CA 2001	Penalty units	Term of imprisonment	Both?	Is it a civil penalty provision?[33]	Pecuniary penalty limits	Compensation	Disqualification order?[34]
								Prescribed offence[44] Query whether repeated contraventions would attract s 206E(1)(a)(i)
68AB	s 250R(7)	200	5 years	yes				Automatic upon conviction per s 206B(1)(b)(i) irrespective of sentence imposed. Sentence imposed will be relevant for determining period of disqualification under s 206B(2)
69A	s 250SA[45]	5	-					No Prescribed offence[46] Query whether repeated contraventions would attract s 206E(1)(a)(ii)
70A	s 250W(5)	10	-					No Query whether repeated contraventions would attract s 206E(1)(a)(ii)
71	s 251A(1) to (5)	10	3 months	yes				Not automatic as dishonesty is not an element of the contravention (thus not s 206B(1)(b)(ii)) might attract s 206E(1)(a)(ii) if they have contravened the Act at least twice while they were an officer of a body corporate
103B	ss 307A(1) and (2)	50	-					Offence is committed by an auditor
103C	s 307B(1)	50	-					Offence is committed by auditor
103D	s 307B(3)	50	-					Offence is committed by auditor
104	ss 308(1), (2), (3), (3A), (3C) and (4)[47]	50	-					Offence is committed by auditor
116CA	s 324CA(1)	25	6 months	yes				Offence is committed by auditor
116CB	ss 324CA(1A) and (2)	10	-					Offence is committed by auditor
116CC	s 324CB(1)	25	6 months	yes				Offence is committed by auditor
116CD	ss 324CB(1A), (2) and (4)	10	-					Offence is committed by auditor
116CE	s 324CC(1)	25	6 months	yes				Offence is committed by auditor

[44] Corporations Act 2001 (Cth), s 1313(8); *Corporations Regulations 2001* (Cth) r 9.4.01.

[45] Chair must allow a reasonable opportunity for the members as a whole to ask questions about, or make comments on, the remuneration report.

[46] Corporations Act 2001 (Cth), s 1313(8); *Corporations Regulations 2001* (Cth) r 9.4.01.

[47] Offences relating to the content of the auditor's report.

Schedule 3 item number	Section/ proposed section CA 2001	Penalty units	Term of imprisonment	Both?	Is it a civil penalty provision?[33]	Pecuniary penalty limits	Compensation	Disqualification order?[34]
116CF	ss 324CC(1A), (2) and (4)	10	-					Offence is committed by auditor
116DA	s 324 CE(1)	25	6 months	yes				Offence is committed by auditor
116DB	ss 324CE(1A) and (2)	10	-					Offence is committed by auditor
117	s 344(2)[48]	2,000	5 years	yes				Automatic disqualification for a director Conduct may also contravene directors and officers duties found in ss 180-184
119	s 648A(1)	25	6 months	yes				offence committed by either bidder or target
	s 648A(3) s 667B(3)	-	-	-	no	-	-	prescribed offence per s 1311(1) of $550 per s 1311(5) and enforced via penalty notice regime in s 1313

Figure 5: Comparative table of penalties and sanctions under CA 2001 for conduct related to executive remuneration or 'conflicts of interest' situations for directors, remuneration consultants and auditors

To determine the appropriate penalty and sanction, it might be useful to think of the range of possible conduct along a continuum. One suggested continuum is illustrated below in Figure 6:

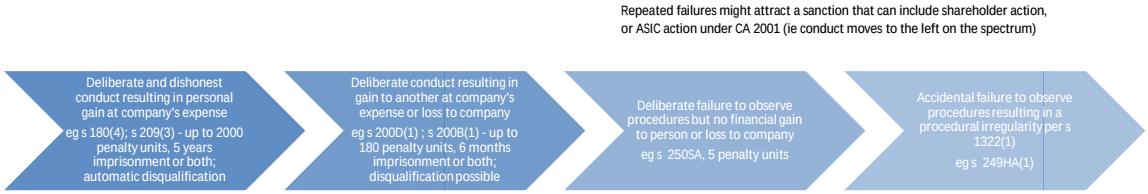

Figure 6: Continuum of conduct relating to executive remuneration or conflicts of interest, in breach of CA 2001

On this reasoning, it appears as if some of the proposed sanctions are out of step with the nature of the conduct, when compared with other conduct.

Conclusion

The government should carefully consider whether the activities targeted in the exposure draft warrant the creation of an offence, given that ASIC will have to undertake investigations and initiate court proceedings in relation to the offence.

Regulatory impact statement

The costs and benefits of Option B, the two-strikes and re-election process are set out in table 8.5 on pages 42-43 of the Explanatory Memorandum. No benefits or costs are currently shown for

[48] Section 344(2) creates an offence for a person, being a director of a company, registered scheme, or disclosing entity, to contravene s 344(1) by failing to take all reasonable steps to comply with, or secure compliance with Part 2M.2 or 2M.3 (which includes s 300A) and the contravention is dishonest.

'Government/Regulators'. I believe this is incorrect as sanctions are proposed in ss 250W(5), (6), and related proposed sections 250R(7), s250A(5B), that will require ASIC to monitor, investigate and undertake enforcement action (because the sanctions can only be imposed *upon conviction* per s 1311(2) as the offences are not intended to be 'prescribed offences' as defined in s 1313(8) (and hence subject to the penalty notice regime in s 1313(1)).

It is recommended that the regulatory impact statement be amended to reflect the costs involved for ASIC in monitoring, investigating and taking enforcement action , so that the Parliament can consider whether that impact justifies the measures taken.

2 Remuneration consultant provisions

Policy goals

The stated policy goals for these reforms are to address the potential conflicts of interest that might exist for remuneration consultants:

> A key concern raised by stakeholders 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 (either for remuneration advice or other services the consultant may provide to the company).[49]

The fact that some remuneration consultants also advise on the remuneration strategy for the rest of the company and that this advice typically attracts a higher fee earner than advising the remuneration committee on the remuneration for the senior executives is well known. There may be sound commercial reasons for retaining the same advisor for both pieces of advice: for example a financial institution subject to APRA prudential supervision might want to ensure a consistent remuneration strategy is applied across the company.[50]

If the policy goal is truly about transparency of the board and remuneration committee's decision-making process,[51] while conflicts of interest may exist for remuneration consultants, it is by no means clear that these provisions are a proportionate response to that conflict of interest.

As the EM notes

> While the advice of remuneration consultants may be influential in determining a company's remuneration decisions, *the primary responsibility for remuneration arrangements rests with company directors*.[52]

[49] EM, [2.2].

[50] The *Governance* Prudential Standards issued by APRA require an APRA-regulated entity to establish and maintain a document Remuneration Policy for the entity (see Draft *Prudential Standard CPS 510 Governance*, paragraph 42). Currently there are separate prudential standards: *Prudential Standard APS 510 Governance* (2009), paragraph 33; *Prudential Standard LPS 510 Governance* (2009), paragraph 30; Prudential Standard GPS 510 Governance (2009), paragraph 34. The Remuneration Policy as defined covers more than the executive team: see APS 510, paragraph 39; LPS 510, paragraph 36; GPS 510, paragraph 40.

[51] EM, [2.1]-[2.2].

[52] EM, [2.3], emphasis added.

The board of directors' decision-making process for remuneration is an appropriate site for legislative intervention in general terms. This is consistent with the broad power of management given to directors under s 198A, a replaceable rule, or a typical constitutional provision. Thus, in seeking to regulate the conflicts of interest that might arise for a remuneration consultant, the focus should remain on the decision-making activities of the board of directors (including any person or committee it has delegated its decision-making powers to pursuant to *Corporations Act 2001* (Cth), s 198D). Any new provisions of the *Corporations Act* should focus on the steps taken by the board of directors in respect of seeking and using any external advice on remuneration.

It is important to remember that remuneration consultants provide data and advice to inform the decision-making of directors, rather than performing a certification or verification function. As noted *The Voluntary Code of conduct in Relation to Remuneration Consulting in the UK*, issued by the Remuneration Consultants Group in 2009:

> In this connection it is important to clarify the role that executive remuneration consultants fulfil. Their role is to provide advice and information which they believe to be appropriate and in the best interests of the company. Their input should take fully into account the Combined Code[53] principle that pay should be sufficient, without being excessive, to attract, retain and motivate executives of the right calibre.
>
> The purpose of their input is to support robust and informed decision making by the company on remuneration matters. This is the case regardless of whether these are decisions of the Remuneration Committee or executive directors. Under the UK's unitary board structure, both share a common duty to promote the success of the company.[54]

Remuneration consultants occupy a different position vis-a-vis company than auditors

To understand why focusing on the decision-making of the board of directors and how the exercise of independent judgment may be compromised is the correct approach, rather than on creating offences in relation to the giving of remuneration consulting advice, an analogy can be drawn with the regulation of auditors under the *Corporations Act 2001* (Cth).

An audit of the financial reports is required by section 301(1). The integrity, reliability and credibility of financial reports is important to shareholders and other company stakeholders, and to the financial markets more generally. As Professor Ian Ramsay notes

> Audited financial statements are an important part of the financial information that is available to the capital markets and an important part of effective corporate governance.[55]

This justifies the registration of auditors under part 2M.4, and the requirements for auditor independence in ss 324CA, 324CB and 324CC. The auditor is required to form an opinion on several matters listed in s 307, conduct the audit in accordance with the auditing standards (or else commit an offence of strict liability per s 307A(3); retain audit papers for 7 years (or else commit an offence

[53] Now the UK Corporate Governance Code.

[54] *Companies Act 2006* (UK) c 46, s 172.

[55] Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform* (2001), [4.01].

of strict liability per s 307B(2) for an individual auditor or audit company or s 307B(4)a member of an audit firm); make a declaration of independence *to the board of directors* under s 307C(1) (individual auditor), s 307C(3) (lead auditor for an audit firm or audit company); and comply with the audit report content requirements in s 308, which includes an audit opinion on the remuneration report (in terms of whether it complies with the requirements of s 300A) (with a strictly liability offence in s 308(5) for an offence based on ss 308(1), (3), (3A), (3C) or (4).

The statute also recognises the importance of the auditor's role by giving the auditor certain powers: for example, the auditor has a power to obtain information under s 310 as a right of access to the books of the company and, providing the request is reasonable, to require any officer to give the auditor information, explanations or other assistance for the purposes of the audit or review. Officers of the company, registered scheme or disclosing entity are under complementary statutory obligations found in s 312 to allow access and give information.

The auditor must avoid a conflict of interest situation. 'Conflict of interest situation' is defined in s 324CD(1) and incorporates the concept of not being able to exercise objective and impartial judgment in relation to the conduct of the audit, and allows for this to be assessed objectively by the reasonable person with full knowledge of all relevant facts and circumstances in s 324CD(1)(b). There are also further independence requirements that take the form of identifying persons and entities covered[56] by the requirement to take all reasonable steps should a conflict of interest situation arise,[57] and defines several relationships as relevant for this purpose.[58] Examples of the offences for breaching these provisions are noted above in Figure 5.

Remuneration consultants in a different role to that of experts preparing expert reports required under the Corporations Act 2001 (Cth)

Remuneration consultants are also in a different role to experts who write reports on proposed transactions, such as a merger or acquisition,[59] a scheme of arrangement[60] or a compulsory acquisition of capital.[61] ASIC's *Regulatory Guide 112: Independence of Experts* identifies independence of reports as important to security holders because 'they will assume that an expert report is an independent opinion and will be misled if the opinion is not'.[62] Furthermore as Brooking J notes

> '.. they are supposed to be for the protection of individuals who are being invited to enter into some kind of transaction. Unless high standards are observed by those who prepare these reports, there is

[56] Section 324CE (5) (individual auditor), s 324CF(5) (audit firm) and 324CG(9) (audit company).

[57] A suite of offences is created in sections 324 CE(1) and (2) (individual auditor), ss 324 CF(1) and (2) (audit firm) and ss 324CG(1) and (2) (audit company).

[58] Section 324CH(1)

[59] Section 648A.

[60] Section 411(13) reports and *Corporations Regulations 2001* (Cth), r 5.1.01(1).

[61] Section 667B.

[62] ASIC, Regulatory Guide 112: Independence of Experts (2007), RG112.5.

> a danger that systems established for the protection of the investing public will, in fact, operate to their detriment through reliance on these reports and the reputations of those who furnish them.[63]

The Act provides for particular disclosures to be made by these experts,[64] including disclosure in their report of relationships and fees. It is clear that this is the model that has been used for the proposed amendments to the remuneration report (s 300A(1)(h)).

However, remuneration consultants are not providing expert reports on a transaction proposed by management, with the report being provided to shareholders to assist in their decision-making.

Conclusion

The rationale for regulating remuneration consultants via amendments to the Corporations Act 2001 (Cth) such as s 206L is not as compelling as it is for regulating auditors and the providers of expert reports on proposed company transactions. There is no reason to treat remuneration consultants differently from any other kind of management consultant or a professional advisor.

Constitutional law issues

It is because of this very different role and the fact that, other than the replaceable rule in s 202A and the reasonable remuneration exception in s 211 to the related party transaction requirements in s 208(1), remuneration decisions are not regulated by the *Corporations Act* but via the company's internal governance rules, that I question whether the proposed amendments that seek to directly regulate the conduct of remuneration consultants[65] might overstep the reaches of the Corporations power in s 51(xx) of *The Constitution*, notwithstanding the broad interpretation of that power as evident in the joint judgment in the *Work Choices Case*:

> Second, if follows that the power conferred by s 51(xx) extends 'at the very least' to the business functions and activities of constitutional corporations and to their business relationships. Third, once the second step is accepted, if follows that the power 'also extends to the persons by and through whom they carry out those functions and activities and with whom they enter into those relationships.'[66]

I note also the reasoning of Gaudron J on the s 51(xx) power:

> I have no doubt that the power conferred by s 51(xx) of the Constitution extends to the regulation of the activities, functions, relationships and the business of a corporation described in that sub-section, the creation of rights, and privileges belonging to such a corporation, the imposition of obligations on it and, in respect of those matters, to the regulation of the conduct of those through whom it acts, its employees and shareholders and, also, *the regulation of those whose conduct is or is capable of affecting its activities, functions, relationships or business*.[67]

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[63] From the judgment in *Phosphate Co-operative v Shears (No 3)* (1998) 14 ACSL 323 at 339.

[64] Section 648A(3) and s 667B(2).

[65] Proposed sections 206K-206L.

[66] *New South Wales v Commonwealth (Work Choices Case)* (2006) 229 CLR 1, 114 [177].

[67] *Re Pacific Coal Pty Ltd; Ex parte Construction, Forestry, Mining and Energy Union* (2000) 203 CLR 346, 376.

Proposed s 206L seeks to regulate the conduct of remuneration consultants by requiring remuneration consultants to give their advice on the nature and amount or value of the remuneration of one or more of the key management personnel of a company that is a disclosing entity, to either or both of the directors of the company; the members of a committee defined as the remuneration committee by virtue of the fact that it is a committee of the board of directors of the company and has functions relating to the remuneration of key management personnel for the company. Proposed subsections (3) and (4) creates offences of strict liability for giving the advice to a person who is an executive director (unless all of the company's directors are executive directors)[68] or to give the advice to neither a director nor a member of the remuneration committee (for example, to give the advice to the company secretary, the usual conduit for communications with the board of directors and its sub-committees; someone who is a secretary or executive assistant in the company; or the company's HR director).

Treasury is advised to seek an opinion on this matter.

Impact of s 1322 on irregularities

The proposed amendments, as currently drafted, are largely procedural. Consideration should be given as to the interaction of these provisions with s 1322(4).

Offences and sanctions

There are some offences created by these new provisions which I have included in Figure 5 above. Sixty penalty units appears to be excessive for the offence created by sections 206L(3) and (4), given the penalties applied to auditors in sections 307A(1) and (2) for example (50 penalty units) and the conduct being impugned is not as serious as the breaches of the independence provisions for auditors found in section 324CE(1) for example (25 penalty units or 6 months imprisonment or both).

Regulatory impact statement

Because offences are created, there is a government cost/burden in monitoring, supervision, investigation and enforcement activities to be undertaken by ASIC.

As recommended above, the regulatory impact statement should be amended to reflect this, so that the parliament can consider whether the impact justifies the measures taken.

3 Drafting issues

Turning to the exposure draft, I offer the following comments:

Proposed section	Drafting issue	Proposed solution
s 9 definition of 'closely related party'	As currently worded the definition is exhaustive; query whether an inclusive definition is more appropriate, with 'closely related' to be a question of fact. This is especially so in light of sub-section (d) which will attach to 'family' other than spouses and children, but ignores the influence of non-family on the member of the KMP or the influence of the member of the KMP upon the non-family person, with the requirement that this	Amend the wording as follows: Closely related party of a member of the key management personnel for an entity *includes*

[68] Which will incidentally create difficulties under the proposed two strikes rule.

Proposed section	Drafting issue	Proposed solution
	influence relates to the member of the KMP's dealings with the entity	
definition of 'executive director'	no current definition	It is a well understood commercial term and best left undefined.
s 9 definition of 'remuneration consultant'	the definition may be easily circumvented by a consultant providing *information* on the remuneration received by companies in a comparator group selected by the board of directors or remuneration committee (nature) without making any recommendations on salary levels (amount or value of remuneration) for one or more members of the key management personnel of the company.	Consider redrafting as 'advice relating to the nature or the amount or value of remuneration'
s 206J(2)	definition of hedging relies also upon regulations which have not yet been made available for review	Provide an opportunity to review the definition in light of any definitions provided for in the regulation
s 206K	Proposed s 206K seeks to regulate who can sign a contract on behalf of the company (that is a disclosing entity) for the provision of advice on the nature and amount or value of remuneration for one or members of the key management personnel of that company. It creates an offence of strict liability for a person who is not a director or who is an executive director to execute that contract on behalf of the company in s 206K(3), although the validity of the contract is not affected. It should be borne in mind that s 126 and s 127 of the *Corporations Act 2001* (Cth) currently provide for the execution of contracts by a company. Section 126 allows an agent to enter into a contract on behalf of the company, while s 127 will also allow execution by two directors or a company secretary and a director either with or without the company seal. The statutory assumptions in ss 128 and 129 rely upon execution in accordance with s 127.	Section 206K should be removed or amended to allow for the company secretary to sign on behalf of the company.
s 206L	The provision as currently drafted fails to consider the reality of corporate life where a committee of part-time non-executive directors relies upon the services and support of a company secretary and other personnel to act as conduits for receiving and distributing reports.	The provisions, if retained, should be amended to reflect the role of company secretaries as secretaries to the board's committee.
s 250A(5B)	No words currently create an offence for a breach of this section and intention evident from drafting of proposed item 66A in schedule 3 is to specify the sanction, rather than creating a prescribed offence	Add a subsection to s 250A(5B) to create the offence.
s 250A(5C); s 250R(6)	As currently worded, the words 'The declaration has effect accordingly. The declaration is not a legislative instrument' would seem to indicate that the intent is to not treat the declaration as a legislative instrument whereas ASIC's powers to exempt, modify or make declarations about particular provisions in the Act are treated as legislative instruments. Hence the status of any declaration made by ASIC pursuant to these provisions is unclear.	Check for consistency with other provisions in the *Corporations Act 2001* (Cth) and redraft accordingly If retain current drafting, provide a rationale for doing so in the EM, beyond that currently found in EM [3.9]. If retain current drafting, separate the words 'the declaration has effect accordingly' into a separate sub-section (see s 224 for an example).
s 250R(8)	drafting is attempting to treat the vote as not cast, but to enable the offence created by s 250R(7) to exist, the vote has to be cast Query whether the real intention is to ensure any vote cast in breach of s 250R (4) cannot be counted.	Consider amending wording to be consistent with s 224 and s 225(1).
s 250W(3)	The appointments of directors are terminated immediately prior to the spill meeting has the effect of leaving the company with only executive directors and hence in breach of s 201A(2) requirements for a minimum of three directors.	Consider redrafting to be consistent with the practice that the directors remain in office until either they resign or are removed by the members in general meeting which, in this context, means the spill meeting.
ss 250X(3),(4)	This potentially creates a difficulty for companies in conducting an orderly election of directors at the spill meeting.	Consider the effect of the board limit resolution in s 201(2) which will be in place until the next AGM.

Proposed section	Drafting issue	Proposed solution
	The method of election allows for the appointment of directors whose election was not supported by a simple majority, with any 'tie' in the board result to be determined by the directors not subject to the spill meeting (executive directors or directors subsequently appointed). This appears to give the executive directors great power in determining the make-up of the board of directors.	It might be appropriate to require a board limit resolution to be passed at the same AGM as the spill resolution so that the numbers of candidates required is known.
s 250Y	The provision seeks to keep the time clock running on the directors' appointment (to allow for the operation of the ASX Listing Rule 14.4). However, it seems unfair to require the director to submit for re-election following a spill resolution but not take into consideration the vote by shareholders at the spill meeting to appoint that person as a director by allowing the clock to start again.	Consider redrafting to allow for the term of the appointment to begin from the time of re-election at the spill meeting.
s 300A(1)(a)	Consider whether this amendment should wait to incorporate any recommendations made by CAMAC in its examination of remuneration report disclosures	
s 300A(1)(g)	The response does not require a summary of what the comments received were. There is currently no obligation to seek out comments and engage with those parties.	If retain, consider redrafting to include a requirement to specify the comments received, and the process undertaken by the board to identify the comments, and respond to them.
s 300A(1)(h)	As the provisions are currently drafted, they are selectively targeting only one of the main advisers to the remuneration committee – remuneration consultants – while overlooking the other main advisers to remuneration committees – lawyers and tax accountants. Lawyers will advise on the terms of employment service agreements, share plans and other matters, while tax accountants will advise on the taxation implications of any package. It is also not clear why the consideration received by the remuneration consultants needs to be disclosed (subsections (v) and (vi)). Unlike auditors and expert report preparers under s 667A of the *Corporations Act 2001* (Cth), remuneration consultants are not preparing advice on the financial accounts prepared by management (auditor) or a transaction proposed by management (expert preparing report on compulsory acquisition). That is, they are not performing a certification or verification function for the remuneration committee but are providing input via data for the remuneration committee's decision-making.	Amend the opening words to the subsection to include all *material advisers* to the remuneration committee and delete the definition of 'remuneration consultant' in section 9. Consider deleting the sub-sections requiring disclosure of the amounts of fees ss 300A(1)(h)(v) and (vii), but leave the requirement to disclose the nature of other work undertaken for the company.
item 66A in Schedule 3	The proposed penalty seems onerous and out of kilter with the penalty imposed in s 250A(5) of 5 penalty units.	If retain provision, revise penalty to be in line with other penalties relating to proxy appointments.

Should you have any questions about my submission, I can be contacted on 02 9351 0493 (w) or 0414 062 788 (m).

Yours sincerely

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