RiskMetrics (Australia) Pty Ltd
Level 4, 190 Queen Street
Melbourne VIC 3000
ABN: 88 081 368 327 AFSL Licence No. 297008

Attention: Executive Remuneration Inquiry
Productivity Commission
Locked Bag 2
Collins St East
MELBOURNE VIC 8003

By email: exec.remuneration@pc.gov.au

20 November 2009

Thank you for the opportunity to comment on the issues noted in the Productivity Commission's discussion draft on "Executive Remuneration in Australia".

RiskMetrics strongly supports many of the draft recommendations contained in the discussion paper, including, in particular, those relating to ending the 'no vacancy' rule, prohibiting directors and key management personnel from voting their shares on remuneration reports, and disclosing the identity of remuneration consultants.

These draft recommendations, if implemented, will enhance shareholder ability to hold directors accountable, including for remuneration-related matters.

There are, however, three issues that RiskMetrics wishes to address in more detail:

- The Commission's view that "the current focus of Listing Rule 10.14 on dilution of shareholder equity would appear appropriate".
- The ASX's offer, its original submission to the Commission to remove the Listing Rule provisions as they relate to executive pay (the 'related party' Listing Rule) to the Corporations Act.
- The "two strikes" test proposed in draft recommendation 15.

ASX Listing Rule 10.14

Listing Rule 10.14 is designed to prevent senior executives (ie. executive directors) and other insiders from increasing their interest in the company in a way not available to other shareholders. Whether the shares acquired by the executives have been acquired on-market with the company's funds or are new shares that have been issued by the company to the executives, the danger to 'outsider' shareholders posed by the acquisition of shares on advantageous terms by insiders is the same.

Listing Rule 10.14 is the only binding vote that shareholders possess which specifically relates to executive remuneration outside of termination payments. We have commented on the limited voice that shareholders have in relation to executive remuneration in our initial submission to Commission (pp. 6-7). It suffices to note here that, outside of Listing Rule 10.14, the right of shareholders to vote on remuneration-related matters is generally negated due to listed companies typically structuring their executive remuneration in such a way that the requirement for a shareholder vote under the related party transaction and termination payment provisions of the Corporations Act is avoided. RiskMetrics has indicated and reiterates its support of the government's proposed amendments in relation to shareholder approval of termination payments.

Therefore, absent the introduction of other voting rights for shareholders on executive remuneration, Listing Rule 10.14 assumes considerable importance in terms of improving the

remuneration practices of listed companies in Australia and empowering the shareholders of those companies.

The Commission correctly identifies dilution as one of the principal governance concerns that Listing Rule 10.14 addresses. The concept of dilution that has been employed in some submissions to justify Listing Rule 10.14 and the exception contained in it is a narrow one that treats only the creation of additional shares as being dilutive. It is incorrect to suggest that there is never a dilution concern with on-market purchases. Changes to the distribution of the ownership of existing shares are, as the Commission recognises, also dilutive. The transfer of existing shares – sourced from on-market purchases using company money – to executives is equally dilutive of other shareholders as it reduces and therefore dilutes the voting power and dividend rights of those other shareholders. No other shareholder, other than company insiders, has the right to have their voting power increased through the purchase of shares on their behalf with company funds. The purchase of shares on-market using company funds for the benefit of insiders is analogous to a selective buy-back and the Corporations Act recognises the implicit dangers of such buy-backs by requiring prior approval by non-beneficiaries by a special resolution.[1]

A non-binding vote is clearly not adequate protection against the dilutive potential of on-market purchases for insiders using company funds and it is not clear why shareholders' rights to protect themselves against insider share acquisitions on preferable terms should not be restored. Listing Rule 10.14 as it stood prior to 2005 is part of the fundamental set of rules that protect shareholders from abuses by company insiders and no evidence has been advanced to date on what benefit shareholders – as opposed to company insiders - have received from the removal of this protection.

It should also be noted that at many ASX listed companies, grants of equity to executive directors are meaningful as a proportion of the company and have potential control implications reiterating the requirement for all equity grants to face shareholder approval. Under ASX Listing Rule 10.11 all other share allocations to directors outside of pro rata issues require shareholder approval and the exemption for grants under 'employee equity schemes' circumvents the purpose of Listing Rule 10. At small ASX listed companies grants of options or equity incentives representing more than 1 percent of shares on issue to individual directors are common (RiskMetrics is happy to provide additional information to the Commission on this point if required). In other cases it appears large companies use on-market purchases of shares only for executive director incentive schemes so no shareholder approval is required.[2] As the only rationale for such grants is to align executive and shareholder interests it is also difficult to understand why the right of shareholders to decide on the allocation of voting and dividend rights to insiders should not be restored.

RiskMetrics therefore restates its opinion that the Corporations Act should be amended to require shareholder approval for all grants of shares by listed companies to their executives, regardless of whether such a grant is effected via an issue of shares or an on-market purchase of shares.[3]

Jurisdiction of the ASX

As part of our comments on Listing Rule 10.14 we would also like to draw to the Commission's attention the ASX's original submission to the Commission dated 29 May 2009. In this submission ASX noted Listing Rule 10.14 is designed to supplement the related party transaction provisions of the Corporations Act and recommends consolidating in the Corporations Act the various provisions in Listing Rule 10, including Listing Rule 10.14, that deal with related party transactions.

---

[1] Section 257D.

[2] As an example, at Wesfarmers in the 2009 financial year 9.3 percent of shares granted under its Long Term Incentive Plan were acquired on market with the remainder being newly issued. The number acquired on market corresponds (approximately) to the number of shares allocated to the two executive directors under the LTIP in the 2009 financial year. See Wesfarmers Limited, *2009 Annual Report*, pp. 144 & 172.

[3] We also wish to draw the Commission's attention again to our position paper "Removing shareholder approval of equity grants to directors" which formed part 2 of our initial submission to the Commission.

This, as the ASX notes, would "increase the ease of access to provisions dealing with similar issues" and "provide a wider range of enforcement options", including "enforcement options targeted at individuals". We would urge the Commission to re-consider this recommendation from the ASX. RiskMetrics notes that in an environment where it is possible exchanges will arise in competition to the ASX that having a single set of related party and executive pay rules for listed companies, regardless of the exchange on which they are listed, would be beneficial and avoid the potential for a 'race to the bottom' among exchanges competing for listings.

The "two strikes" test

RiskMetrics does not support the imposition of a "two strikes" test as proposed in draft recommendation 15:

- Minority shareholders who disagree with their company's remuneration practices or with any other aspect of the directors' oversight of the company already enjoy the right under the Corporations Act to put a resolution at a general meeting to remove one or more of the directors from office or call a general meeting at which such a resolution can be moved.[4] The introduction of the "two strikes" test will not therefore materially expand the powers of shareholders.
- The accountability of boards for the company's remuneration practices (and other matters) can be enhanced without an automatic board 'spill' by taking steps to improve the overall integrity of the voting process and thus ensure the effectiveness of shareholder votes. Ending the 'no vacancy' rule (draft recommendation 1), preventing directors and key management personnel from voting undirected proxies on remuneration-related matters (draft recommendation 6), requiring proxy holders to cast all of their directed proxies on remuneration-related matters (draft recommendation 7) and facilitating electronic voting (draft recommendation 14) will all contribute positively to the integrity of the voting process. We also draw the Commission's attention to our comments in our initial submission on improving the governance of listed companies in Australia (pp. 13-16).
- The automatic board spill provided for in the "two strikes" test could potentially dilute the non-binding vote's effectiveness as a feedback mechanism on remuneration practices. This is because shareholders, confronted with the possibility of forcing a board spill as a result of voting against a remuneration report at a company where shareholders are generally satisfied with company performance and board oversight, may be unwilling to vote against. The present set of mechanisms available to shareholders in addition to the non-binding vote – director re-elections every three years and the ability to seek the removal of directors at any time – coupled with certain of the Commission's suggested reforms to the voting process (such as the end of the 'no vacancy rule') already provide sufficient director accountability mechanisms.

Please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail. Thank you once again for the opportunity to comment on the issues raised in your Discussion Draft.

Yours sincerely

Dean Paatsch and Martin Lawrence
RiskMetrics Australia
03 9642 2062

dean.paatsch@riskmetrics.com or martin.lawrence@riskmetrics.com

[4] Sections 249D(1), 249F(1) and 249N(1).