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SUBMISSION

To the Productivity Commission re their

September 2009 Discussion Draft Executive Remuneration in Australia

by

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Index

	Page
1 Note	1
2 Observations on some criticism of the draft report	2
3 Shareholder engagement	3
4 Independence	4
5 The no vacancy rule	6
6 Caps triggers and thresholds	6
7 Other matters	10
8 The Draft recommendations overall	11

1 Note

This public submission addresses the September 2009 Productivity Commission (PC) Discussion Draft (the Draft) on Executive Remuneration in Australia, which the PC advises has been prepared for further public consultation and input prior to the final report in December 2009.

This submission is supplementary to my May 2009 public submission (PC No 28) to the Productivity Commission's Inquiry into the Regulation of Director and Executive Remuneration in Australia.

This is a personal submission by Andrew Murray and does not represent the views of any other individual or entity. Suffice to say that this submission again draws on my active policy and central legislative engagement with corporate law from 1996-2008 (see Senate Hansard), and not least, (with respect to this PC Inquiry) my 1998 amendments supported by Labor that ushered in modern company remuneration disclosure practices.

2 Observations on some criticism of the draft report

I have watched read and heard with interest the many reactions to this comprehensive and thoughtful Draft Report.

Insiders

There are critics (who could be loosely termed 'insiders') who feel the Draft is too strong, particularly with regard to Recommendations 1 and 15 (concerning the 'no vacancy' rule and the 'two-strikes spill' of directors). These recommendations undoubtedly rein in boards somewhat.

No doubt the PC will assess the reaction by such critics carefully on their merits, but the negative reaction is a positive sign that the recommendations may have some bite.[1]

Outsiders

There are those who could be loosely termed 'outsiders' who have condemned the Draft as weak and over-responsive to the views of remuneration practitioners or beneficiaries.[2]

It is worth pondering the origin of such criticism of the Draft, and whether it is fair.

As to origin, it seems that the primary criticism from 'outsider' critics is that the Draft has not responded appropriately or adequately to the central community concern as to remuneration quantum.

Secondly, there seems to be a low level of community or shareholder trust in management boards and directors. If trust is absent in deciding the propriety of remuneration design and quantum, then regulation is more likely to be demanded by the community. The Draft page 193[3] quotes Charles Macek: *"...Today that trust of Boards by shareholders does not exist..."*.

The Draft does acknowledge evidence that some executives have been over-rewarded for average not superior performance; some executives had managerial power over weak or inadequate boards; some executives have been rewarded for failure; and some executives 'just got lucky' in a rising market rather than delivered superior performance.

As far as it is ever possible to divine community feelings, it seems the community[4] at large believes that multi-million-dollar salaries or packages are neither justified warranted or

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[1] Unfortunately, major business groups can have an initial but active resistance to better governance and accountability, concerns invariably subsequently allayed by experience – see for instance Draft Box 8.10, and page 238 penultimate paragraph.
[2] One example of such criticism is provided by Ross Gittins: *The West Australian* Wednesday 7 October 2009, p20 who condemns the Draft as 'weak', 'mealy mouthed' and showing signs of capture by the well-heeled well-resourced executive and director set.
[3] In that same page of the Draft Trevor Eastwood and Charles Macek are also making the point that trust diminishes even more when remuneration packages are complex; or presented in a complex manner.
[4] For the purposes of this argument community equals shareholders, in a general sense. The community segues into shareholders because millions of Australians are (indirect) shareholders via superannuation funds and investment funds. See also Draft Chapter 2.

needed, and are simply ‘wrong’. Critics believe such a widespread public concern has not been properly addressed in the Draft, and that the Draft therefore represents a moral failure to confront a wrong.

As to whether criticism of the Draft as weak or a failure is fair, the PC will have opened itself to such claims if its Draft is considered not to sufficiently or adequately address or confront the central moral question of ‘wrongness’ in a substantial manner.

One critical theme appears to be that the PC has misconstrued a question on justice, which is a matter of fairness and conduct requiring sanctions, as a question on law and process, concerning rules and efficiencies.

Some ‘outsider’ critics plainly believe the Federal Government has taken offence on behalf of the broader community at executive remuneration packages that “reward excessive risk-taking or promote corporate greed”.[5] In these critics’ judgement, in its statements (for example see Draft 1.1) the Government[6] has explicitly supported this widespread moral and value-driven public viewpoint. This has raised the expectation of effective action and sanctions.

These critics seem to have the impression that the PC’s moral framework makes it indifferent to community outrage, and that they are therefore relatively unconcerned at excessive risk-taking and corporate greed, and believe significant measures are not warranted so resulting in modest recommendations.

In my view, such criticisms should not go unanswered.

Although the Draft does already reflect on community outrage, societal norms, and community values, my recommendation is that the PC consider whether it should enlarge on these matters in its final report and address the external criticisms I have tried to summarise above. This is necessary to answer the critics that the PC has not fully addressed its brief.

3 Shareholder engagement

The value of the Draft is that it has helped expose weaknesses in the ability of shareholders to exercise their ownership rights appropriately. Shareholders are presently limited in their abilities to act by some company constitutions, by some company practices and by some current corporate law provisions.

Because of weaknesses and inefficiencies in the current corporate system and culture shareholders do not and cannot act as an automatic self-correcting mechanism on board decisions on executive or director remuneration.

[5] Productivity Commission Draft Report Terms of Reference Background; page iv; and other statements by the Prime Minister and Cabinet members.

[6] An example of the Government being concerned with quantum is that it introduced a bill to parliament on 24 June 2009 to significantly reduce board discretion and raise mandatory shareholder approval on termination payments.

The Draft usefully follows up on a parliamentary inquiry's recommendations for better and more effective shareholder engagement.[7]

The Draft does comment in passing on barriers to entry to company boards. Its proposal to end the 'no vacancy rule' addresses one aspect of board election processes, but in general (as it was not in its terms of reference) the Draft does not examine non-remuneration barriers to entry and restrictive practices in those corporations that have poor company constitutional provisions, and/or poor board nomination and election practices.

From a competitive, equity and efficiency perspective such barriers to entry and restrictive practices may be worthy of further review.

My recommendation is that the PC add a recommendation that suggests to the Government, that once it has finalised its legislative and regulatory response to the PC report and to the Parliamentary Committee's *Better Shareholders* report, that it should consider whether to further review outstanding issues of weak shareholder engagement, restrictive practices and barriers to entry with respect to company boards and company constitutions.

4 Independence

The Draft emphasises the importance of independence, particularly with respect to remuneration committee members and non-executive directors.

The PC is well aware that just because a director is non-executive that does not necessarily mean that director is independent, and the PC uses the terms non-executive director and independent director to distinguish between the two.

A board committee like a remuneration committee may not be independent if its director members are subject to the patronage or direction of dominant shareholders or individuals. Such a relationship can be both direct and indirect. The ASX Corporate Governance Council fails to fully address this issue.[8] In contrast, WHK Horwath does much better.[9]

The *Corporations Act 2001* lacks definitions or clear criteria for independence, but as the Draft confirms, that does not mean that there are no established guidelines for corporations to rely on.

Independence is characterised by the exercise of objective and impartial judgement, unfettered by conflicts of interest or allegiances.

JCPAA Report 391[10] had some useful insights into independence:

[7] Parliamentary Joint Committee on Corporations and Financial Services *Better shareholders – Better company Shareholder engagement and participation in Australia* report June 2008 Canberra.
[8] Draft page 133 Box 6.1 first dot-point, the ASX Corporate Governance Council uses the narrower '*associated directly*' rather than *'associated directly or indirectly'.*
[9] Draft page 155 footnote to Table 6.5: *(7) ['an independent director is not a member of management and'] 'is free from any interest or relationship, that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company'.*
[10] The Parliamentary Joint Committee of Public Accounts and Audit, Report 391, Review of Independent Auditing by Registered Company Auditors, August 2002.

> The concept of independence is open to various definitions depending on the context in which it is used. In a very general sense, being independent refers to a person or group being self-governing and unwilling to be under obligation to others. More specifically, independence can be seen to have two complementary characteristics:
>
> - a state of mind that allows for opinions to be arrived at without being affected by external influences; and
> - a matter of appearance in that facts and circumstances are avoided that would lead a third party to conclude that a person's ability to arrive at an independent opinion has been compromised.
>
> The independence of the stakeholders in Australia's financial reporting environment is a critical issue.... Independence is important to ensure that a person or group of persons undertake their work professionally, with integrity and objectivity and free of bias and undue influence.
>
> ....
>
> ....the independence of directors is important because they must be in a position to effectively monitor the management of a company and be able to ask management the right, and often difficult, questions in the best interests of both shareholders and the company.
>
> ...[A] core set of mechanisms and criteria in each of the following areas, are common to enhancing the independence of each group:
>
> - appointment;
> - security of tenure;
> - termination; and
> - remuneration.[11]

Full independence is only possible when:

- the method of appointment is objective, on merit, and not subject to patronage, favour, or inducements;
- remuneration is sufficient, profitable and secure for a reasonable period, and not hostage to other services or retainers;
- tenure is reasonable and secure; and
- objective fair and consistent separation or contract-ending mechanisms exist.

Without these elements in place a full independence of mind may not be possible for many, apart from the strong, the virtuous, or the uncommercial.

Where boards' director election processes are less than ideal, independence can be compromised.

Dominant shareholders are common in listed companies. It defies human nature to imagine that where dominant shareholders exist, that some at least of the dominant shareholders would not decide or influence which non-executive 'independent' directors would be

[11] The Parliamentary Joint Committee of Public Accounts and Audit, Report 391, Review of Independent Auditing by Registered Company Auditors, August 2002, paragraphs 1.23-1.30, pp. 6-7.

nominated and elected, and then knowing those directors would be left with a sense of obligation, later seek to influence those directors' decisions to some degree.

In those circumstances that would mean that some directors are under the patronage of a dominant shareholder or shareholders, who will quite naturally seek to ensure that their interests are taken into account.

This dominance and patronage over some directors can not only be reinforced by company constitutions and board behaviour that allow or foster poor director election processes but by weaknesses in corporations law.

I would suggest that the PC should consider whether it could expand on how to deal with patronage and indirect influence.

Nevertheless, in light of these issues, the PC's recommendations to end the 'no vacancy rule', reduce conflicts of interest, and address proxy and voting weaknesses are therefore positive and welcome advances in shoring up and increasing independence.

5 The no vacancy rule

The impact of Recommendation 1 (ending the 'no-vacancy' rule) should not be overstated, but it is a valuable start to increasing the fluidity, variety and independence of some boards.

I support Recommendation 1 on the 'no vacancy' rule which was also examined by the parliamentary committee of which I was a member, (and whose 'shareholder engagement' reference was initiated by me).[12]

Some of the reaction to Recommendation 1 has been disingenuous, in that it is said it may result in larger boards.

Leaving aside that in some cases larger boards, particularly where that means more non-executive directors, are not necessarily a bad thing, the argument that getting rid of the 'no vacancy' rule will result in unwisely expanded and over-large boards does not have merit. In any case the size of boards is a matter for shareholders, via the company constitution.

Shareholders have the right to decide on the size of board they want, subject to advice; and, if experience indicates that board numbers are greater than optimal for a particular company, then it is a relatively simple matter to put forward a company constitutional resolution to change the size of the board.

6 Caps triggers and thresholds

Caps

The Draft rules out caps on salaries. This is the right decision. Market efficiency and competitive forces dictate that remuneration practices need to vary by company, and to be tailored to suit each company's needs.

[12] See Draft page 145 third paragraph.

The Draft recognises that board remuneration process is not always perfect or efficient. The Draft recognises that not all Australian companies meet best practice requirements; conflicts of interest are an issue for some; and board weaknesses are a problem for others.[13]

When the chair is also the CEO

Axiomatically, board 'capture' by management is more likely where the chair is also the CEO. Possibly, 'rent-skimming' by an executive or executives is a greater possibility in those circumstances.

A minority of companies defy the ASX Corporate Governance Council's recommendation[14] against combining the role of chair and CEO.

The Draft (page 137) says that in some companies *'it may not always be best to separate the role of chair and CEO...[but] From the perspective of promoting good corporate governance, separation of the CEO and chair is an important principle'.*

Shareholders have not necessarily had the opportunity to vote on such a combination of roles, which on a conflict-of-interest basis alone can be problematic with respect to setting remuneration.

Not only should separation of those roles be actively encouraged, as the ASX Corporate Governance Council and others do, but the combination of these roles should be able to be tested by the shareholders.

I suggest that the PC should add a recommendation that where the chair of the board is also the chief executive officer then the remuneration of that individual is subject to a binding shareholder vote.

The 25% vote

The Draft only contemplates one trigger and that is in Recommendation 15 – firstly requiring a formal explanation and board response to a 25% 'no' vote on the remuneration report; and secondly, where a substantial 'no' vote of 25% on two consecutive remuneration reports triggers the whole board re-election.

In combination with recommendations ending the 'no vacancy' rule and increasing shareholder engagement by addressing proxy voting and electronic voting problems, Recommendation 15 should have a useful chilling effect on boards that continue to ignore significant shareholder sentiment.

I concur with Recommendation 15, in that it will positively affect board conduct and increase board responsiveness to shareholders views on remuneration.

I have noted the criticism of the second part of Recommendation 15 that a 25% vote could be manufactured to destabilise boards. At best this criticism is overstated.

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[13] See for instance Draft 4.5 page 114.

[14] See Draft 4.3 page 86 and Draft page 134 *Current Practice.*

As an example, Section 203D of the *Corporations Act 2001* (the 100 shareholders rule) already exists as a low trigger for challenging boards; it is seldom used, and even when it is used seldom has real effect.

Wild claims have been made that this 'spill measure' is like 'throwing the Government out'. It is nothing of the sort. If boards as a whole have majority support before the 25% vote, they will retain that support when they are all put up for re-election.

If the PC wants to ensure a higher participation rate to moderate the 25% rule, it could simply recommend that institutions holding shares on behalf of members (and therefore in trust) must vote on remuneration matters.[15]

Trigger on excessive remuneration

The Draft could be viewed as more concerned with poor remuneration practices than with high remuneration. Such an approach is sound from an efficiency and governance perspective, but equity, which focuses on remuneration quantum,[16] remains an issue.

There is no doubt that criticism of the PC arises because despite the outrage and concern that prompted this Inquiry the Draft fails to recommend any penalty or consequence of any kind for those executives who benefit from excessive remuneration, (the PC provides examples of excessive remuneration in Draft Box 1.2).

It is for this reasons that the PC should reconsider its opposition to a threshold-based trigger on excessive remuneration.

The difficulty for the PC is that 'excessive' is a subjective community-based verdict, not easily measured, and bearing little relation to the comparative or benchmarked measures that might be used by remuneration consultants management or boards.

The Draft opposes binding votes, largely because of contractual uncertainty and a reduction in board power. Maintaining contractual certainty is a legitimate concern.

Binding votes are hardly a threat to most companies. When considering the resistance to binding votes, it is worth remembering that historically very few shareholder votes on remuneration have ever exceeded 50% - Telstra 2007 and Wesfarmers 2008 being two of them – and therefore the fears of a binding vote are overstated. The record shows that board resolutions on remuneration are almost always carried.

In passing, it might have been expected that to be consistent with its arguments against binding votes the PC would be opposed to existing binding votes already required for significant elements of executive packages, such as options or share issues, and retirement benefits, but it is not.

[15] For the full argument on institutions being obliged to vote on substantial matters, see my May 2009 submission – PC No 28. As the Draft recognises, in the USA certain types of funds must exercise their proxy vote.

[16] The remarks on quantum quoted in Box 1.7 are noted, but 'tossing the directors out' is not always a desirable option, or (see voting and other issues) a possible option.

With the obvious caveat that remuneration needs to be reasonable relative to the company's size performance and prospects, in general there is no justification for remuneration averaging three times average weekly earnings, or even twenty times, attracting community concern, but one hundred and fifty times average weekly earnings surely does and will. Why else did the Government frame its terms of reference as it did?

The proposal in my May 2009 submission (PC No 28) was that defined *excessive* remuneration of *key executives who are also directors* should be subject to a binding vote by shareholders. (At present the remuneration of directors[17] is subject to a binding shareholder vote,[18] unless it is 'reasonable'.[19])

The PC may have considered this proposal but it is not apparent from the Draft.

The proposition I put was that a binding vote above a threshold would not be automatic unless the executive *with excessive remuneration* wished to remain a director. As at present the non-binding advisory vote would remain for those key executives who are not directors, or for those executive directors below the threshold.

My proposal was that executives enjoying excessive remuneration who did not wish their package put to a binding vote could not also be directors.

Not being able to remain a director would be a signal to the community that there was some consequence, albeit a very modest one, to excessive remuneration.

Non-director executives would still be able to attend board meetings as required by the board. If anything the separation of powers between board and management would be enhanced.

The question is what should be the threshold of remuneration to trigger the potential for a binding vote? It is fair to surmise that if it were to be based on community views it would be considerably lower than a level that might be chosen by remuneration analysts or directors.

A base figure needs to be simple, justifiable, current, easy to administer and self-evidently 'reasonable'. The PC could either take a stab at a community standard, or could adopt a median figure fixed against current data.

As examples, a base could be an absolute figure, (say) above $1 million dollars annually adjusted for inflation, or (say) where the value of the total remuneration exceeds 20 times the full-time adult ordinary time earnings as periodically reported by the Australian Bureau of Statistics.

The value of this proposal (that executives enjoying *excessive* remuneration who did not wish their package put to a binding vote could not also be directors) is that it respects and responds to legitimate and widespread community concern where executive salaries exceed a reasonable multiple of average wages.

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[17] But not all remuneration; of a director's termination payment at present shareholder approval is only required when the director's termination payment exceeds seven times the annual average of the director's total remuneration package over the past three years. This was far too generous. Rightly so, the Government announced in March 2009 that this will be reduced to one year' base salary.
[18] Under ASX listing rules a non-executive director can only receive a fixed-sum payment.
[19] Section 202A, (which is a replaceable rule), *Corporation Act 2001 (Cwlth)*.

The difficulty with this proposal (see Draft Tables 3.4 and 3.5) is that, depending on the threshold trigger used, if it applied to total rather than fixed remuneration, a large number of executives could be caught up in it.

7 Other matters

Recommendation 7

With respect to Recommendation 7 obliging all directed proxies on remuneration resolutions to be cast, it would seem a logical and ethical extension of this principle that it should apply to all resolutions.

Recommendation 12

Recommendation 12 requires institutional voters to periodically disclose their voting record on remuneration matters. I concur with this recommendation but it should go further.

In my May 2009 submission (PC No 28) I argued that institutions who hold shares or make investments on behalf of their members or investors, effectively hold those shares or investments in trust or escrow. Both trust and escrow means there is a positive duty to exercise a fiduciary responsibility.

The trustees and managers of superannuation funds and managed investment schemes have a fiduciary duty to act in the best interests of their investors, members and beneficiaries. Trustees can only satisfy their fiduciary obligations by taking an active interest in material corporate governance matters affecting their equity investments.

The Investment and Financial Services Association (IFSA) standard No 13 'requires' (they have no means to enforce it) members to vote on all resolutions and to publish their voting record.

Unfortunately the scale and variety of resolutions in a multitude of companies makes voting on all resolutions difficult for some institutions to do. The volume of company resolutions across the market would make it doubly difficult for regulators to police, if they had to.

With regard to Recommendation 12, at the very least reporting should apply to the most important votes: constitutional resolutions, the election of directors, as well as on the remuneration, benefits and retirement packages of directors and key executives.

With respect to Recommendation 12 the PC has requested views on stock lending for voting purposes. I concur with the views of the parliamentary committee on this matter:

> 4.30 The committee shares the view of a number of contributors to this inquiry that vote renting should not be permitted. Paying for the voting entitlements attached to securities to achieve a desired voting outcome in no way contributes to good corporate governance. The committee is of the opinion that institutional investors should advise their fund managers not to engage in this practice and this policy should be clearly expressed to members. It also holds the view that the government should investigate an appropriate regulatory framework for ensuring that voting rights are retained by stock lenders.

> *Recommendation 16*
> 4.31 The government should investigate the most appropriate regulatory framework for ensuring that stock lenders retain the voting rights attached to the lent shares.[20]

Finding 1

Finding 1 does not pick up on the community concerns that prompted this inquiry (see Section 1 above). Perhaps the way to address those concerns in this checklist is to include 'reputational risk assessment' as an item.

8 The Draft recommendations overall

The overall question is whether the Draft recommendations would if implemented

- Improve shareholder engagement and the exercise of shareholder rights by improving information availability and useability; and by making effective shareholder action easier
- Improve board performance and conduct
- Reduce excessive risk-taking, and
- Reduce excessive remuneration practices

As a general expectation, on the first dot-point that would seem a likely outcome of the Draft recommendations; the second is a possible outcome; the last two dot-points are less easy to predict.

Undoubtedly however, the Draft recommendations in aggregate represent a positive step forward in addressing these issues.

[20] Parliamentary Joint Committee on Corporations and Financial Services *Better shareholders – Better company Shareholder engagement and participation in Australia* report June 2008 Canberra, page 50.