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25 January 2011

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

Macquarie Group Limited (Macquarie) welcomes the opportunity to provide feedback on the proposed changes to the Corporations Act 2001 (Cth). The proposed changes warrant extensive consultation to ensure that desired outcomes are achieved and unintended consequences are avoided.

As the legislation recognises, appropriate governance of remuneration is essential to maintaining confidence in Australia's publicly listed companies. Such confidence is critical to the attraction and retention of executives and capital both in Australia and overseas. At the same time, Boards of Directors must have the flexibility to manage executive remuneration in ways that ensure Australian companies stay globally competitive.

To that end, building confidence in remuneration practices requires regulation that upholds the following overarching governance principles:

- It should be proportionate to the issue addressed;
- It should allow conflicts of interest to be appropriately managed;
- It should avoid unintended consequences;
- It should provide appropriate disclosure;
- It should uphold shareholders interest; and
- It should allow non-executive directors to maintain their independence.

Some of the regulatory changes proposed by the draft legislation maintain the integrity of these principles. Others, however, if implemented in the way proposed, are contrary to such principles and pose significant risk of adverse consequences.

Macquarie reiterates its commitment to best practice corporate governance in relation to remuneration. However, pursuing the approach proposed in the draft legislation could have significant unintended consequences that could destabilise Australia's enviable reputation for the quality of its corporate governance. As a result, alternative approaches are proposed in a number of specific cases. Each of the key issues addressed by the legislation is discussed in the attached submission.

We appreciate your consideration of this submission.

Please do not hesitate to contact me or Nicole Sorbara on 8237 5015 if you wish to discuss this submission in more detail.

Yours sincerely

Helen M. Nugent

Dr Helen Nugent AO
Chairman
Board Remuneration Committee

# Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

## Macquarie Group Limited - Submission

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## 1. Strengthening the non-binding vote - “two strikes”

Macquarie opposes the two strikes rule as proposed which would result in a spill of the board if 25% of shareholders voted against the Remuneration Report over two consecutive annual general meetings. Macquarie takes this position because:

- It is a disproportionate response;
- It is likely to have unintended consequences;
- It is not necessarily in shareholders’ longer term interests.

### 1.1 Disproportionate Response

The threshold of 25% is too low. An ordinary resolution of shareholders must be passed by a majority of shareholders (over 50%) and a special resolution must be passed by 75% of the votes cast by members entitled to vote on a resolution. In this case, it is proposed that a minority (25%) of shareholders could trigger serious consequences over an issue that is not as significant as many others faced by a company and its shareholders.

More specifically, major investments or divestments, capital and the election of individual directors only require a majority vote. None of these issues trigger an action as significant as the spill of a board as proposed by the legislation.

Moreover, the Corporations Act already provides mechanisms for shareholders to call for and vote on the removal of directors. Shareholders have the ability under the Corporations Act to convene an extraordinary general meeting to consider a motion put by shareholders. Shareholders (5% or 100 members) may also require a company to include a resolution in its notice of meeting to be moved at an annual general meeting. Typically, such a measure is not taken indicating a low demand for a motion of this kind.

More generally, where a company is compelled to proceed to a spill vote the process would be destabilising for the company. The process would be time-consuming for management and expensive for shareholders. However, shareholders have generally not sought this kind of measure nor used their existing rights to pursue it.

Macquarie, therefore, submits that a spill vote on remuneration with a 25% threshold is a disproportionate response.

### 1.2 Unintended Consequences

The two strikes rule may destabilise a company in ways not intended.

First, companies suffering from poor performance may be unwilling to pay the remuneration necessary to obtain executives of the quality required to turn a company around because they fear a negative vote on remuneration. As a consequence, shareholders may suffer over the longer term. This could further destabilise a company facing challenges.

Second, the two strikes process could be used to take control of a company by stealth without paying shareholders a premium. Macquarie notes that it is possible for stock and a vote to be temporarily obtained over a voting period for little cost under a securities lending arrangement. High velocity trading by those with little long-term interest in a company exacerbates this issue. When combined with an active media programme, a board could be deliberately destabilised through the process, allowing another party to acquire control of the board through the spill vote. This would not necessarily be in shareholders' interests if, in so doing, shareholders did not receive a premium for their shares.

Third, a board of directors, faced with the prospect of a spill might simply resign, leaving the company without an appropriate governance structure. This conflicts with the expressed aim of promoting accountability of directors, as stated in the Explanatory Memorandum.

In addition, shareholders who might under the existing system vote against the Remuneration Report to send a message to directors about current remuneration might be reluctant to do so in future because they are concerned that their action could lead to a spill vote. In these circumstances, directors would not receive the desired message through the voting system. The dialogue encouraged by the current system might, therefore, be weakened which perversely, would be inconsistent with the expressed intention of the proposed legislation.

In those cases where there has been significant voting against a Remuneration Report there has not been a significant vote against incumbent directors seeking re-election. This indicates a tenuous link between the Remuneration Report and the appointment of directors.

### 1.3 Not Necessarily in Shareholders' Interests

While some shareholders only hold shares for short periods, long-term shareholders (such as major fund managers and retail shareholders) have a legitimate expectation that directors will act in a way consistent with their long-term interest. However, the two strikes rule may result in directors taking a short-term view simply to ensure a favourable remuneration vote. That is not necessarily in the interests of long-term shareholders.

Moreover, the draft legislation does not provide any indication as to how a company would identify the specific concerns that cause a "no" vote above a certain threshold, nor is this discussed in the explanatory material. In the absence of clearly identified concerns, a board would not be in a position to provide a response satisfying the requirement.

A vote on the Remuneration Report cannot be compared to specific issue votes held at an Annual General Meeting. It is multi-faceted, with shareholders often raising a diversity of issues. The following hypothetical example illustrates the point. Suppose in Year 1, three discrete issues generate shareholder concern, namely:

- 10% of votes cast are in opposition to the quantum of the Managing Director's remuneration;
- 10% oppose the hurdles for the issue of long-term shares; and
- 8% are aimed at concerns about the company's overall performance.

With a total 28% negative vote, the first of the two strikes would be triggered, even though no single specific issue generated more than a 10% negative vote.

In the second year, different issues may emerge, such as termination benefits (15% negative) and the structure of short-term incentives (12% negative).

The company would be forced to a spill vote even though five different issues over two subsequent years had triggered the spill, none with less than 85% support. This would mean that the views of a small proportion of shareholders on a particular issue dominate the majority of shareholders. Under these circumstances the unintended consequence is that the will of the majority of shareholders on a particular issue is ignored. This is not a desirable outcome.

This is exacerbated when taking into consideration the proportion of shareholders who choose not to vote. For example, if 40% of total available votes are not cast on a specific resolution (which is not unusual), a 25% no vote would be the equivalent of 15% of total possible votes. It would not seem desirable to put control of a company in the hands of such a small group of shareholders. This is also inconsistent with the "one share one vote" principle and is not in the interests of the majority of shareholders.

**Alternate Approach**

As a stand-alone measure, Macquarie suggests a formal response requirement where a "no" vote is greater than 50%. Combined with the ability of shareholders to vote on the election of specific directors, this will not destabilise the entire board, while providing shareholders with the option of voting for or against those directors up for election.

If the proposed two-strike approach is to be adopted, the threshold to trigger a spill vote should be 50% rather than the proposed 25%.

The legislation as drafted provides that where a spill vote is triggered, the relevant directors (other than the Managing Director) cease to be directors immediately before the spill meeting. This would mean that the company would be in breach of the Corporations Act which requires that a listed company must have at least three directors at any given time. In addition, only the Managing Director could chair the meeting. Macquarie suggests that if the legislation is pursued, it should be amended so that the current directors remain in office until the meeting concludes. This is consistent with most company's constitutions.

## 2. Prohibiting Directors and Executives Voting on Remuneration Reports and Voting Undirected Proxies

The proposal to prohibit directors and KMP from voting on Remuneration Reports and voting undirected proxies raises issues in relation to the following key principles:

- It should be proportionate to the issue addressed;
- It should allow conflicts of interest to be appropriately managed;
- It should uphold shareholders interests.

Macquarie strongly supports the principle that conflicts of interest should be appropriately managed. A conflict of interest as defined by law is where a person will directly and materially benefit from the outcome of a resolution.

Macquarie has previously stated that KMP should not be able to vote on remuneration matters where the person has a direct interest in the outcome of the resolution. This particularly applies to executives who are designated as KMP.

A different situation exists in relation to non-executive directors. The pool of funds allocated for the payment of directors is the subject of a specific shareholder vote. Disclosure occurs and shareholders are fully informed. It is a binding vote. In contrast, non-executive directors do not have a material personal interest in those aspects of the Remuneration Report related to executive remuneration. While they make a recommendation, they are not a beneficiary. This applies to a range of other issues on which directors make a recommendation. In those circumstances, they are not excluded from voting.

Under the proposed legislation, in the case of a spill vote where directors are up for re-election, KMP are excluded from voting. The Explanatory Memorandum does not indicate why KMP who are not directors have a material interest in the outcome of the resolution. It is difficult to understand the basis on which they should be denied the right to vote their shares. Therefore, it is difficult to understand why the legislation provides for their exclusion.

Macquarie submits that the exclusion of non-executive directors from voting on the Remuneration Report is a disproportionate response. It is also disproportionate that KMP who are not voting directors should be denied the right to vote in the case of a spill vote. KMP who are not directors do not have a material personal interest in this regard.

Equally, the proposed broad range of closely related parties of a director or KMP should not be denied the ability to vote their shares. In almost all cases, it cannot be said that these parties would have a material personal interest in the outcome of the resolution.

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

Disenfranchising shareholders by preventing the exercise of undirected proxies is not in shareholders' interests. The right to vote at an Annual General Meeting is a fundamental shareholder right. This should not be denied.

Where a shareholder gives an undirected proxy to another party, they exercise a clear choice in relation to their vote. A shareholder should not be disenfranchised simply because of their choice of proxy holder.

ASX listing rule 14.2.3 requires that where a shareholder gives an undirected proxy to the Chairman, they must tick a box on the voting form acknowledging that the Chairman may vote those shares even if he/she has an interest in the outcome of the resolution. They must also acknowledge that any votes cast by the Chairman (other than as a proxy holder) will be disregarded. Under listing rule 14.2.3B, where a shareholder fails to make that acknowledgement, the vote is not counted towards the outcome of the resolution. In this way, the shareholder is making a conscious choice to appoint the Chairman. This approach does not disenfranchise shareholders, while taking account of the need to manage any possible conflicts of interest.

**Alternate Approach**

Macquarie submits that non-executive directors should be able to vote on the Remuneration Report, given that the pool of directors' fees is the subject of a separate shareholder vote. Alternatively, the non-executive directors section of the Remuneration Report could be subject to a separate shareholder vote. This would allow directors to exercise non-directed proxies on executive remuneration.

Macquarie opposes the disenfranchising of shareholders who choose to give their proxy to a KMP. Macquarie submits that voting exclusions, where there is a conflict of interest, are already adequately dealt with in the Listing Rules and the Corporations Act. ASX listing rule 14.2.3B could appropriately be extended from the Chairman to other parties. This would make it clear that shareholders are exercising a clear choice in giving their proxy to a specific individual other than the Chairman where a conflict of interest exists.

## 3. Hedging

The key principles involved in the proposals on Hedging Equity Requirements are:

- It should allow conflicts of interest to be appropriately managed;
- It should uphold shareholders' longer term interests.

Macquarie has previously indicated its support for the proposals and considers that an appropriate balance has been maintained. Macquarie is one of a number of companies that prohibits executives from hedging unvested equity, as it considers this to be best practice.

## 4. Cherry-picking

Macquarie has previously stated that it supports the voting of directed proxies on all resolutions, not just remuneration-related resolutions. Macquarie submits that if all directed proxies should be voted, the same considerations apply to undirected proxies on any resolution. An undirected proxy is an instruction from the shareholder to the proxy to cast a vote as they see fit. In that way it is essentially a conscious direction. Where a shareholder takes the active step of completing an undirected proxy, it cannot be said that they expect the proxy to abstain. If the shareholder wanted to abstain, they could lodge an "abstain" vote themselves or simply not complete the proxy form.

## 5. Remuneration Consultants

The main principles involved in the draft proposals on remuneration consultants are as follows:

- It should be proportionate to the issue addressed;
- It should allow conflicts of interest to be appropriately managed;
- It should avoid unintended consequences;
- It should ensure appropriate disclosure; and
- It should allow non-executive directors to maintain their independence.

Macquarie supports the principle that conflicts of interest should be appropriately managed in relation to the appointment of remuneration consultants, where such advice is provided to directors as the basis of the Board making its determination in relation to executive remuneration.

Similarly, as an example of best practice governance, Macquarie supports the disclosure of those remuneration consultants who provide advice. Macquarie has a long-standing history of disclosing in its Remuneration Report its principal advisers on executive remuneration and its advisers on the setting of fees for non-executive directors.

Macquarie considers that such advice should be provided independently to the Board Remuneration Committee and to the full Board of Directors.

Appropriate governance arrangements should be put in place, typically through the Chairman of the Remuneration Committee.

However, the legislation as framed poses the risk of significant unintended consequences and is disproportionate to the issues to be addressed. It could weaken the independence of non-executive directors in a number of ways.

First, the draft legislation provides that only non-executive directors can interact with the consultants providing advice. While the Chairman of the Board Remuneration Committee might commission and oversee a report, in practice, management (such as the Head of Human Resources) must be able to provide data and have the ability to check facts. Without such support, the Chairman of the Board Remuneration Committee risks becoming a de facto executive. In reality, the commissioning of reports would not be practical without the involvement of management, who for this purpose report to the Board.

In addition, it would often be difficult for the Chief Executive Officer to develop and support recommendations to the Board for key senior executives without being able to access data from remuneration consultants. In a market with relatively few highly qualified remuneration consultants, the practical difficulty of obtaining advice from a firm that does not undertake work for management is also an issue.

Macquarie also notes that advice may be sought that covers a broad range of employees generally, which may incidentally include KMP. In those circumstances management should be able to engage and liaise with remuneration consultants directly.

Moreover, the draft legislation is not limited to material advice. In complex situations, Board Remuneration Committees may seek advice not just from remuneration consultants, but also from law firms and accountants on a range of aspects related to remuneration. The broad brush manner of the legislation suggests that all such advisers are captured. It is simply not feasible to isolate remuneration advice obtained from a law firm from other types of legal advice generated from that firm. Nor is it appropriate to disclose the nature of other advice, which might be on behalf of clients or of a commercially sensitive nature.

Moreover the scope of the information required to be disclosed is too detailed and does not provide significant benefit to shareholders. Indeed, it is more prescriptive than the disclosure required for audit firms under the Corporations Act and AASB 101. It is, therefore a disproportionate response.

At another level, the perverse and unintended consequence of the way the legislation is drafted may be that directors will seek less advice than has previously been the case. This would be a regrettable outcome.

**Alternate Approach**

Macquarie recommends that the names of material remuneration consultants be disclosed, along with a summary of the nature of their advice. Further, Macquarie suggests that directors attest to the independence of that advice. This will allow responsibility for ensuring independence properly rests with the board of directors. As is appropriately acknowledged in the Regulatory Impact Statement, directors – not remuneration consultants – have responsibility for determining executive remuneration. It is equally the responsibility of non-executive directors to ensure they operate in a way that is independent of management. Non-executive directors should, therefore, be obliged to make a declaration as to the independence of the remuneration advice obtained.

Other non-core remuneration advice – such as incidental advice provided by a law or accounting firm – should not have to be disclosed. In addition, a board of directors should have the ability to allow management to engage with remuneration consultants in a way that does not compromise the independence of either the remuneration consultant or the non-executive directors.

**6. No Vacancy Rule**

The Regulatory Impact Statement (RIS) states at paragraph 8.20:

> *….there is little conclusive evidence that low levels of contestability for board positions and lack of effective shareholder oversight leads to excessive or unwarranted levels of executive remuneration. However, there is a strong perception that this is the case.*

The only explanation provided for the proposal is that the proportion of former CEOs on boards might lead to their "identifying too closely with executives when determining their compensation." However, because former CEOs have knowledge and deep experience, it is not surprising that a significant number should become directors of publicly listed companies. Having individuals with such experience would appear to be in the interests of shareholders.

In the absence of other evidence to support the no vacancy rule, Macquarie submits that it is inappropriate to establish legislation with far-reaching implications that deals only with perceptions.

The risk is that the no vacancy rule, when used in conjunction with the two strikes and spill vote process, could have the unintended consequence of destabilising a listed company. There may be a range of scenarios in which the no vacancy rule could be used to introduce a candidate who may be unsuitable, or introduced with a purpose other than that contemplated by the proposed legislation.

The proposal, therefore, is a disproportionate response to perceived issues in relation to executive remuneration, where there is little evidence provided that the current system is not achieving the desired outcome.

## 7. Transitional arrangements

The Government proposes that the legislation will take effect from 1 July 2011. A number of elements of the proposed legislation may need to be taken into account when drafting a notice of meeting. Macquarie is concerned that the draft legislation does not take into account that the legislation will have an effective retrospective effect for those companies who hold their Annual General Meeting in July and possibly August 2011, if the legislation is not finalised and passed until June 2011.

The following timetable generally applies to the preparation and despatch of a notice of meeting:

- Statutory notice period under the Corporations Act – four weeks. Macquarie generally gives more notice, e.g. up to six weeks;
- two weeks for printing of notices and despatch to shareholders;
- four weeks (or more) in drafting of the notice of meeting including obtaining Board approval.

In Macquarie's case, its Annual General Meeting is typically held in July and Macquarie would expect to finalise its notice of meeting in late May/early June in order to despatch to shareholders by the middle of June, at which time the legislation may not be in its final form.

Macquarie suggests that additional clarification of the transitional arrangements should be included in the legislation and that a minimum three month transitional period apply from the commencement of the legislation, to take into account the normal time period necessary to prepare a notice of meeting and send it to shareholders prior to an Annual General Meeting.

In addition the way in which sections 300A(1)(g) & (h) operate needs to be clarified in regards to the dates to which they apply. It is unclear whether a degree of retrospectivity could occur because of ambiguity in the wording of s300A(1)(h), which might be contrary to the intent of the wording in Part 10.17, 1518 Application of sections 206J, 206K and 206L.