Law Council
OF AUSTRALIA

10 November 2009

Mr Gary Banks AO
Chairman (presiding)
Productivity Commission
Level 28, 35 Collins Street
MELBOURNE VIC 8003

By e-mail: executive_remuneration@pc.gov.au

Dear Mr Banks

Re: **Executive Remuneration in Australia - Discussion Draft**

These are the submissions of the Corporations Committee of the Business Law Section of the Law Council of Australia (the "Committee") in relation to the discussion draft of the Productivity Commission's paper on Executive Remuneration in Australia. This submission has been endorsed by the Business Law Section, but due to time constraints, the submission has not been reviewed by the Directors of Law Council of Australia Limited.

1. No vacancy rule

The Committee supports the abolition of the 'no vacancy' rule. This would be effected by an amendment to the Corporations Act providing that, despite any provision in a company's constitution to the contrary, any determination by the directors of the maximum number of directors is not binding. The amendment should also provide that the shareholders in general meeting can increase or reduce the maximum by ordinary resolution, but not so as to exceed any maximum number or be less than any minimum number fixed by the constitution (which could only be changed by special resolution). Also, any reduction in the maximum by the shareholders in general meeting should not reduce the maximum to a number which is less than the number of directors in office at the time.

2/3. Remuneration committee membership

The Committee supports the introduction of a new ASX listing rule requiring substantial listed companies to have a remuneration committee. In principle, the Committee has no objection to this being struck at the level of ASX 300, although the Committee recognises that the size and resources of companies after the ASX 100 falls off relatively precipitately and the Committee considers that these are relevant factors to be taken into account in determining the level at which the listing rule requirement should cut in. As to the composition of the remuneration committee to which the listing rule should apply, the Committee considers that the ASX Corporate Governance Council's current guidance is adequate.

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The Committee supports the recommendation that for other ASX listed companies, the ASX Corporate Governance Council should elevate what is currently a suggestion on the existence and composition of remuneration committees to a 'comply or explain' recommendation.

If the requirements in relation to remuneration committees are to be included in the listing rules for ASX 300 companies and are to be elevated to the status of a 'comply or explain' for other listed companies, the Committee believes that the ASX Corporate Governance Council's guidance should also explicitly set out the functions of the remuneration committee. In particular, the guidance should make it clear that the committee is responsible for setting the remuneration of senior executives including the CEO, rather than being limited to policy matters and approval of the annual remuneration report.

4. Directors and executives voting on remuneration

The Committee supports the proposal to prohibit executives voting on the remuneration report or other remuneration related matters, but believes that this restriction should not extend to non-executive directors. The restriction is not necessary or appropriate for non-executive directors because their maximum aggregate remuneration is already subject to a binding shareholder vote under ASX Listing Rule 10.17, and those directors are excluded from voting on that resolution. There is also the fact that shareholders can remove non-executive directors at any time, or when they stand for re-election under the rotation provisions, without further liability to the company if the shareholders have an issue with their remuneration. Non-executive directors should therefore not be precluded from voting in their capacity as shareholders on the remuneration report, particularly as they may wish to express their views as shareholders in relation to remuneration for executives (non-executive directors do not have any conflict in voting on executive remuneration).

The Committee's other main concern is the proposal to extend the voting exclusion to any 'associate' of key management personnel or directors. The Corporations Act definition of 'associate' is extremely broad, and we consider that such an amendment needs to be approached with extreme caution. The effect of this could be that every major shareholder in an ASX listed company who has a nominee on the board will be disenfranchised on the issue of remuneration, because they will be an 'associate' of that director, yet that shareholder may have the predominant economic interest in the success of the ASX listed company and arguably is the shareholder most affected by the payment of the remuneration. If there is to be a voting exclusion, it should therefore be limited to those directors and any entities that they control, and care should be taken not to exclude corporations with significant economic interests in the ASX listed entity.

5. Prohibition on hedging equity remuneration

Although the Committee considers it inappropriate for executives to hedge unvested equity remuneration, the Committee thinks that this issue would be best dealt with under the ASX Corporate Governance Council's guidance, rather than by attempting black letter law changes to the Corporations Act. This is because there is likely to be considerable difficulty in drafting any such prohibition in black letter law to properly capture the relevant hedging arrangements, while not inadvertently capturing arrangements not meant to be caught. The Committee notes that the ASX Corporate Governance Council already recommends that ASX listed entities have a trading policy which prohibits hedging of unvested equity remuneration and the Council has counselled listed entities to exercise

caution when describing “alignment” of executives with shareholders interests due to the existence of equity holdings if those holdings are in any way qualified.

Further, before any change is made, the Committee recommends that the Commission first determine whether there is in fact any market for executives to hedge entitlements to equity remuneration which are subject to a performance condition. We suspect that this would be very difficult to obtain, so that there is no issue in practice.

6. Prohibition on executives and directors voting undirected proxies on remuneration matters

(a) Chair voting undirected proxies

The Committee does not support a prohibition on the Chair voting undirected proxies on a resolution on remuneration matters. Assuming that the Chair will be excluded from voting their own shares on the resolution, under ASX Listing Rule 14.2.3A the proxy form must contain a statement as to how the chair intends to vote undirected proxies and a notice stating that the chair may have a conflict of interest. Shareholders must mark a box indicating that they have understood this statement. If the box is not marked, the undirected proxies must be disregarded. In the Committee's view, if a shareholder, after acknowledging that they understand the conflict, still wants to appoint the chair as an undirected proxy, they should be free to do so.

The report suggests that there is an issue because the proxy form will often indicate which way the chair intends to vote undirected proxies, and there is some uncertainty as to whether the chair is legally bound to follow those voting intentions. For that reason, the report suggests that shareholders should be required to give a directed proxy. The submission from Risk Metrics referred to in the report states that this uncertainty derives from the decision in *Campbell v Jervois Mining Ltd [2009] FCA 401*.

It is important, however, not to overstate this uncertainty. While the court in *Jervois Mining* held that a statement of voting intention in the proxy form did not turn what was an undirected proxy into a directed proxy for the purposes of section 250A(4)(c), normally a chair is likely to be precluded from voting contrary to the intention statement by the laws relating to misleading or deceptive conduct. In *Jervois Mining*, the intention statement in the proxy form was plainly incorrect and directly inconsistent with the statements in the chair's letter which accompanied the notice of meeting, including the board's recommendation that shareholders remove Mr Campbell as a director and retain the balance of the board.

(b) Other directors and executives voting undirected proxies

The Committee does not have an issue with other directors and executives being precluded from voting undirected proxies on the remuneration report if they are precluded from voting their own shares. For the reasons given above, the Committee believes there is an argument that non-executive directors should not be precluded from voting their own shares.

7. 'Cherry picking' by non-chair proxy holders

The Committee supports the amendment to the Corporations Act which was proposed in the Corporations Amendment Bill (No. 2) 2006 to stop cherry picking by non-chair proxy holders. That amendment states that if the proxy is not the chair, the proxy need not vote on a poll, but if they proxy votes on the poll in any capacity, the proxy must vote on the

poll in the exercise of the proxy appointment and must vote in a way specified in the proxy appointment.

The Committee acknowledges that this does not stop a non-chair proxy holder deciding not to vote their own shares or any proxies, if they have received a large number of proxies that do not support their views on a resolution. But this would only be where the non-chair proxy holder actually attended the meeting but didn't vote any shares – if they did not attend, the proxy would revert to the chair who must vote all directed proxies on a poll. As an alternative to the amendment proposed in the Corporations Amendment Bill (No. 2) 2006, the Committee would support a requirement that if the non-chair proxy holder attends the meeting he or she must vote all of their directed proxies in accordance with the directions. But it is not practical or necessary to require non-chair proxies to attend and vote directed proxies at a meeting where they are unable or unwilling to attend the meeting for some reason.

The Committee notes that these issues would be overcome in practice if electronic direct voting is introduced as discussed in 14 below.

8/9. Remuneration reports

The Committee agrees that remuneration reports have become very lengthy and complex, and that there is a strong case for streamlining the requirements in section 300A to focus on the core aspects of remuneration important for investors. The Committee does not support the introduction of a short report to accompany the existing report – the focus should be on streamlining the requirements for the existing report.

The Committee suggests the following requirements for the remuneration report:

- The report should be limited to reporting on the remuneration of key management personnel as defined in AASB 124 (those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity). The requirement to disclose in relation to the five highest paid group and company executives should be deleted. The reason for this is that the focus of disclosure should be on those who can influence their own pay or who could materially influence the performance of the company. This change would have little impact amongst larger companies because their five top earners are usually also key management personnel, but will be of benefit to smaller companies.
- The report should include a short plain english summary of the remuneration policies for key management personnel, including the key elements used in determining remuneration. The regulations could give examples of matters which the summary may discuss, such as use of comparator groups for benchmarking remuneration; the use of constraints or caps to guard against unexpected or extreme outcomes from formula based contractual obligations; performance measures and why they were selected; the mix of base salary and short and long term incentives.
- The requirement to disclose performance conditions attaching to remuneration and an explanation of why the performance condition was chosen should be retained. However, the requirement in relation to performance conditions attaching to short term remuneration should be to disclose the nature of the condition rather than a detailed summary of the actual condition, as disclosure of that level of detail is likely to reveal commercially sensitive information to competitors of the company, to the detriment of all shareholders.
- The report should disclose actual realised pay (cash payments plus equity based remuneration actually received by the key management personnel) in the relevant year,

rather than the estimated cost to the company of the equity based remuneration. The estimated cost to the company of equity based remuneration at the grant date and the amount expensed over the performance period can be set out in the section of the financial statements dealing with equity interests, rather than including it in the remuneration report as is currently the case. In addition to the actual realised pay, the report should identify the equity grants to the executive during the year and those equity grants from prior years that have not expired or vested in the relevant year.

- The report should include in summary form the equity holdings for each individual covered by the report.

10/11. Remuneration advisers

The Committee agrees that it is not practical to mandate that external remuneration advisers consult only with the board or remuneration committee. The external advisers will need to work with management to formulate their advice on structuring of performance based remuneration.

The Committee supports the recommendation that the external remuneration advisers be engaged by and provide their final advice to the remuneration committee (or, where there is no remuneration committee, the full board). However the Committee believes that this could be achieved more effectively through a ASX Corporate Governance Council recommendation, which can be more principles based, than a new listing rule. There may also be situations where compliance is not appropriate, and companies may wish to disclose this and explain why.

The proposal should make it clear that remuneration advisers only includes advisers that advise on quantum of remuneration and does not include lawyers advising on remuneration structuring.

On the question of whether remuneration advisers should be named in the remuneration report, the Committee's view is that there is no material benefit to be gained from this. Advisers may not wish to be named, and naming advisers may actually encourage companies to shop around advisers for advice.

12. Disclosure of voting by institutions

The Committee does not object to the proposal that institutions disclose on an annual basis how they voted on remuneration reports and other remuneration related issues. The Committee notes however that implementation of the recommendation would depend on relevant key industry associations adopting the recommendation.

13. Removal of taxation point impediment to deferred equity

The Committee supports the recommendation.

14. Confirm allowance for electronic voting

The Committee believes that the introduction of electronic direct voting would overcome many of the issues which arise in relation to proxy voting (such as where the proxy fails to attend the meeting or to vote) and many of the issues associated with a paper based system such as lost votes, illegible proxy forms and processing error. The Committee recommends that the Corporations Act be amended to expressly authorise electronic direct voting for listed companies, subject to any restriction in the company's constitution.

The Committee agrees that the better view is that, because the Corporations Act does not expressly prohibit electronic direct voting, it is available to companies now if an authorisation is included in the company's constitution. However, the Committee believes that it would be better to put this beyond doubt through an amendment to the Act. This is in line with the Corporations and Markets Advisory Committee's 2000 recommendations regarding shareholder participation in the modern listed public company.

The Committee notes the draft recommendation that ASIC issues a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments. If here 'electronic voting' refers to electronic proxies, then this does not need ASIC to say anything as it already clear from the Act and Regulations. If it is a reference to electronic direct voting, the position is not clear and an ASIC confirmation will not change the legal position.

The Committee acknowledges that there is an argument that electronic direct voting is not necessary as the same result can be achieved now through a shareholder lodging a proxy electronically which is in favour of the chairman and directs him or her how to vote. The Committee believes however that rather than have electronic voting operate through an indirect proxy system, it would be preferable if shareholders could vote their votes directly.

15. 25% no vote triggering obligation to explain/two strikes test requiring all directors to submit for re-election

The Committee does not support the proposed two strikes test requiring all elected directors to submit themselves for re-election at an extraordinary general meeting or the next annual general meeting. The Committee understands the concerns that the Commission is trying to address with this proposal, but disagrees with the proposal for the following reasons:

- As a point of principle, we believe that the final decisions on remuneration policy and key executive remuneration should reside with the board, like all other major strategic decisions affecting the company. There is no reason to single out executive remuneration for a shareholder vote which can require a board spill, over other major decisions made by boards.
- In most cases, the current non-binding vote on the remuneration report has been an effective weapon for shareholders and corporate governance groups to influence board thinking on executive remuneration. The Commission's discussion draft acknowledges that the evidence suggests that boards do respond to the threat of a no vote or to an actual no vote.
- Shareholders already have extensive rights to remove directors in the event that they are unhappy with decisions on executive remuneration. Under section 249D of the Corporations Act, 100 members or members holding 5% of more of the shares can requisition a meeting of shareholders to consider resolutions for the removal of one or more directors. Moreover, under the rotation provisions mandated in the constitutions of listed companies, one-third of the directors must submit themselves for re-election at each annual general meeting. If shareholders wish to indicate their disapproval of the remuneration report by voting directors out of office, they therefore have an existing ability to do that immediately in relation to one-third of the board at that annual general meeting. Under the proposed two strikes rule, the board spill may not occur until the two further annual general meetings after the meeting at which the remuneration report was first considered. Under the rotation provisions as they currently stand, the shareholders could have removed the entire board during that period in any event.

- The resignation of the entire board if the two strike test is triggered is likely to cause significant damage to the listed company. During the period following the second strike and up to the election of the new board, the board will be very reluctant to take decisions affecting the long term strategic direction of the company. There is also a significant likelihood that the incumbent board, after having received a second no-vote on the report, will simply accept the shareholders decision and resign and not submit themselves for re-election. If this occurs, there is a risk that following the subsequent election the company will have no functioning board. This is obviously a major issue for a listed company, and may mean that shareholders are very reluctant in any event to trigger the spill by voting no a second time.
- The operation of the proposed rule is also unclear where the shareholder concerns with the original remuneration report have been addressed at the time of the second vote, but the report is voted down as a result of some new issue which the board has not had an opportunity to address. Does this mean the board spill is triggered or not? How will it be possible to determine with any accuracy the reasons that different shareholders have voted in the way that they have on the report?

If the two strike test were to be adopted, the Committee believes that the prescribed threshold for the second vote must be more than 50% of votes cast. In the Committee's view, it would be completely nonsensical for the law to require the whole board to spill after a majority of shareholders have voted in favour of the board's remuneration report. There is also the risk that third parties seeking to gain control of the company through a proxy fight could gain significant advantage by engineering a vote on the remuneration report to cause a board spill.

As well as the second vote requiring more than 50% of the votes cast, the shareholders eligible to vote on the resolution must be the same as those entitled to vote on election of directors. Again, it would be nonsensical if the majority which votes down the remuneration report a second time can cause a board spill when those shareholders do not comprise a majority able to elect a director on the resultant spill.

In relation to the first part of the recommendation - that where a remuneration report receives a no vote of 25% or more - the board is required to report back to shareholders in the subsequent remuneration report, the Committee does not object to the proposal in principle, but again believes that the threshold on that first vote should be 50%. In the Committee's view, the board should not be required to report back to shareholders and explain how shareholder concerns have been addressed when in fact a majority of shareholders voted in favour of the remuneration report.

If you have any questions in relation to this submission, in the first instance please contact Mr Guy Alexander on (02) 9230 4874 or Mr Bruce Cowley on (07) 3119 6213.

Yours sincerely

Bill Grant
Secretary-General