6 November 2009

Freehills

Submission

Regulation of Director and Executive Remuneration in Australia

1 Introduction

This submission is made to the Productivity Commission (**Commission**) in response to the Discussion Draft released on 30 September 2009 as part of the Commission's inquiry into the Regulation of Director and Executive Remuneration in Australia (**Draft Report**).

Freehills **supports Draft Recommendations 8 and 9** that are intended to improve the content and accessibility of remuneration reports and remove superfluous disclosures.

Freehills also **supports Draft Recommendation 13** which recommends the removal of the cessation of employment as a trigger for taxation of equity-based payments. The payment of income tax on equity at termination of employment even where there is a 'real risk of forfeiture' in practice precludes companies from ensuring sustainable long term alignment between company performance and remuneration.

Draft Recommendations that Freehills does not support, or does not support in their current form, are discussed in further detail below. Freehills considers that those recommendations will result in significant disadvantages that outweigh any perceived benefit.

Draft Recommendations that are not dealt with in this submission are neither endorsed nor opposed.

2 Draft Recommendation 1 – End the 'no vacancy' rule

Draft Recommendation 1 provides that the Corporations Act 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).

Freehills does **not support Draft Recommendation 1**. Freehills recognises the value and necessity of board diversity, but does not believe that the removal of the 'no vacancy' rule is an effective means of increasing board diversity.

The removal of the no vacancy rule is not an effective means of addressing any lack of board diversity. Rather, the removal of the no vacancy rule may have the adverse effect of restricting the board's ability to adapt and adjust to changing strategic and operational circumstances of the company. The board is almost certainly in a better position than shareholders to determine the appropriate size of the board from time to time, recognizing that board size can be critical to the effectiveness of the board.

Shareholders will always have the capacity, by a majority vote, to remove and replace any director should they wish to do so. Shareholders also have the opportunity, at each annual general meeting, to consider new candidates who wish to stand against those seeking re-election. These measures adequately provide shareholders with the ability to drive board change, without the need to remove the no vacancy rule.

Freehills does not consider that an inquiry into the remuneration of directors and executives is an appropriate forum for a review of board diversity. Board diversity is an

issue that is independent from remuneration and should be addressed in a separate, targeted review.

3 Draft Recommendation 4 – Key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration-related resolutions

Draft Recommendation 4 provides that the Corporations Act should be amended to prohibit company executives identified as key management personnel (**KMP**) and all directors (and their associates) from voting their shares on remuneration reports and any other remuneration-related resolutions.

Freehills does **not support Draft Recommendation 4**. As shareholders, KMP and directors have the same voting rights as all other shareholders. The ASX Listing Rules already exclude directors from voting on certain matters. Further restricting the voting rights of KMP and directors will unfairly disenfranchise them.

The interests of KMP and directors, in *their capacity as shareholders*, is of the same nature as all other shareholders and should not be treated otherwise. To do so would unfairly disenfranchise KMP and directors in their capacity as shareholders – recognising that where their aggregate votes are likely to be significant, this will be transparent to the market.

By way of analogy, directors are entitled to vote their shares in respect of their own election – voting their shares in this context is not considered to be an inappropriate conflict of interest because the director *as a shareholder* of the company ought to be entitled to vote in respect of the composition of the board.

4 Draft Recommendation 15 – 25 per cent 'no' vote on remuneration report triggers formal explanation and response and substantial 'no' vote on two consecutive remuneration reports triggers board election

Draft Recommendation 15 provides that the Corporations Act should be amended to require that where a company's remuneration report received a 'no' vote of 25 per cent 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 received 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.

Freehills does not support the second limb of Draft Recommendation 15.

In our view requiring boards to include an explicit statement in the remuneration report explaining how concerns raised the previous year have been addressed merely codifies the existing practice. In contrast, the 'two strikes' approach has several significant disadvantages.

In the event that the 'two strikes' approach is adopted, the threshold for the second year should be at least 50 per cent so that the vote represents the opinion of the majority of the voting shareholders. Freehills supports the Commission's view against adopting a binding vote on the remuneration report.

In our view, the reporting obligations of corporations, the statutory and general law duties of directors and mechanisms for shareholder action already provide a strong framework for board accountability in respect of remuneration issues, including in relation to the quantum

and structure of remuneration and the adequacy of linkages between remuneration and the performance of the company.

Our submission to the Commission in response to the Issues Paper released on 7 April 2009 outlined, in detail, the mechanisms to ensure board accountability.

In our experience boards take their obligations seriously, and have been particularly active in responding to advisory votes. Where a significant 'protest' vote has been received, companies have taken considerable measures to address this, including re-assessing their remuneration framework and engaging in dialogue with institutional shareholders and proxy advisers. Requiring boards to include an explicit statement in the remuneration report explaining how concerns raised the previous year have been addressed merely codifies the existing practice.

However, Freehills considers that mandating the re-election of all directors upon a remuneration report receiving two consecutive 'protest' votes has several significant disadvantages which will reduce the board's practical control over, and ironically, their responsibility for, the remuneration setting and structuring process. It serves to erode accountability to the detriment of the company and its shareholders.

The instability and uncertainty resulting from the 'two strikes' approach, particularly where it is set as low as 25 per cent, will inappropriately distract board and management and adversely impact on the governance of the company. In the event that a significant percentage of the board were removed as a result of the 'two strikes' approach, the company will lose continuity, stability and reputation and may not be in a position to readily refresh that balance.

The existing three year cycle under ASX Listing Rule 14.4 ensures that shareholders are able to refresh boards at appropriate intervals without the risk that boards will lose continuity, especially where, as is still relatively common, one third of the board retires and seeks election at each annual general meeting.

There is also a real risk that the 'two strikes' approach, if set at a level below 50 per cent, may be misused as a vehicle to engineer a board spill.

Freehills notes that the perceived benefit of introducing a 'big stick' consequence for two consecutive significant 'protest' votes has the same disadvantage as the flawed proposal to introduce a 'binding' remuneration report vote. While institutional shareholders have been willing to send a protest vote through the non-binding advisory vote (because they are able to do so without damage to the company and their investment), they are not likely to do so where that 'protest' vote could actually result in a board spill. This will, in effect, 'silence' institutional shareholders who will not wish to risk a board spill.

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Freehills

Head Office Advisory Team

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