Submission to

The Productivity Commission

Executive Remuneration inquiry

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In response to the announcement of the Productivity Commission's inquiry the Australian Financial Review ran an article entitled "Win for boards [and] shareholders" (AFR, March 19).

We submit, that the proposed changes to executive remuneration are not yet a win for boards, shareholders or the community at large. A genuine win would be for shareholders to find the resolve to exercise the power they already have to determine and renew the terms of the contract between themselves and their directors to run the company.

If the majority of companies already had remuneration principles in their constitution (the contract between the shareholders and the company) it would be unnecessary for any government to intervene and unilaterally rewrite the constitution in shareholders perceived favour.

Whilst government intervention in contracts may sometimes be necessary to protect the interests of those with unequal bargaining power, the same rationale cannot be applied to shareholders. Shareholders may at any time, by altering the terms of their constitutions determine, how much of the company's funds are paid to executives (along with other matters).

We submit that the Commission should consider:

- why universal intervention is necessary in circumstances where there is no legal impediment to shareholders resolving the question of executive remuneration;
- how shareholders may be engaged in the question of executive remuneration such that each relevant company's Constitution reflects the expectation of a special majority of its members; and
- what competitive advantages there are to encouraging Shareholders to design and enshrine in their constitution differentiated executive remuneration.

The mechanisms for negotiating the shareholder-director contract have changed little since 31st December 1600 when the East India Company was formed. Back then, however, the primordial shareholders didn't need much

structure to their decision making as they were a small, well connected group who could exert significant influence.

As companies have grown, the ability of shareholders to rewrite the terms of the contract has become harder. AGMs are a sham as a shareholder decision making forum. Most shareholder sponsored special resolutions are (rightly) seen as trouble making distractions to the business. Constitutions, once written, are infrequently revisited.

Clearly some boards have been out-negotiated by CEOs; what other commercial contract has a termination payment on the conclusion of the service agreement, especially if there has been breach of contract by the CEO. However, shareholders have left themselves open to government intervention by failing to enshrine key principles for running the company in the constitution and to regularly revisit the terms of this constitutional contract as the world changes.

We submit that the Commission should examine ways in which greater constitutional intentionality could be encouraged within existing "governance processes":

- AGMs could be reinvented to provide a genuine forum for shareholders to revisit the appropriateness of the Constitution. This could provide clearer shareholder expectations to their boards and for boards to provide a statement of their intent (their promise) to shareholder for the coming year. For example, shareholders could cap the total percentage of EBITDA that can be applied to performance based pay.
- Boards could form a Constitutional Committee comprising both Directors and shareholder representatives. The terms of reference could include:
    - reviewing the constitution against shareholder expectations;
    - recommending amendments of the constitution to the Board;and
    - exploring and recommending alternative processes to engage with shareholders to ensure that the constitution reflects the expectations of a special majority of members.

Alternatively Australia could explore the German model of a supervisory board used by such companies as Bosch to regularly debate and review the terms of the agreement and recommend changes to shareholders.

The intervention of the government in remuneration was politically inevitable in the absence of a board or shareholder response to excessive remuneration, a response motivated by the size of the payments, not necessarily commercial rationale. The global financial crisis will provide political cover for more state-sponsored rewriting of the shareholder-director contract unless directors and shareholders take the initiative to do so themselves and do so on commercial terms.

Clearly executive remuneration requires realignment with the interests of shareholders and the wider community. However, we submit that it would be wiser to take a systemic approach of rejuvenating shareholder oversight of companies rather than making incremental and costly regulatory interventions as each new symptom of poor governance emerges.

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