Kym Sheehan

6 November 2009

Commissioner Banks AO,
Assistant Commissioner Fitzgerald AM and
Assistant Commissioner Fels AO
Productivity Commission Inquiry into Executive Remuneration

Via email: exec_remuneration@pc.gov.au

Dear Commissioners

Submission in response to the Productivity Commission's Draft Report (September 2009)

Please find enclosed my submission in response to the Productivity Commission's Draft Report.

Please let me know if there is any further information I can provide to assist the Commission.

Yours sincerely

Kym Sheehan

The purposes of the review

As noted by the Commission in its report, a catalyst for this review was ‘a concern that executive pay has got out of hand’. The broader societal concern about the growing gap in remuneration of executives with those of ordinary workers is also mentioned in the Overview chapter.

The five areas for reform noted are

- Improving board accountability
- Avoiding conflicts of interest
- Enhanced disclosure and communication
- Promoting efficient incentive alignment
- Encouraging shareholder engagement.

Approving accountability of all parties involved in remuneration is crucial and thus the restriction in the report to considering only the board’s accountability is insufficient. Given the interests of superannuants in ensuring good company performance, and the relationship between company performance and executive pay, it appears important for superannuation trustees to not only engage with companies on remuneration practices, but for there to be some measure of accountability to their beneficiaries. This may well be addressed by the first phase of the Super System Review (Governance).

Promoting efficient incentive alignment is to be addressed by a remuneration checklist set out in Draft Finding 1. The focus is to ensure better remuneration policies, with the assumption that better remuneration policies equates to better remuneration outcomes. My concern is that the checklist will be used to drive disclosure, not necessarily practice. Given today’s remuneration outcomes reflect policies previously disclosed, the sources of poor remuneration outcomes are (1) poor policies and (2) poor application of policies, the checklist addresses (1) but does not adequately address (2). *In particular, the checklist needs to make explicit reference to the exercise of board discretion within policies: when will it be exercised, the parameters in which it will be exercised and, ex-post when it has been exercised.* The post-remuneration evaluations might go someway towards addressing (2) but in essence remuneration committees can respond to this requirement by saying ‘yes, they have and the outcomes all relate to the remuneration policy’ which, if the policy is poor, might mean poor outcomes.

The checklist needs to be one that will ensure not only better policies are made but that they are also result in better outcomes.

Further issues not identified in draft recommendations

Three particular issues not addressed in the draft recommendations, but warranting further consideration are shareholder voting on grants of equity to key management personnel, the widening gap between executive remuneration and ordinary wages and government policies goals for executive remuneration.

Shareholder voting on grants of equity-based remuneration

Consideration should be given to moving LR 10.14 resolution requirements to the *Corporations Act 2001* (Cth) with a voting restriction for directors, KMPs and their associates. There should also be sanctions against 'persons involved' for contraventions of this requirement.

This appears consistent with the general thrust of the draft recommendations towards avoiding conflicts of interest. Placing it within the Act allows for the wide range of sanctions that can be imposed by ASIC under the *Corporations Act 2001* (Cth), when compared with sanctions that can be imposed for a breach of the ASX Listing Rules.

Widening gap

If the widening gap is a concern, then one way of addressing this is to begin by introducing disclosure of this gap. A further recommendation that the Productivity Commission should consider is to amend s 300A to require disclosure along the lines proposed by the Private Members' Bill initiated in the House of Lords, the Companies' Remuneration Reports Bill 2008 (UK), set out briefly below.

After section 430 (quoted companies: annual accounts and reports to be made available on website) insert—

"430A Annual accounts and report: public quoted companies

(1) Every public quoted company, as defined …***shall publish on the first page of the chairman's statement, chief executive's statement, or directors' report, whichever comes first in the annual accounts and report, the ratio between the total annual remuneration of the highest paid director or executive and the total annual average remuneration of the lowest paid ten per cent of the workforce.***

(2) The ratio referred to in subsection (1) shall appear in bold type on the first page of the chairman's statement, chief executive's statement or directors' report.

(3) The total annual remuneration of the highest paid director or executive and the total annual average remuneration of the lowest paid ten per cent of the workforce shall also appear in bold type in the text of the annual accounts.

…

(5) In this section, "the lowest paid ten per cent of the workforce" means the ten per cent of people who have been on the company's payroll during the previous financial year and received the lowest annual remuneration.

(6) The remuneration of any person employed on a part-time basis, or not employed for the full year, shall be calculated on a pro-rata basis.

(7) The requirement to publish the ratio, as stated in subsection (1), applies equally to electronic versions of the report and the term "publish" shall be construed accordingly."

While this recommendation alone won't reduce the widening gap, it is hoped that just reviewing the draft of the remuneration report (assuming it is, in fact, reviewed by the remuneration committee and the board prior to inclusion in the annual report), might give the board something to reflect upon. It also provides shareholders, employees, the broader community and other stakeholders with information on these issues.

Government policy goals for executive remuneration?

Analysing the proposed reforms against the regulated remuneration cycle (Sheehan, 'The regulatory framework for executive remuneration in Australia' (2009) 31 *Sydney Law Review* 273) shows that these are directed towards improving shareholder voting rights, accountability mechanisms (remuneration consultant briefings, proxy appointments, institutional investor voting records) and shareholder engagement.

What is absent is a recommendation that the Federal Government develop and promulgate a policy on the regulation of executive remuneration in terms of the practice outcomes sought from the regulation, when governments will intervene and how that policy might be adopted via amendments to the

- *Corporations Act 2001* (Cth) and regulations, and
- Taxation Initiatives.

Comments on draft recommendations

Draft recommendation	Agree
1. Shareholders in general meeting to set maximum number of serving directors at a given time	No comment
2. ASX Listing Rules amended for ASX 300 companies: must have a RemcCo of at least 3 directors, with majority independent	Committee should only consist of independent non-executive directors. Consideration should also be given to specifying the requirements for skills and expertise for this committee, although this might be best addressed by amending the ASX Corporate Governance Recommendation 8.1
3. ASX CG Recommendation 8.1 to be elevated to reporting on a 'comply or explain' basis	Seems a sensible requirement to address conflicts of interest issues and aligns with suggestions for the briefing of remuneration consultants. If ASX CG Council does not agree, then this should be monitored further to see if it creates problems. Given a choice between introducing recommendations 2+10/11 or introducing recommendations 3+10/11, 2+10/11 is to be preferred.
4. Voting restrictions to be included in CA 2001 for RRV and other remuneration-related resolutions	Aside from the resolution on the remuneration report in s 250R(2), voting restrictions already exist for remuneration-related resolutions • S 208 related party-transactions (s 228) • LR 10.14 issues of securities (LR 10.15) • Does not exist in current legislation (as at 2 November 2009) for termination payments approved under s 200E, but is addressed in the Corporations (Improving Accountability on Termination Payments) Bill 2009 (Cth), Schedule 1, part 1, clause 22. The proposed restriction appears consistent with existing restrictions: Directors/ KMPs and their Associates cannot vote.
5. CA 2001 to be amended	Currently there is a requirement for companies to

Draft recommendation	Agree
to ban executives from hedging unvested – share-based rem and any shares vested but subject to holding locks	disclose details of any policy in respect of hedging by executives: s 300A(1)(da). Maybe the next stage is to require disclosure to company's board of any such arrangements as an addition to s 191's requirements.
6. Amend CA 2001 to prohibit directors and executives who hold undirected proxies from voting proxies 7. CA 2001 to be amended to require proxy holders to cast all directed proxies on remuneration related resolutions	Recommendations 6 and 7 should be considered together. Should shareholders be able to appoint a proxy to vote at the proxy's discretion? In essence, an undirected proxy is a vote for the management position on any particular resolution. I question whether this is the amendment that really should be made: no undirected proxies on any resolution. Recommendation 7 is a welcome change, but if this amendment is to apply to all resolutions (not just remuneration resolutions) in essence the recommendation requires shareholders to express an intention when they make a proxy appointment if their vote is to count. In other words, the intention must set out for each resolution that the proxy vote for, vote against or vote withheld. *An alternative* is to amend s 250A(4)(d) to say that a proxy must vote on a poll and must vote the way they are instructed for all resolutions. This can lead to amendments to s 250A(5) and perhaps giving disaffected shareholders some right of redress against the proxy in the *Corporations Act 2001* (Cth). The proposed alternative imposes a positive obligation to vote and to vote the way instructed, rather than what Professor Davies describes as a negative obligation not to vote contrary to the instructions (Paul Davies, *Gower and Davies' Principles of Modern Company Law*, 8th Edition (2008), 458-459.
8. Amendments to s 300A	The proposed Plain English Statement of policies is welcome, but better companies probably do this already. If there is a need to set some standards for the overall readability of remuneration reports, maybe amend s 300A to include something about readability etc, along the lines suggested by the case law for notices of meeting: fully and fairly inform shareholders about remuneration policies and outcomes, readable by an ordinary man or woman of commerce and, like the financial statements, present a true and fair view of remuneration practices. While the suggested change to require disclosure of the actual remuneration received, there is still a need to disclose potentials. Support for this is also evident in Draft Recommendation 1's list of principles, which speaks of sensitivity analyses in relation to bonus payments and 'post-remuneration evaluations'. Today's policy can lead to tomorrow's poor practices, so shareholders need to understand how policies not

Draft recommendation	Agree
	only do work, but might work. The change to require the total shareholdings for each director and KPM reported to be disclosed is welcome. The final change to require accounting for equity at fair value only in financial statements is fine; but within the rem report itself (and thus part of the vote) there needs to be clear reporting of number of equity instruments granted, the price and conditions for vesting and on termination. A proposed additional change is to require disclosure under s 300A(1)(a) not only of policies that applied during the period reported, but also any changes made to the policy for the year/years ahead.
9. Amend CA 2001 so that Rem Report only requires disclosure for KMP	Agree: this might address issues of overly long reports.
10. ASX LR amendment – ASX 300 RemCos only can brief Rem Consultants and advice provided directly	Recommendation 10 and 11 should be considered together with recommendations There is a need to be realistic about the information needs of the remuneration committee, given it is a committee of non-executive directors. While requiring that remuneration committees alone brief remuneration consultants and that any report is supplied directly to the remuneration committee is a good initiative, short term incentives are linked with business plans and budgets developed by management. If the CEO and the senior management team are to be allowed to manage, then remuneration cannot be developed 'in a black box' by the remuneration committee.
11. ASX CG Council make recommendation to disclose information on expert advisors to company (not remco?) on rem matters	
12. Institutional investors to disclose at least annually their voting record for remuneration report votes and other rem related resolutions	Agree with this recommendation. The disclosure should be public via website and, for superannuation funds, should be provided in annual reports to members, or else available via the fund's website. A further recommendation that could be made is to require public disclosure of the superannuation fund's engagement and voting practices: does the superannuation trustee delegate voting decisions to its fund managers or does it retain discretion to direct the vote (and when will it/has it exercised this discretion), does it retain a proxy advisory firm, how does it undertake engagement activities and what is the outcome of those activities?
13. Cessation of employment trigger for tax on SBPs removed	No comment
14. ASIC to issue a public confirmation on legality of electronic voting	Appears to be a reasonable recommendation.

Draft recommendation	Agree
15. 25% against – formal explanation and response and 'Two-strikes' rule: 25% against RRV in two consecutive years results in entire board being up for re-election.	I disagree with this recommendation: remuneration reports are the wrong issue for this type of right. This would appear to be more appropriate if, instead of merely tabling the annual report and accounts, there was an advisory vote to adopt the Annual Report and Financial Report? Then a 'two-strikes' rule might be appropriate, but it would need to be consistent with the majorities required for an ordinary resolution. If there is a need to provide a mechanism for shareholders to hold boards accountable for remuneration decisions, then director re-elections are already conducted annually and could be used. There is nothing to suggest that an additional right is needed. The 25% threshold is inconsistent with practice where only a majority vote under an ordinary resolution is required to adopt a remuneration report. Waiting until next AGM is preferable to EGM as additional costs and allows time for identifying suitable new director candidates and for existing directors to consider their position.