SUBMISSION TO THE PRODUCTIVITY COMMISSION IN RESPONSE TO ITS DISCUSSION DRAFT REPORT ON EXECUTIVE REMUNERATION IN AUSTRALIA

The Discussion Draft Report of the Productivity Commission on Executive Remuneration in Australia is a well considered and thorough document. It provides an excellent overview of the state of executive remuneration in Australia today and makes a valuable contribution to the debate on remuneration.

While we believe that Australia's regulatory framework for remuneration is robust and not in need of radical overhaul, we agree that the corporate governance framework governing executive remuneration could be strengthened.

Boral supports many of the Commission's draft recommendations and has in fact already adopted several of those recommendations – for example:

- Boral's Remuneration Committee comprises three independent non-executive directors;
- executives are prohibited from hedging unvested equity remuneration;
- at Boral's 2009 Annual General Meeting, directors, key management personnel and their associates did not vote their own shares on the resolution relating to the 2008/09 Remuneration Report, and
- having received a 56% proxy vote against the 2007/08 Remuneration Report, Boral explained, in its 2008/09 Remuneration Report, the fundamental review undertaken by the Board and the Remuneration Committee of Boral's remuneration practices and policies and set out in detail the steps taken to address shareholder concerns expressed at the time of the 2008 Annual General Meeting. Boral received a 93% proxy vote in favour of its 2008/09 Remuneration Report.

We refer below to those of the Committee's draft recommendations with which we disagree or in respect of which we wish to make particular comments.

Draft Recommendation 1 – The Corporations Act 2001 should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).

Comment:

Addressing the 'no vacancy' rule in the manner proposed would not necessarily remove an unwarranted barrier to entry for appropriately qualified individuals to contest board elections, and may well have undesirable consequences for the proper functioning of boards.

Shareholders, through voting on and adopting the Constitution, already determine the maximum size of the board. The chairman and other directors, not shareholders, are best placed to know what size board, within the constraints set by the shareholders in the Constitution, is the most effective for the company. Furthermore, the size of a company's board may fluctuate from time to time – for example, to facilitate a transition of membership.

This proposal would create a tendency to maximise the board size. As suggested in the draft Report, boards might seek to put forward more endorsed candidates to fill the vacancies, leading to bigger and potentially cumbersome boards (and increased fees) without a commensurate increase in the quality of decision-making.

If the objective is to promote greater diversity on Boards, then this is not the appropriate remedy. Such a proposal is likely to encourage vexatious nominations rather than nominations from the appropriately qualified individuals to whom the report refers. To promote greater diversity, there needs to be a focus on the underlying issue – ie how to increase diversity in the key 'feeder group' of senior executives. This recommendation will do nothing to address the underlying problem, and may well lead to a decrease in proper functioning of boards.

Draft Recommendation 6 – The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.

Comment:

In the interests of reducing conflicts of interest, as well as the appearance of conflicts of interest, we believe it is appropriate that directors, executives named in the remuneration report and their associates should not vote their own shares on the remuneration report. Boral adopted this position at this year's Annual General Meeting in relation to the 2008/09 Remuneration Report.

We believe that a distinction should be drawn between a director or executive voting his own shares and the chairman (or another director) voting undirected proxies on behalf of another shareholder. In the latter situation, the shareholder appointing the proxy does so in the knowledge of the conflict. The wish of the shareholder that the chairman should exercise a discretion how to vote, notwithstanding the conflict, should be respected – that is, that shareholder should not be disenfranchised in such circumstances.

If the Commission were concerned to ensure that the shareholder appointing the proxy did so in full knowledge of the conflict of interest, the incorporation in the proxy form of a statement along the lines of that contained in ASX Listing Rule 14.2.3B could be mandated in relation to the resolution on the remuneration report – that is, a statement as to how the chairman intends to vote undirected proxies and requiring the shareholder appointing the chairman proxy to mark a box on the proxy form, confirming that the shareholder does not wish to direct the chairman how to vote on the relevant resolution. By marking the box, the shareholder appointing the proxy would acknowledge that the chairman may exercise the proxy even if he has an interest in the outcome of the resolution and that votes cast by the chairman for that resolution other than as proxy holder will be disregarded because of that interest. This would constitute an appropriate safeguard without disenfranchising shareholders who give the chairman (or other directors) undirected proxies.

We do not believe it is contradictory to provide that on a remuneration resolution directors and executives should not vote their own shares, but may vote as someone else's proxy. Clearly the ASX does not view such a stance as contradictory, having regard to the approach it has adopted under its Listing Rules. For example, in relation to the issue of securities to a director under an employee incentive scheme (Listing Rule 10.14), the chairman may not vote his own shares but may vote undirected proxies, provided an acknowledgment in terms of that referred to in the paragraph above is included on the proxy form.

Draft Recommendation 8 – Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include actual levels of remuneration received by shareholders.

Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.

Comment:

Actual levels of fixed remuneration and variable remuneration (typically short term incentives) paid in cash in the reported year are well defined and easily understood by shareholders.

Long term incentive (LTI) grants or deferred short term incentive values are not easily understood by many shareholders as the values reported are defined by the accounting standard as expensed values which are apportioned over the life of the particular grant.

Various ways of looking at the value of an LTI grant may be considered:

- Expensed value – as expensed in the accounts.

- Actual value received in the period – this would be the value of grants which vest and are transferred to the executive or are exercised by the executive in the period. This value could include grants from several years which may have vested in the reporting year or could be zero if no grants vested in the reporting year.

- Intended value granted in the period. Most companies make an LTI grant based on a value (often a percentage of fixed remuneration) or number of equity units with performance hurdles applying. Therefore, the realised value at some later stage is dependent on the achievement against the performance hurdles. A "fair market valuation" of such grants is done for financial expensing purposes. This should be the intended value of the grant made during the reporting period.

It is submitted that the expensed value may be appropriate for financial reporting but is very difficult for shareholders to understand and often does not represent the value granted to the executive during the reporting period. It should therefore not be included in the Remuneration Report.

To give shareholders the most accurate indication of the LTI component of remuneration granted to an executive in the reporting period, the intended "fair market value" of the LTI grant should be reported. As these grants may or may not vest depending on future performance against performance hurdles, a supplementary disclosure of which previous grants vested during the reporting period should be included.

Draft Recommendation 15 – The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a 'no' vote of 25% or higher, the board be required to report back to shareholders in the subsequent remuneration report, explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why.

If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re-election (a 'two strikes' test) at either an extraordinary general meeting or the next annual general meeting.

Comment:

While it is reasonable to expect a board to report back to shareholders explaining how their concerns have been addressed following a 25% or higher "no" vote on the remuneration report, a requirement to "spill the entire board" following a second negative vote above a prescribed threshold (perhaps as low as 25%) is an extreme and unnecessary step for the following reasons:

- The spilling of an entire board would have a significant destabilising effect on a company.
- There can be many reasons why various shareholders may vote against a remuneration report. The reasons may not be common among those shareholders (and may in fact be mutually exclusive). Therefore a 25% threshold could be exceeded by a small number of shareholders in some instances.
- Shareholders already have an opportunity to vote on the election of directors annually.
- Shareholders already have the right to requisition the directors to convene a meeting to consider a spill of the board.

- Such a rule would potentially give a small number of shareholders the opportunity to spill a board and destabilise a company through rejection of the remuneration report when their real motivation may be something entirely different. A large shareholder may have reasons to destabilise the board which are unrelated to the remuneration report – for example, in contemplation of a bid, to support short selling of the stock.

Boral Case Study:

At Boral's 2008 Annual General Meeting, the vote on the remuneration report was not carried. Within one week the Boral Remuneration Committee met and commenced a fundamental review of Boral's remuneration policy and practices. An independent remuneration adviser was selected and appointed by the Remuneration Committee to carry out the review, working with management and reporting to the Remuneration Committee. The review was carried out over five months with regular reporting back to the Remuneration Committee and through it to the Board. An extensive consultation process was undertaken with institutional shareholders, retail shareholder representatives and governance advisory firms. This consultation process involved Boral directors and management and included obtaining feedback and advising the review outcomes.

A number of changes were made to Boral's remuneration practices and the Remuneration Report was extensively restructured within the constraints of the reporting requirements to provide shareholders with more information in an easier to understand format. The 2008/09 Remuneration Report received a positive proxy vote of 93%.

It is submitted that a "two strikes" rule is an extreme reaction and is unnecessary as a requirement that the Board report back to shareholders following a 25% or higher "no" vote is sufficient to ensure appropriate board attention and action.