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10 November 2009

Director and Executive Remuneration Inquiry
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne VIC 8003

By email: exec_remuneration@pc.gov.au

Dear Sir/Madam

Productivity Commission Discussion Draft on Executive Remuneration in Australia

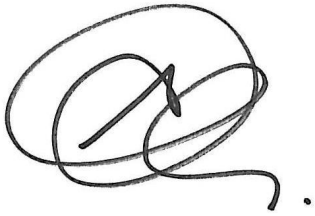
Thank you for the opportunity to comment on the Productivity Commission Discussion Draft on Executive Remuneration in Australia (Discussion Draft). CPA Australia has considered the above Paper and our comments follow.

CPA Australia represents the diverse interests of more than 122,000 members in finance, accounting and business in 100 countries throughout the world. Our mission is to make CPA Australia the global professional accountancy designation for strategic business leaders. We make this submission not only on behalf of our members and in the broader public interest.

CPA Australia's response is limited to comments about remuneration committees, remuneration report disclosures, determining who should have detailed remuneration disclosures and the "two strike" policy. We find the bulk of the other recommendations highly commendable and we will leave it to other respondents to the Discussion Draft to identify any shortcomings or potential for unintended consequence. Our detailed comments and recommendations on the above issues are included in Appendix 1.

If you require further information on any of our views, please contact John Purcell, CPA Australia Policy Adviser Corporate Regulation via email john.purcell@cpaaustralia.com.au.

Yours sincerely



Alex Malley FCPA
Chief Executive Officer

cc: J Purcell

Appendix 1

Draft recommendations 2 and 3 – remuneration committees

CPA Australia supports recommendation 3 to elevate the ASX Corporate governance Council's current suggestion on the composition of remuneration committees to a 'recommendation' within the Principles.

However we consider that recommendation 2 should be consistent with recommendation 3 regarding composition of remuneration committees and should not place an unnecessary burden on companies when they become part of the ASX 300. Further, in many circumstances, the involvement of the CEO or MD on the remuneration committee is valuable, as this committee will look at many other areas of remuneration other than the CEO or MD salary. Therefore, we would propose removal of the words 'all of whom are non-executive directors' from recommendation 3.

Draft recommendation 8 – remuneration report disclosures

CPA Australia supports the disclosure of 'actual' or 'realised' levels of remuneration as part of recommendation 8, although suggest that this is limited to equity rights (as this is the only area of confusion) and is defined in a manner that utilises existing methodologies. We consider the value assessed to taxation in the hands of the executive would be an appropriate methodology in determining 'actual' or 'realised' levels of remunerations. This methodology is enshrined within the current Australian tax law and therefore will not create any significant additional compliance burden on corporates.

We agree that the remuneration report is a better place to disclose equity holdings by individual key management personnel. However, we advise that this will essentially duplicate the disclosures required by AASB 124 *Related Party Disclosures* in the financial statements. In order to reduce the potential for duplication, we would encourage the Commission to make a recommendation to government to consider removal of all the Australian specific paragraphs in this accounting standard (applying to companies and disclosing entities) and if these disclosures are determined necessary by law, they are included in the remuneration report or another relevant section within the Corporations Act.

Draft recommendation 9 – determining who should have detailed remuneration disclosures

We fully support the removal of the top 5 executive disclosures in order to focus disclosure of detailed information on individual 'key management personnel' as defined by AASB 124. However, we do not support confining detailed individual disclosures to the CEO and 'top key management personnel'. This will create additional complexity and confusion around determining who are 'top key management personnel' versus 'normal key management personnel' as compared with 'key management personnel'.

Draft recommendation 15 – facilitating shareholder engagement

Draft Recommendation 15 is that which has generated greatest attention in the media and business domain. CPA Australia considers it important to identify how the underlying objective of the Recommendation might be achieved whilst addressing the various concerns which have been put forward in relation to the 'two strikes' test.

The first element of the Recommendation - board response to a 25 per cent or higher no vote under s 250R(2) - is acknowledged as highly commendable. It is further recognised that the Productivity Commission has rejected as inappropriate any move to capping of executive remuneration. As such, Draft Recommendation 15, along with many of the other recommendations, emphasise the empowering of shareholders and the strengthening of the relationship between boards and members in terms of improved governance practices. It is with these broader objectives in mind that the following observation and suggestions are made in relation to the 'two strikes' test.

The "replaceable rule" option is CPA Australia's preferred position for the reason that it preserves the intent and structure of Draft Recommendation 15, but gives greater discretion to its application. Two other options - "members' rights and remedies" and "capacity to obtain information about executive remuneration" option are presented as alternative means of empowering shareholders in relation to oversight of executive remuneration. However, they do not represent CPA Australia's preferred position. Each, as with the 'two strikes' test element in Draft Recommendation 15, would involve incremental development of the law which should be viewed with caution. Finally, the "development of supporting guidance" may offer a procedural approach to draft Recommendation 15's spill of board position – this is based on procedure adopted in relation to shareholders powers to initiate the removal of a company's auditors. A drawn out procedure along the lines of auditor removal could negate precipitous or vexatious shareholder actions and give time for a fuller consideration of the matter at hand. A procedural approach is not CPA Australia's preferred position, rather, it is provided for completeness.

Replaceable rule

The Corporation Act 2001 contains numerous sections that are signposted as replaceable rules. Section 141 provides a table of replaceable rules and s 135 sets out the procedure by which such rules come into effect, and in particular, the basis of the corporate constitution to modify or displace a replaceable rule. It is recommended that consideration be given to introducing Draft Recommendation 15 as a replaceable rule. This would enable shareholders to deliberately choose whether or not the proposed power would be applicable through specific modification of the corporate constitution (s 136(2). Additionally, this measure would give greater certainty and reflect the contractual character of the corporate constitution (s 140).

Members' rights and remedies

It is fair to conclude that the Commission in its deliberations has adopted the view that it is shareholders who are most adversely affected by excessive executive remuneration and should thus be appropriately positioned, as a last resort, to compel moderation.

The division of corporate powers in which directors are vested by statute (s 198A) or by corporate constitution with responsibility for management of the company's business, is accompanied by provisions which enable the shareholders to seek a court order in relation to the affairs of the company where, for instance, conduct is contrary to the interests of members as a whole. The powers granted to courts under these provisions are extensive, including the making of a winding up order, but can on the other hand be highly targeted in relation to regulating the company's affairs in the future. Noteworthy are the comments of the authors of *Ford's*[1] concerning the basis in the Oppressive Conduct of Affairs[2] provisions for capacity of shareholders to challenge and have set aside directors' remuneration.

Whilst the courts have consistently expressed a reluctance to intervene in matters of management (see for example the Privy Council's remarks in *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832) a limited extension of the members' remedy provisions to address concerns about excessive remuneration, we suggest, is on more radical, and indeed possibly more targeted, than the proposal for a spill of board positions.

Capacity to obtain information about executive remuneration

A clear dichotomy is drawn in corporate law between shareholder oversight of the setting of directors' remuneration and the determining of executive remuneration as a function of directors' powers of management. The intention of Draft Recommendation is to enable shareholders to have greater influence in the setting of executive remuneration. Such objective might alternatively be achieved through a limited extension of shareholders' powers in relation to directors' remuneration to matters of executive remuneration.

[1] R P Austin & I M Ramsay, *Ford's Principles of Corporations Law* 13th ed. LexisNexis Butterworths, Australia (2007) p 256.
[2] Pt 2F.1

Shareholder rights in relation to director remuneration is based on governance and fiduciary principles, whereas the determining executive remuneration, is seen as falling within the domain of directors powers of management - each of these approaches is grounded in long standing common law principles. Concerning the remuneration of directors s 202A(1) provides the following:

Remuneration of directors (replaceable rule--see section 135)

(1) The directors of a company are to be paid the remuneration that the company determines by resolution.

Working on the principle that directors cannot without fully informed shareholder consent, divert to themselves property that belongs in law or equity to the company, the remunerating of directors is thus a matter for decision by shareholders. In its *Corporations Commentary*, CCH states the principle in the following terms:

> "At common law, directors are not entitled to remuneration unless they can point to an express authorisation for payment in the company's constitution."

That this principle of express authorisation is governed by the notions of a division in corporate powers and the contractual basis of the corporate constitution, is further emphasis in CCH's reference to the following judicial remarks:

> "Directors have no right to be paid for their services, and cannot pay themselves or each other, or make presents to themselves out of the company's assets, unless authorised so to do by the instrument which regulates the company or by the shareholders at a properly convened meeting."[3]

As a matter of practice then, remuneration of directors is governed by the replaceable rule[4] s 202A, or where this is opted out of, by the company's constitution which may in turn make provision either by way of resolution of shareholders or direct provision for the determining of the amount and form of remuneration to be delegated to the board.[5]

The understanding of the distinction between shareholders powers and rights in relation to the setting of director remuneration and directors' powers of management extending to the setting of executive remuneration, is also addressed in the *CCH Corporations Commentary* on s 202A, in this instance with reference to the words contained in Article 80 of the former Table A (model articles of association):

> " - - - a managing director shall, subject to the terms of any engagement entered into in a particular case, receive such remuneration (whether by way of salary, commission or participation in profits, or partly in one way and partly in another) as the directors determine."

Of particular note, the Corporations Act in s 202B makes provision for shareholders to obtain information about directors' remuneration, subject to relatively low thresholds of voting entitlement (a 5% voting or 100 member rule). Potentially then, these powers could be extended to executive remuneration in a targeted and limited manner, say in relation to key management personnel, operating at a higher voting threshold and a requirement of the members acting bona fides.

Development of supporting guidance

One of the criticisms of Draft Recommendation 15 is that it is skewed in seeking to give a power to members in relation to a narrow matter, whereas members' opportunities for involvement in more significant matters remains very limited. The latter position is a function of limited liability whereby shareholders surrender involvement in day-to-day management in exchange for protection from liability for the company's debts.

To further illustrate, the shareholders most direct means of gauging directors' performance and stewardship is the company's annual statutory financial statements. These contain the cumulative outcome of executive and management performance in a host of areas of which decisions about executive remuneration are but a small component. Shareholders have no power to vote on or approve the annual statutory financial statements.

The shareholders key safeguard in relation to the annual accounts is through the conduct of independent audit. Shareholders do have specific statutory powers enabling the removal of auditors. The procedure for removal is highly regularized and involves a series of notifications to ASIC before, during and after the process. The mechanism for removal requires the convening of a general meeting of shareholders and the passing of the resolution by simple majority - that is at least 50%.

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[3] *Re George Newman & Co* [1895] 1 Ch 674

[4] See s 135 Replaceable Rules

[5] R P Austin & I M Ramsay, *Ford's Principles of Corporations Law* 13th ed. LexisNexis Butterworths, Australia (2007) p 256.

In contrast the Productivity Commission draft proposal contains at least in first instance a much lower threshold for shareholder intervention potentially leading to a highly disruptive spill of board positions. Admittedly, once the "two strikes and you're out" is reached individual board members can be re-elected. However, were government to proceed with the draft proposal, we suggest it be accompanied by a type of procedure similar to that applied to the removal of auditors. Whilst having clearly distinct duties and powers, a drawn out procedure along the lines of auditor removal could negate precipitous or vexatious shareholder actions and give time for a fuller consideration of the matter at hand.