6 November, 2009

The Commissioners
Executive Remuneration Inquiry
Productivity Commission
Level 28, 35 Collins Street
Melbourne Vic 3000

Dear Commissioners,

In my opinion, *Executive Remuneration in Australia: Discussion Draft* is a generally measured response to shareholder and community concerns about executive remuneration. However, for reasons submitted below I am concerned that "facilitating shareholder engagement" in executive remuneration processes by way of increasing the power of shareholder votes (Draft Recommendation 15) is very likely to have the unintended consequence of imposing substantial losses of wealth on some shareholders, notably shareholders in companies that for various reasons are inherently difficult to manage. Such losses would be reflected in less efficient use of resources and, consequently, lower living standards for Australians generally.

Traditionally the appointment and remuneration of executives in public companies has been delegated to boards (and frequently by boards to subsidiary remuneration committees) rather than being determined by shareholder voting. Presumably, the reason for this is that a small group of specialist decision-makers is likely to be collectively far better informed in dimensions relevant to remuneration decisions than all except tiny minorities of shareholder. The smaller group is therefore more likely to make decisions consistent with maximization of shareholder wealth than shareholders collectively. The kinds of information essential for wealth-maximizing appointments and remuneration arrangements include:

- the idiosyncratic knowledge and skills required for satisfactory performance in a given executive position;

- the performance of an incumbent executive, either in absolute terms or relative to an executive occupying a similar position in a similar company;

- the alternative opportunities open to an incumbent executive; and

- the qualities of possible replacements for an incumbent, and the alternative opportunities open to possible replacements.

The performance of public companies over time (notably over more than 200 years preceding the introduction of non-binding shareholder votes) in competition with other organizational forms (private companies, co-operatives, worker-managed firms) is strong evidence of the efficacy of delegation and, importantly, also of effective control of agency costs resulting from separation of ownership and management. In particular, leadership transitions, which can seriously impair performance in some organizational forms (e.g. family-owned companies, political parties), are generally effected relatively smoothly by boards in public companies. Termination payments play an important, although perhaps not sufficiently widely appreciated, role in smoothing these transitions.

One reason for the efficacy of the traditional remuneration processes is that, although the power of shareholder "voice" was largely constrained, the ease with which shares can be traded gave shareholders substantial and effective indirect "exit" power over the determination of executive remuneration. Both boards and managers were indirectly disciplined through their recognition that justifiable shareholder dissatisfaction with the remuneration/performance relationship of a company would place negative pressure on share prices, thereby increasing its vulnerability to takeover.

Related considerations bear on the issue of facilitating shareholder engagement. An advantage of exit power in the context of public company governance is that the transaction costs associated with share disposal (e.g. brokerage) discourage shareholders from exercising the power capriciously. The relatively recent introduction of non-binding votes on remuneration in Australia and other countries seems not to have had detrimental consequences (perhaps even desirable consequences). However, there is a risk that, because of its low cost, the power of "voice" may be used to mobilise extraneous sentiments rather than primarily to strengthen the pay/performance relationship. For example, it may be used to express disappointment associated with negative investment outcomes caused by factors other than deficient management or dissatisfaction with the distribution of income and wealth in society.

To be disappointed is entirely human. Ambitions to reduce inequality are legitimate and understandable, but reforming company law is simply not a sensible approach to achieving them. In my opinion, there is a danger that strengthening shareholder engagement will undermine the governance of public companies by empowering shareholders to pursue extraneous objectives at low cost to themselves but substantial costs for other shareholders. The risk will be inversely related to the percentage of the shareholder vote required to reject a remuneration report.

In evaluating the likely consequences of facilitating greater shareholder engagement in executive remuneration by way of voting on remuneration reports, it is instructive to focus on recent cases of shareholder disaffection with companies such as Pacific Brands, Qantas and Telstra. In my opinion, there are circumstances which make each of these companies inherently difficult to manage and which make reliable performance evaluation extremely difficult, ***notably for shareholders***. Pacific Brands faces continuing pressure to restructure and reorganize as a result of increasing competition from imports, This pressure is exacerbated by a strengthening Australia dollar. Qantas faces

competition from overseas companies enjoying soft budget constraints deriving from oil wealth and government ownership. This is exacerbated by the effects of union power on costs and perhaps the global financial crisis. Telstra management is obliged to cope with rapid technological change in a complex set of markets, regulatory uncertainty and perhaps the need for continuing "cultural change" deriving from the era of government ownership. The circumstances of each of these companies severely complicate assessments of performance of these companies and especially the performance of their managers.

Since each of these companies has valuable assets (market capitalization of Pacific Brands approximately $1.1 billion; Qantas approximately $6 billion; Telstra approximately $40 billion) in assessing the merits of Draft Recommendation 15, attention should be focused on its implications for management beyond the immediate future. Consider the future consequences of a first instance of shareholder disapproval of a remuneration report by more than 25 per cent of shareholders as envisaged under Draft Recommendation 15. The vote might elicit better performance by incumbent executives. However, if a disapproval vote is tainted by shareholder failure to take adequate account of inherent management difficulties the pool of candidates for any future senior executive vacancy in the company is likely to be smaller and of lower quality than otherwise. This is likely to be especially so and if there is perceived risk of a subsequent disapproval vote by shareholders. This would tend to erode management quality and consequently the value contributed to the company by future appointees would be lower than otherwise, to the detriment of shareholders. For parallel reasons, the qualities of future non-executive board members are likely to be eroded, again to the detriment of shareholders. A little reflection suggests the possibility of downward spiraling quality of management, perhaps ending in company demise. In this respect it may also be illuminating to reflect on whether management quality in the Detroit motor corporations was gradually eroded over time because of the reluctance of high quality managers to risk their reputations by accepting posts, either as executives or board members, in corporations which had become inherently difficult to manage because of essentially politically-imposed employee entitlements.

Two consecutive shareholder disapprovals are likely to have similar but stronger effects on management quality. Moreover, the resultant "spill" and subsequent election of board members seems likely to increase uncertainty about the future of the company, thereby compounding the difficulty of managing it. In particular, given that candidates for board position can be nominated any shareholder, there is a risk that such an election will produce a board lacking coherence and cohesion.

In conclusion, my concern is that Draft Recommendation 15 can be expected to systematically erode over time the future quality of executives and board members of companies such as Pacific Brands, Qantas and Telstra to the detriment of shareholders.

The Commission's recommendations for improving board capacities, reducing conflicts of interest and improving relevant disclosure seem likely to be either efficacious or

innocuous. In this respect, Cremers and Romano (2009) find that mandating mutual fund voting disclosure had little, if any, effect on board behaviour.

I look forward to your final report

Yours sincerely,
Geoff Hogbin

Reference

Cremers, Martijn and Romano, Roberto. 2009. "Institutional investors and proxy voting on compensation plans: the impact of the 2003 mutual fund voting disclosure regulation", mimeo, NBER Working Paper Series, Working Paper 15449, http://www.nber.org/papers/w15449.