CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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Executive Remuneration Inquiry
Productivity Commission
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By email: exec_remuneration@pc.gov.au

Dear Commissioners

Executive remuneration in Australia: Productivity Commission Discussion Draft

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the Productivity Commission's (the Commission) discussion draft report *Executive remuneration in Australia* (the draft report).

CSA is the independent leader in governance, risk and compliance. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency. Our members comprise company secretaries in listed, unlisted, private and government-owned corporations.

General comments

CSA welcomes the Commission's findings that it would be inappropriate and have adverse impact on the economy to bypass the central role of boards in setting remuneration by capping pay. While the referral to the Commission on the issue of executive remuneration was triggered by community and political concern with the levels and structure of executive remuneration, CSA agrees with the Commission that strengthening the corporate governance framework is the most appropriate manner in which to manage such concern.

CSA supports the Commission's findings that remuneration should remain a largely private matter to be agreed between executives and companies, applying governance processes which properly protect the interests of owners.

In preparing this submission, CSA has drawn on the expertise of the members of our two national policy committees.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

CHARTERED SECRETARIES AUSTRALIA

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Chartered Secretaries Australia (CSA)

Submission to the Productivity Commission's discussion draft: Executive remuneration in Australia

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Improving board capacities

Recommendation 1

The Corporations Act 2001 should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).

We note that the Commission's rationale for this recommendation is based on ensuring diverse representation on boards. CSA does not believe that an inquiry into and report on executive remuneration is the appropriate vehicle for a proposal concerning board diversity. CSA believes that the issue of board diversity is extremely important but is much broader than executive remuneration. A review of measures to promote board diversity should be subject to a targeted consultation process, where different proposals for improving board diversity can be canvassed. For example, it would be useful to consider the role nomination committees could play in improving board diversity. What is the role of executive directors on nomination committees? CSA notes that, while the Corporations and Markets Advisory Committee (CAMAC) issued a very useful report earlier in 2009 on board diversity, the CAMAC report was not the result of a public consultation process.

CSA does not support the inclusion in the Commission's final report of a recommendation to amend the Corporations Act to specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution). CSA believes that the Commission should recommend that a targeted consultation on board diversity should take place, to consider both this suggestion and other approaches, such as the call for a debate on targets, as recently suggested by the Federal Sex Discrimination Commission, Elizabeth Broderick. There is no evidence presented to show that the proposal put forward by the Commission will be the most efficacious approach to tap into and utilise available board talent, as claimed in the draft report. Given the need to improve both intellectual and demographic diversity on boards, CSA hopes that the Commission will be keen to promote the need for studied consultation of a variety of approaches to ensure the optimal outcome, rather than recommending one approach only.

Notwithstanding this central concern, CSA notes that the removal of the 'no vacancy rule' removes the flexibility of the board to determine its appropriate size to meet the changing needs of the company or to make appointments of particularly well suited potential directors who may emerge from time to time. For example, as a result of a merger or acquisition, a board may need to provide room for more directors, to ensure that full advantage can be gained from the corporate action. Or a new director that has been noted as meeting selection criteria could become available some months before an annual general meeting (AGM), and may no longer be available by the time the AGM is held. Boards are best placed to make decisions concerning succession planning, given their access to and understanding of the broad range of decisions concerning the operational and financial performance and strategic intent of a company, and this includes an understanding of the most appropriate number of board positions at any given point in time.

Furthermore, Listing Rule 14.5 provides that an election of directors must be held each year — this means that there must be at least one board position each year for which candidates can stand for election. Listing Rule 14.3 provides that nominations for directorships must be accepted. The effect of these two current Listing Rules is that the opportunity exists each year for any person to put forward a nomination for election to the board, in accordance with the requirements of the constitution. There is no barrier to non board-endorsed candidates standing for election. However, shareholders need to be persuaded to vote for a candidate, and it is up to the candidate to influence shareholder voting.

CSA recommends that an amendment to the Corporations Act as set out above is premature, given the Commission's stated objective is to improve board diversity and given the absence of a public debate through targeted consultation on this topic. We believe that the proposed amendment in itself is highly unlikely to achieve the stated objective.

CSA does believe that boards need to improve their communication of the selection and retention criteria for board candidates and the reasons for their choices and recommendations. This in turn provides shareholders with the opportunity to scrutinise board decision-making.

Reducing conflicts of interest

Recommendation 2

A new ASX listing rule should specify that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.

CSA does not support the introduction of a new ASX Listing Rule specifying that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chairman and majority of members being independent.

CSA believes that it is inappropriate to apply to remuneration committees the prescriptive approach to composition that is currently, and rightly, in place for audit committees. The audit committee is responsible for oversight of the financial reporting of the company, which is of essential importance to the overall health and performance of the company and accountability to shareholders. The oversight of remuneration is also important, but relates to only one aspect of company performance, while financial reporting goes to the heart of company sustainability and growth and the heart of board accountability.

However, CSA recommends that the composition of the remuneration committee should be elevated to a Recommendation in the ASX Corporate Governance Council's guidelines (as set out in the Commission's Recommendation 3 below). CSA believes that it is for shareholders to test directors' thinking and behaviour through shareholder engagement and for boards to be accountable to justify their decisions to shareholders. Elevating the current suggestion on remuneration composition to an 'if not, why not' Recommendation in the Council's guidelines will ensure that boards must explain to shareholders their reasons for structuring the remuneration committee in a particular manner (if that structure differs from the recommended composition), including why the different structure is in shareholders' interests.

Mandating that ASX300 companies must have a remuneration committee of a particular composition would introduce a second exception to the 'if not, why not' reporting regime. CSA is a strong supporter of the 'if not, why not' reporting regime and believes that remuneration committees should be an integral component of it and not an exception to it.

CSA emphasises that remuneration committees should exercise independent judgment and demonstrate that their decisions are consistent with the interests of shareholders and the company's financial situation and future prospects. The members of remuneration committees should have the skills and experience to reach an independent judgment on the suitability of the company's remuneration policies, including the implications for risk and risk management.

Recommendation 3

The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a 'comply or explain' recommendation which specifies that remuneration committees:

- *have at least three members*
- *be comprised of a majority of independent directors*
- *be chaired by an independent director.*

CSA supports this Recommendation. CSA believes that it is for shareholders to test directors' thinking and behaviour through shareholder engagement and for boards to be accountable to justify their decisions to shareholders. It may not always be feasible for boards to meet the remuneration composition arrangements recommended by the Council (for example, smaller companies may have only three directors in total on the board), but an 'if not, why not' regime provides boards with the opportunity to explain to shareholders the reasoning behind their remuneration committee composition arrangements.

Recommendation 4

The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration-related resolutions.

CSA understands that the Commission is concerned that a perception of conflict of interest can arise when the boards has approved the remuneration report and then votes on it. CSA agrees that a conflict of interest exists for executive directors and executives identified as key management personnel, who have a material interest in the remuneration report. As we noted in our original submission, there is a conflict of interest in directors and CEOs voting on their own remuneration policies. **CSA supports** the recommendation that *executive directors and executives* be prohibited from voting their shares on remuneration reports.

However, **CSA does not support** the Commission's proposal in relation to *non-executive directors*. The Commission's proposal assumes a conflict of interest for non-executive directors where none exists. Non-executive directors have no material personal interest in the remuneration report.

There are a number of key issues that need to be borne in mind when considering this issue:

- Non-executive director's remuneration is already subject to direct shareholder approval (s 202A). Listing Rule 10.17 requires that the total remuneration of non-executive directors cannot be increased without shareholder approval. Thus, non-executive directors have no material personal interest in the remuneration report. In the case of non-executive directors, shareholders are already the ultimate arbiters.
- Shareholder approval must be sought for a new issue of shares granted to directors (encompassing executive and non-executive directors) (Listing Rule 10.14).
- With limited exceptions, directors have approved all resolutions that go before shareholders at general meetings, including the resolution on the remuneration report. Their support or otherwise for resolutions is clearly set out in the notice of meeting. Shareholders can be in no doubt as to the board's position on resolutions. If non-executive directors are excluded from voting on the remuneration report, why should they not also be excluded from voting on all other resolutions?

CSA urges the Commission to consider the substance of conflict of interests, not the mere fact that someone holds the title of non-executive director. The perceived conflict that he Commission's proposal is responding to applies equally to every resolution put before shareholders by directors.

Recommendation 5

The Corporations Act 2001 should prohibit all company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks.

CSA supports the recommendation that the Corporations Act should be amended to prohibit company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks. We note that executives should be free to hedge equity remuneration after it has vested and is no longer subject to a holding lock.

CSA stresses that the prohibition should be on the individual and the promoter of any such scheme, rather than on the company. This is consistent with other statutory obligations relating to trading in company securities and enhances deterrence and enforcement.

Recommendation 6

The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.

CSA does not support this proposal. CSA understands that the Commission's view is that, if the chairman is prohibited from voting his or her own shares on remuneration reports due to an alleged conflict of interest, the chairman's capacity to vote undirected proxies needs to be similarly constrained.

However, as noted above, CSA does not believe that non-executive directors and chairmen have an automatic conflict of interest in relation to the remuneration report simply by virtue of holding the title of director or chairman and approving the report. Unless there is a material personal interest in the outcome of the vote on the remuneration report, CSA cannot see that any conflict of interest exists.

Moreover, CSA is very concerned that shareholders stand to be disenfranchised by this proposal. An undirected proxy to the chairman reflects the shareholder's confidence in the board and is an expression of intent by the shareholder. This proposal would deny the shareholder the right to exercise their vote, unless they could either physically attend the meeting or appoint another proxy to exercise that right for them. Shareholders may not know of another person attending the meeting that they can appoint as their proxy.

In companies dominated by a retail shareholder base, a large percentage of proxies lodged are in favour of the chairman. CSA is very concerned that these shareholders will be disenfranchised, as our members note that the percentage of undirected proxies in such companies can be up to 70 per cent.

CSA notes that voting forms could change, to specify to shareholders that they must either vote against the remuneration report or give their undirected proxy to the chairman, who will vote in favour of it. Given that notices of meeting already indicate how the chairman will exercise undirected proxies, this provides further clarification to shareholders wishing to appoint the chairman as their proxy and ensures that their capacity to exercise their right to vote is not constrained.

CSA also notes that the implementation of direct voting will assist, given that shareholders who cast a vote directly do not need to appoint a proxy in order to exercise their right to vote if they are unable physically to attend the meeting.

Recommendation 7

The Corporations Act 2001 should be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any other remuneration-related resolutions.

CSA supports the proposal to prevent 'cherry picking' of proxies, but cautions that any amendments to the Corporations Act need to be carefully drafted.

CSA notes that amendments were proposed to ss 250A(4) and (5) in both the Corporations Amendment Bill (No 2) 2005 and the Corporations Amendment Bill (No 2) 2006 to ensure that the voting intentions of members are carried out by appointed proxies by prohibiting the 'cherry picking' of proxy votes. CSA first raised the issue of 'cherry picking' in 2003 and made a number of submissions to government on the matter, including in response to the Exposure Drafts of these two bills. CSA is disappointed that neither bill has progressed.

It is important to note that neither bill imposed a blanket obligation on all proxy holders. CSA supports this, as persons may be unknowingly appointed as proxies or there may be legitimate circumstances where a person other than the chairman is unable to vote on a poll at all (for example, the person may have an accident on the way to the meeting, or may need to leave the meeting before the vote is taken). It is therefore very important that any amendments to the Corporations Act do not mandate that all proxies held be voted.

Notwithstanding our support for this proposal, CSA does not believe that an inquiry into executive remuneration is the appropriate vehicle for a proposal concerning the 'cherry picking' of proxy votes. CSA believes this should be addressed as part of a reform of voting in general.

Improving relevant disclosure

Recommendation 8

Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include:

- *a plain English summary statement of companies' remuneration policies*
- *actual levels of remuneration received by executives*
- *total company shareholdings of the individuals named in the report.*

Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.

CSA supports the principle of this recommendation, but believes careful consideration needs to be given to its implementation.

'Plain English summary'

CSA is aware that the Commission has reviewed the legislation governing the remuneration report, to assess if the level of statutory information required could be streamlined to assist disclosure, and found that it could not make recommendations in this regard. Furthermore, while retail shareholders in particular are seeking shorter, more digestible remuneration reports, institutional investors have advised that they do not wish to sacrifice any of the detail that is currently available. Notwithstanding the differing needs of retail and institutional investors, all parties are seeking remuneration reports that tell the 'why' as well as the 'what' of remuneration decisions.

CSA encourages companies to 'tell their own story' to shareholders. However, CSA is concerned that the Commission's proposal to legislate a 'plain English summary statement of companies remuneration policies' will not achieve this objective. In our earlier submission we pointed to the issues that arose with the concise annual report as a precedent for what can happen when a prescriptive approach is chosen as the means to encourage companies to communicate more efficiently with their shareholders. The fate of the concise annual report does not fill CSA with hope that legislating a ‘plain English summary’ will provide the communication that is being sought.

The concise annual report was originally introduced into the Corporations Act to facilitate shareholder communication, but increased regulation saw the concise report increase dramatically in length, such that it no longer met the needs of shareholders. Moreover, the concise annual report became increasingly legalistic as companies strove to ensure that they had met all statutory requirements. This second report became a lengthy, complex document, despite the original intent being to legislatively provide for short-form, meaningful communication to shareholders. CSA contemplates the prescription of a ‘plain English summary’ of the remuneration report with foreboding, believing it will create a second remuneration report that in turn will fail to meet shareholder needs.

It was for this reason that CSA recommended in our first submission to the Commission that companies should be left to communicate directly with their shareholders as to what form of *non-statutory* remuneration reports shareholders would like to receive, and such short-form remuneration reports should remain *non-statutory*.

The Commission has noted that it believes that there has been excessive zeal evidenced by companies in meeting the demands of s 300A. CSA believes that companies seek to ensure they are not in breach of the legislation, given the liability attached to any such breach as well as the potential damage to reputation. Legislating a short-form, ‘plain English’ report will lead to legalistic reports, no matter how well intentioned the legislation or the boards presenting such reports to shareholders.

CSA recommends that s 300A of the Corporations Act 2001 should *not* be amended to specify that remuneration reports should additionally include a plain English summary statement of companies’ remuneration policies. **CSA recommends** that such short-form reports be *non-statutory*.

CSA also recommends that it could be useful for the ASX Corporate Governance Council to include further guidance on how to encourage good reporting on remuneration in the *Corporate Governance Principles and Recommendations*. Such guidance should not be elevated to a Recommendation, but be included as reference material. The Council has developed additional guidance on reporting against Principle 7, which is available on the ASX website, and this serves as a precedent for the additional guidance that could be developed on remuneration reporting.

Actual levels of remuneration received by executives
CSA supports this proposal.

Total company shareholdings of the individuals named in the report
CSA supports this proposal.

Accounting Standards
The requirements of the remuneration report do not hinge on the Corporations Act obligations alone. The Accounting Standards introduce an additional level of complexity and are not always in direct alignment with the Corporations Act. They should be reviewed concurrently with the Corporations Act obligations. Any amendment to the Corporations Act in relation to the remuneration report needs to be accompanied by amendments to the Accounting Standards, to ensure that the policy objective of ensuring that shareholder needs are better met can be achieved.

CSA also recommends that the accounting standards relating to remuneration reporting be simplified and made more harmonious with the Corporations Act requirements.

Recommendation 9

Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to the key management personnel. The additional requirement for the disclosure of the top five executives should be removed.

CSA supports this proposal. The identification and determination of who are the key management personnel and the five most highly remunerated executives are a source of some difficulty for companies. The definitions are challenging to apply in practice. In particular, identifying the key management personnel and the five most highly remunerated executives may be made difficult in the context of executives changing roles or leaving or commencing employment part-way through the year and because categorisation depends on actual responsibilities and influence rather than role descriptions and reporting lines. For example, a termination payment to an employee of many decades' service, with attendant accrued legal entitlements (annual leave, long service leave etc), could see the employee meet the requirements of the definition of one of the five most highly remunerated executives for the purposes of the remuneration report. Yet the individual may not be a member of the senior executive team.

CSA notes that the important disclosure is the remuneration of those who can influence the decisions of the company and key management personnel will capture these individuals.

Recommendation 10

The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.

CSA does not support the introduction of a new ASX Listing Rule as worded, requiring that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by and provide their advice directly to the remuneration committee or board, independently of management.

In large companies, CSA notes that remuneration is much broader than remuneration for the executive group alone. It is appropriate at times for management to also engage remuneration advisers, not to determine their own remuneration, but to determine the remuneration of staff across the company. Most companies do not have significant in-house remuneration resources, and require access to external advisers. The proposal for a new Listing Rule as set out above would preclude the engagement of advisers by management, which in turn would have adverse effects on companies. CSA does not support regulation that makes boards responsible for the remuneration of all operational staff within a company. For example, a large company could employ 30,000 staff, and it would be an inappropriate use of board time and expertise to have the directors setting the remuneration for all staff in such situations. Moreover, it is appropriate for any remuneration advisers commissioned by the board to meet with management so that their advice to the board is informed by having access to information about the business, its prospects, its market positioning etc. It will be difficult for the board to make decisions on remuneration packages for senior executives if discussions with management are prohibited.

However, CSA does believe that it is important that shareholders have confidence that where a board or remuneration committee appoints an adviser to provide advice on *executive* remuneration, the adviser must report independently to the board.

CSA therefore recommends that the matters to which the Commission refers in both Recommendations 10 and 11 should be referred to the ASX Corporate Governance Council. Shareholders will receive more information about which companies receive expert advice on remuneration using the 'if not, why not' regime. Many smaller companies do not seek external advice, or do not seek it annually, and the 'if not, why not' regime provides an opportunity to explain to shareholders why this is so. CSA notes that if a Listing Rule is introduced relating only to the ASX top 300 companies, this information will not be available to shareholders for the other 1,700 listed companies.

Moreover, CSA can also point to a variety of issues that will require further consultation. For example, it is not in shareholders' interests to discourage companies from seeking external advice, nor should there be any requirement to do so. CSA believes that the ASX Corporate Governance Council is best placed to consider the exact nature of the matters dealt with in Recommendations 10 and 11 as proposed by the Commission, as well as the wording that will best meet the meet the interests of all stakeholders in any new Recommendation in the ASX Corporate Governance Council guidelines.

CSA recommends that boards should:

- engage their own remuneration adviser to review the remuneration package for senior executives
- ensure their remuneration adviser is appointed by and solely accountable to the remuneration committee and/or the board
- disclose in the annual report the names of the remuneration consultants, whether they were appointed by the remuneration committee and/or the board and the types of services they provide to the company.

CSA recommends that such matters should be dealt with in the charter of the remuneration committee.

Recommendation 11

The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.

CSA supports the referral of the issue dealt with in Recommendation 11 to the ASX Corporate Governance Council. As noted above, CSA believes that the matters straddling Recommendations 10 and 11 are best dealt with by the ASX Corporate Governance Council.

Recommendation 12

Institutional investors should disclose, at least on an annual basis, how they have voted on remuneration reports and any other remuneration-related issues. How this requirement is met should be at the discretion of institutions.

Institutional investors take seriously their responsibility to vote their shares on resolutions put to members at general meeting and consider the governance of the entities in which they invest. Superannuation funds and fund managers are required to assess agenda items with care and caution, and exercise their votes in a manner consistent with their fiduciary duties. Even the best-resourced funds require quality, independent information gathered by proxy advisory services. Accessing quality, independent information, including recommendations on voting on proposals to be put to shareholders in relation to a range of issues assists institutional investors to discharge their voting responsibilities.

CSA recommends that institutional investors be encouraged to vote, **but opposes** any regulation of this. CSA firmly believes that institutional shareholders should not be required to vote, or required to disclose how they vote on individual companies, any more than retail shareholders should be required to disclose their votes. The political pressure to vote according to a popular line could potentially overshadow the benefits being achieved through ongoing dialogue between the institutional investor and the board. Compelling the disclosure of a vote can introduce distortions in voting outcomes.

A decision to abstain from voting on a matter, which may result in no proxy form being lodged and no attendance at a meeting, may be in accord with an investor consideration or policy. Some institutional investors have decided not to vote on director elections, but to sell the stock if they do not agree with the board's decisions.

CSA recommends that institutional shareholders should develop policies on voting, and disclose those policies to their members.

Recommendation 13

The cessation of employment trigger for taxation for equity-based payments should be removed, with the taxing point for equity or rights that qualify for deferral being at the earliest of: where ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.

CSA supports the proposal to remove the cessation of employment trigger for taxation for equity-based payments.

However, CSA notes that there are policy issues that need further consideration. For example, director share ownership was introduced in Australia in response to shareholder activism, which sought to ensure that the interests of directors and shareholders were aligned. The Investment and Financial Services Association's (IFSA) guidelines for listed companies on corporate governance specifically states that 'The board should establish and disclose in the annual report a policy to encourage non-executive directors to invest their own capital in the company or to acquire shares from an allocation of a portion of their fees'.[1] The ASX Corporate Governance Council guidelines also recommend that non-executive directors should be remunerated by way of superannuation contributions or salary sacrifice into equity (this is recommended as one form of remuneration — cash and non-cash benefits are also recommended).

The government recently released its legislation in relation to employee share schemes, which provides that tax deferral for rights-based salary sacrifice schemes will require there to be a 'real risk of forfeiture' in respect of those rights. This 'real risk of forfeiture' test means that tax applies on grant for awards which are 'vested' at grant, notwithstanding that the participant may be prohibited from dealing with the awards at grant. For example, if an employee is required to take 30 per cent of their annual bonus in shares in the company, and is prohibited from selling those shares for three years from acquisition, tax will apply on the acquisition of the shares and not when the prohibition on sale is released three years later, unless the employee is at a real risk of forfeiting the shares. 'Real risk of forfeiting' would include if the shares were to be taken from the employee who resigns before the date on which the restrictions on sale are due to lift, but it may not be appropriate to add such a forfeiture condition to shares received as part of an annual bonus. The 'real risk of forfeiture' test is the reason why tax deferral will no longer be available for non-executive director share plans, notwithstanding that those plans may require the non-executive director to take a minimum percentage of their fees in company shares and also prohibit the non-executive director from selling those shares for a fixed period. Also, the salary sacrifice based arrangements continue to be capped at $5,000, applied each year on a 'per employee, per employment relationship' basis, in order for tax deferral to be available.

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[1] Investment and Financial Services Association, *IFSA Guidance Note No. 2.00 Corporate Governance: A Guide for Fund Managers and Corporations*, May 2009, at 10.3: Guideline 2 – Communication with companies, p 15. This Guide is commonly known as the IFSA Blue Book.

Therefore, it is expected that the legislation will significantly reduce the relevance of salary sacrifice schemes, which in turn has implications for non-executive remuneration and its alignment with shareholder interests.

CSA notes that the policy objective recommended by the Commission is not supported by the legislation on employee share schemes introduced by the government.

Recommendation 14

The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.

CSA supports this proposal. However, CSA notes that this issue is a voting issue, rather than a remuneration issue. While CSA believes that it is an important reform, CSA believes that it should be undertaken as part of the reform of the voting process, as there are multiple resolutions put before shareholders for voting at general meetings, not just remuneration resolutions. This particular voting reform and others that have been identified and are required would improve voting overall, which is the desired outcome.

In 2006, AMP Capital Investors released a study estimating that up to four per cent of its proxy votes cast that year had gone 'missing'. That figure is conservative — AMP was only alerted to the possibility of 'empty voting' because the size of its holding was greater than the reported 'against' votes declared by the companies they owned. IFSA set up a Roundtable, in which CSA and other stakeholders participated, to investigate lost votes. The stakeholder group identified the manual processing of paper-based instructions, the lack of audit trail and time pressure (caused by a coincidence of dates for proxy form lodgment and the determination of vote entitlement) as key weaknesses in the current system. One of the recommendations from the Roundtable, that was also proposed to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into shareholder participation and engagement, was that ASIC issue a Policy Statement or 'no action position' letter clarifying that any issuer that accepts electronic proxies without a relevant constitutional change would not be taken to have breached the relevant sections of the Corporations Act. CSA notes that ASIC is currently exploring voting.

Recommendation 15

The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a 'no' vote of 25 per cent or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why.

If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re-election (a 'two strikes' test) at either:

- *an extraordinary general meeting or*
- *the next annual general meeting.*

CSA notes that shareholders wish to see that directors are accountable for their stewardship of investors' money.

CSA supports shareholders being able to hold a board accountable for their remuneration decisions, including in response to feedback from shareholders through votes on the remuneration report. Shareholder engagement is central to good governance. However, CSA **does not support** the proposal put forward by the Productivity Commission.

Clearly it is desirable to have a mechanism available to shareholders to express their dissatisfaction with the board if the board repeatedly ignores shareholder concerns with remuneration. However, given the extremely negative consequences that could arise from an exercise of the proposed shareholder power to dismiss the entire board at one meeting, which could see a company without any experienced directors, significant damage to the share price and loss of value in shareholder investment, CSA believes that shareholders will be very reluctant to exercise the proposed power. While the proposal is intended to focus directors on their accountability to their investors and the need to address shareholder concerns with remuneration, CSA believes that it is unlikely that it will achieve the outcome intended.

For example, if the board of a major bank was forced to stand for re-election and not returned, CSA queries where directors could be quickly found with the requisite experience to form a new board at short notice. CSA also queries whether any such new board could speedily inform itself sufficiently to manage the company and executive remuneration. CSA believes that the loss of continuity in the governance of the company would have a negative effect on the share price and shareholder value.

Given that shareholders would be unlikely to exercise the power, CSA believes that an unintended consequence of the proposal could be that directors who do not heed shareholder concern would continue to set the remuneration frameworks that had caused the concern, confident that shareholders would not vote to dismiss the board and risk shareholder value. Rather than empowering shareholders, the mechanism proposed could therefore disenfranchise them.

CSA agrees that it is in the interests of good governance to find a mechanism that strengthens shareholders' capacity to hold directors accountable for remuneration, but does not believe that the proposed 'two strikes and you're out' rule will achieve that.

Apart from this overarching concern that the proposal will not achieve the outcome intended, CSA is also concerned that the proposal provides for a vote on the remuneration report to be treated as a vote of no confidence in the board. CSA queries if this is the best way to achieve the expression of shareholder dissatisfaction with the board's stewardship. While the exercise by investors of the voting right attached to the shareholding represents the most visible tool available to them to exert influence over the governance practices of companies in which they invest, shareholder activism could see the use of the 'two strikes and you're out' rule as the means to spill a board despite shareholder concern being potentially unrelated to remuneration. There are many variables in the remuneration report, yet it could be only one aspect that is being voted against. Shareholders who approve of a company's overall remuneration strategy might feel compelled to vote against the remuneration report because they dislike a single element in it. Or there could be issues of shareholder concern unrelated to remuneration where shareholders wish to express a strong opinion. For example, at particular points in the economic cycle, shareholders may hold concerns with an issue such as capital raising, and shareholders may seek to exercise a protest vote through the vote on the remuneration report, which in turn could see the loss of the board on an issue unrelated to remuneration. CSA queries whether it is appropriate for the entire board to be required to stand for re-election based on an issue potentially unrelated to remuneration, or on only one aspect of remuneration. Furthermore, it can be difficult for the board to ascertain why a no vote was received on the remuneration report as there is no obligation on shareholders to disclose their reasons for voting for or against a board resolution.

It has already been shown that corporate behaviour can be modified in response to investors engaging with boards and discussing matters of concern in relation to remuneration. The introduction of the non-binding shareholder vote in 2005 on the remuneration report has seen marked changes in the remuneration structures at companies where shareholders had concerns with remuneration plans. CSA accepts that there are some boards who have not listened to the expression of shareholder disquiet with the remuneration strategies they have put in place for the executive team, and that the proposal put forward by the Commission is intended to ensure such boards do listen and are held accountable. However, given that the number of boards ignoring shareholder concern with remuneration is small compared to the number of boards that have responded to shareholder concern, CSA also queries whether a major change such as the one proposed should be introduced based on outlier behaviour.

CSA also notes that much of the dissatisfaction that has been expressed on the remuneration report is related to termination payments. CSA notes that this issue has been dealt with separately in legislation.

CSA believes it is better governance practice to have shareholders hold a dialogue with the board to examine the issue of concern and board performance overall. **CSA recommends** that existing shareholder rights providing for shareholders with five per cent of the votes that may be cast at the meeting to call a meeting to vote on a resolution to remove the directors is a better means of achieving accountability to shareholders on remuneration issues.

Over a three-year cycle under Listing Rule 14.4, all directors are required to stand for re-election. There is therefore an existing opportunity for shareholders to vote against directors. Rather than creating a new right to force the entire board to stand for re-election, CSA believes that it would be more effective for shareholders to utilise their existing right. CSA points to the possibility of the dismissal of an entire board leaving the company in disarray, with decision making impaired or halted, which in turn could seriously disadvantage the company. Even if the board is re-elected, the distraction from a focus on running the company cannot be underestimated.

However, if the Commission's proposal were to be introduced, CSA believes that prescribing a threshold of an adverse vote of 25 per cent in the second year, as has been recommended by various stakeholders, disregards the views of the majority of shareholders. **CSA recommends** that, if the board is to face re-election on the basis of the Commission's proposal, the threshold would need to be over 50 per cent (in the second year) in order for a majority vote to be achieved. Otherwise, the interests of a minority of shareholders are being served while the majority of shareholders are ignored.