INSTITUTIONAL SHAREHOLDER SERVICES

ISS Australia

Position Paper:

Removing shareholder approval of equity grants to directors

Causes and consequences?

A recent change to Listing Rule 10.14 has removed any requirement for shareholders to approve equity grants to directors if shares are bought on-market, regardless of the terms of those grants.

What is the worse case scenario?

> A junior miner with 3 directors in total (1 non executive / 2 executive) establishes an Executive Share Ownership Plan that will acquire shares on-market.
>
> A placement is made to institutions for the purposes of general working capital.
>
> Performance rights representing 5% of the company's equity are then granted to all 3 directors with NO performance hurdles attached and a vesting period of 12 months. A substantial amount of money from the placement is expended buying stock on-market to satisfy the grants.

As the rule stands at present there is nothing to prevent the above scenario occurring and no contemporaneous disclosure to ensure that investors are given early warning.

This position paper details the effect of the change in Listing Rule 10.14 and the impact on shareholders.

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ISS Australia – Shareholder Approval of Equity Incentives

Executive Summary

- Several large ASX-listed companies — for example, Telstra, Investa Property Group, CSR and Rinker — have not been seeking investor approval before granting equity incentives to executive directors.

- These companies have been relying on a little-known amendment to Listing Rule (L.R) 10.14, proposed in September 2004 and in force from 24 October 2005. The effect of this amendment has been to remove the requirement for shareholder approval of grants of equity to directors if the shares are bought on-market.

Proposed amendment (Sept 2004)

An entity must not permit any of the following persons to acquire securities under an employee incentive scheme without the approval of holders of ordinary securities of the acquisition. The notice of meeting to obtain approval must comply with either rule 10.15 or 10.15A. ***This rule does not apply to securities purchased in the ordinary course of trading on ASX under the terms of a scheme that provides for the purchase of securities for employees by way of salary sacrifice.***

Actual amendment (Oct 2005)

An entity must not permit any of the following persons to acquire securities under an employee incentive scheme without the approval of holders of ordinary securities of the acquisition. The notice of meeting to obtain approval must comply with either rule 10.15 or 10.15A. ***This rule does not apply to securities purchased on market under the terms of a scheme that provides for the purchase of securities by or on behalf of employees or directors.***

*The scope of the proposed Listing Rule change removed the nexus to 'salary sacrifice' and broadened the exemption so that shareholder approval was not required if the securities were bought on market under *any* incentive scheme, regardless of the terms on which those securities were granted.*

Protections against related party acquisition are diminished

Underlying ASX policy on LR 10.14: "*it is directed at preventing related parties obtaining securities on advantageous terms and increasing their holdings proportionate to other holdings*".

- The expansion of the exemption under L.R 10.14 does little to actively protect against the acquisition of material positions in companies by directors, funded by shareholders, unrelated to individual or company performance.

- On one interpretation, the present drafting of the listing rule, in combination with ASX's stated policy, suggests that related parties could *never* obtain securities on "advantageous terms" so long as those securities were acquired on-market pursuant to an incentive scheme. ISS disagrees. We believe it is only by considering the terms on which grants are made to related parties, and the source of the finance for those grants, that such an assessment can be made.

Disclosure standards are reduced

- The effect of the change to Listing Rule 10.14 on disclosure standards is profound:
    - By progressively reducing the circumstances in which shareholder approval of equity grants is required, companies are not compelled in advance of grants to make the case for the alignment of interests between executive incentives and shareholder value.
    - Investors are therefore deprived of relevant information (for example: the precise details of performance hurdles, vesting periods, change of control provisions etc) that, whilst rarely 'material' in absolute terms, is fundamental to assessing the value of a company.
- Unlike other jurisdictions such as the U.S. where the full terms of all material contracts (which by definition include CEO contracts) must be disclosed to the market, Australia has no compensating mechanisms, leaving investors less informed than they were prior to the change.
- The practical effect of the amended LR 10.14 is to remove / diminish the contemporaneous disclosure that would normally be required to secure shareholder approval of equity grants.
- Whilst the non-binding vote on the Remuneration Report sets desirable standards about the relationship between pay and performance – these reports appear up to 15 months after any grants have been made. Many companies choose not to disclose details such as retesting of performance hurdles in remuneration reports where grants have been made under the LR 10.14 exemption.

The scope of the exemption to LR 10.14 was dramatically widened without broad investor support

- Whereas the original proposed amendment to the rule removed the need for separate shareholder approval in the case of director "salary sacrifice" schemes – the effect of L.R 10.14 as actually amended by ASX is to exempt all **"securities purchased on market … by or on behalf of employees or directors"**.
- The original proposed amendment to the listing rule was predicated on the fact that shareholders were comfortable with on-market purchases by way of "salary sacrifice". This factor was equally as important as the lack of impact on dilution. Non-executive directors who chose to apportion part of their fees to the purchase of company securities or executive directors who chose to rollover part of their bonus ALREADY EARNED in to company shares could take advantage of this provision without the bureaucracy associated with separate shareholder approval. In these circumstances no further disclosure was required.
- The sound basis of the original proposed rule change (salary sacrifice) has been undermined by its application to incentive schemes. An incentive scheme, by definition, relates to **at-risk** pay — not salary sacrifice.
- Based on inquiries of shareholder groups, it appears that the proposed changes to the Listing Rule may not have been circulated among the investor community. The ASX itself changed the wording that required a nexus between on-market purchases and salary sacrifice arrangements AFTER calling for public comments. Neither IFSA nor ACSI had a chance to comment on the dramatic effect of this change.

It appears that the ASX had already shifted policy prior to the LR amendment and is now signalling a continued shift to further liberalisation

- It has emerged that well before this amendment ASX had been routinely granting waivers from 10.14 if shares for an executive incentive scheme were being bought on-market.

- WAN has recently disclosed in its annual report that it obtained a waiver from ASX (under LR 10.14) in relation to the performance rights granted to WAN's new CEO, Ken Steinke, where the company has the discretion to either buy shares on-market or issue new shares to satisfy exercise of the performance rights. No public announcement of this waiver was made (either by ASX or WAN) until the company's annual report was released.

- PMP obtained a waiver from the ASX under L.R 10.14 on Oct 25, 2005 in relation to a grant of options to its newly hired CEO. The justification given by the ASX in a summary document posted on its website is:

    - 'Newly appointed Managing Director and Chief Executive Officer to be granted options under incentive scheme as part of overall remuneration package – offer of options made prior to appointment – grantee not a director or shareholder at the time remuneration package was negotiated'

- Similar waivers have been given in relation to grants made contemporaneous to a de-merger, scheme or other corporate transaction where information has been put to shareholders as part of a broader question for resolution.

- If this new shift is representative of broader ASX policy direction, fewer and fewer equity grants (whether they involve on market purchases or share issues) will require shareholder approval.

There are no compensating disclosures or changes in enforcement behaviour

- Most top 100 companies relying on the Listing Rule 10.14 exemption for on-market purchases have also not been seeking shareholder approval for the underlying executive incentive plans — contrary to ASX Corporate Governance Council Best Practice Recommendation 9.4.

- The ASX (not the Corporate Governance Council) has also apparently 'clarified' to listed companies that Recommendation 9.4 is only meant to apply to those plans where new shares are issued to executives and is not meant to apply to plans where shares are purchased on-market.

- Several top 100 companies also appear to be paying lip service to the ASX Listing Rule 4.10.3 requirement to either comply or explain non-compliance with Council Recommendation 9.4. Several companies either make no disclosure on this point (despite having not complied — i.e. not having put plans to shareholders for approval), or make statements that are either incomplete or potentially misleading.

