CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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Exposure Draft — Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Chartered Secretaries Australia (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 have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies, and not-for-profit and public sector organisations.

While CSA Members understand that the government's desire to act on the recommendations of the Productivity Commission in its report, *Executive Remuneration in Australia*[1], is to respond to community and political concern with the levels and structure of executive remuneration, CSA Members do not agree either with the Commission or the government that legislation is the most appropriate manner with which to strengthen the corporate governance framework so as to manage such concern. CSA notes that corporate governance processes that properly protect the interests of owners have been very successful when utilising a principles-based approach but tend, when utilising prescriptive approaches such as black-letter law, to not only produce unintended consequences but also introduce onerous compliance burdens without enhancing accountability mechanisms.

CSA Members are concerned that constructive suggestions made to the Productivity Commission on the practical application of its proposed reforms were not attended to, resulting in this draft legislation that imposes unintended and disproportionately onerous requirements while providing limited practical solutions to the issues they seek to address. CSA Members are also concerned about the period of consultation, being only one month and over the Christmas holiday period.

Notwithstanding this, our comments in the following pages are intended constructively. We have sought to elucidate the practical implications of aspects of the drafting of the Corporations

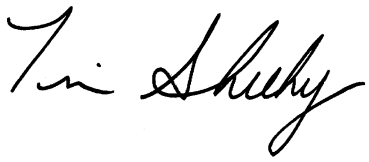
[1] *Productivity Commission, Inquiry Report, Executive Remuneration in Australia*, No. 49, 19 December 2009, Productivity Commission

Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011, and have provided recommendations on drafting changes, in an attempt to reduce some of the unintended consequences. At times, we make recommendations of different approaches where CSA is of the view that the consequences of the proposed legislation are so egregious that the bill needs to change. However, our efforts to provide constructive feedback on the bill should not be read as support for the legislation.

We have attached our previous submission on the Productivity Commission's interim report. This submission sets out our concerns with the Recommendations made by the Productivity Commission — those concerns have not altered.

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

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List of CSA recommendations

1 'Two strikes' test

CSA recommends that the drafting provide for *a high-level summary* of substantive issues raised on the remuneration report and an explanation of whether those issues have been taken into account and of either how they have been taken into account or why they have not been taken into account.

CSA recommends that the removal of directors from office cannot take place until the conclusion of the 'spill' meeting.

CSA recommends that a poll be mandated and that all directed proxies be taken into account as if they were direct voting.

2 The use of remuneration consultants

CSA recommends that the drafting be amended to ensure that it has a narrow definition in terms of who it captures and that it no longer requires a summary of the nature of the advice and the principles on which it was prepared.

CSA also recommends that the drafting in the UK legislation provides a useful model, as it is limited to advice setting or changing the remuneration levels of KMP, and excludes general advice applicable to the broader employee base, including where the KMP participate on the same terms and conditions as other employees. It should also exclude operational or day-to-day advice required to implement existing board-approved remuneration policies.

CSA strongly recommends that the Corporations Act not conflict with the requirements imposed on boards and remuneration committees by APRA, which is a government regulator that has consulted widely and whose prudential standards are acclaimed globally as a model of how to manage remuneration issues. ***CSA recommends*** that the APRA Prudential Practice Guides be followed as a model of how the legislation could deal with remuneration committees seeking independent advice from remuneration consultants in relation to *executive* remuneration.

CSA also recommends that the requirement for disclosure in the remuneration report be that boards disclose 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 also recommends that the original recommendations in the final report of the Productivity Commission could be reviewed as to how to approach the disclosure of advice

received by the board from remuneration consultants on executive remuneration. Those recommendations are that:[2]

> ... companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers ... where an ASX300 company's remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company's remuneration report.

3 Prohibiting KMP from voting on remuneration matters

CSA recommends that a similar approach should be taken as currently exists under Listing Rule 14.11 (the chairman's box), which maintains the shareholder right to appoint the chair as proxy, and vote on behalf of the shareholder.

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

Such an approach would ensure that shareholders:

- could continue to express confidence in the board by appointing the chair to vote on their behalf, even where the shareholder has not directed how the chair is to vote
- are not disenfranchised where they are happy to allow the chair to vote on their behalf.

CSA recommends that the legislation provide that the closely related party definition be consistent with the definition of reportable interest that directors use for the purpose of notifying their interests to the market.

4 Prohibiting hedging of incentive remuneration

CSA recommends that the legislation clarify that it is the hedging of unvested equity remuneration and vested equity remuneration that is subject to holding locks that is prohibited.

CSA also recommends that the Regulations exclude certain remuneration arrangements, such as income protection insurance from the operation of the legislation, rather than try to list on an inclusive basis all forms of remuneration.

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[2] Productivity Commission, *Executive Remuneration in Australia Productivity Commission Inquiry Report*, Recommendations 10 and 11, No 49, 19 December 2009, Australian Government

5 No vacancy rule

CSA recommends that new minimum requirements be introduced that any nomination for election as director be signed by at least the members specified in the Corporations Act as being entitled to give notice of a resolution that they propose to move at a general meeting of the company, that is, by 100 members or with those at least five per cent of the votes that may be cast at a general meeting.

CSA recommends that the legislation provide for a three-year term of shareholder approval, which aligns with the time requirement for proportional takeovers.

CSA recommends that the legislation not require each director to disclose his or her reasons in the explanatory statement when making the recommendation concerning the 'no vacancy' rule in the constitution.

CSA recommends that the requirement to lodge with ASIC a notice of intention to obtain member approval to declare that there are no vacant board positions within 14 days after the board resolution is passed be deleted from the legislation.

CSA recommends that the requirement to retain voting records relating to shareholders resolutions limiting board numbers for seven years, be deleted from the legislation.

6 Cherry picking

CSA recommends that, whether a proxy holder is or is not at a meeting, they are deemed to have voted their directed proxies (of which the registry has a record), even if they are unaware that they have been appointed as a proxy holder. In effect, this converts a directed proxy to a direct vote, with attached rights. This addresses the very real concern that it is an offence not to vote the directed proxies. Indeed, there is no longer a need to impose sanctions, as it removes the mischief.

CSA notes that direct voting is a solution to this problem, as it removes the intermediary between the shareholder and their vote being applied and there is no discretion which can be exercised by a proxy holder not to vote.

CSA also recommends that the Corporations Act be amended to provide for direct voting.

7 Persons required to be named in the remuneration report

CSA supports the proposal that remuneration disclosures will only be required for the KMP of the consolidated entity.

1 Strengthening the non-binding vote — the 'two-strikes' test

CSA has previously expressed its concerns with the proposal to introduce the 'two strikes' test. Our reasons for not supporting this reform have not changed, as CSA Members believe that the 'two strikes' rule:

- will disenfranchise rather than empower shareholders — once shareholders comprehend the extremely negative consequences from the exercise of the new power in dismissing the entire board at one meeting (the lack of continuity in the governance of the company would have a negative effect on the share price and shareholder value) they are unlikely to wield it, which defeats the objective of enhancing shareholder rights to hold boards accountable, and
- it is inappropriate to have a trigger for putting the re-election resolution that disregards the majority view (25 per cent is the minority view).

Notwithstanding this, our views below are intended as constructive suggestions to assist the practical implementation of this reform, should the government continue to support its introduction.

a) Responding to comments received on the remuneration report at the AGM

The Exposure Draft, in s 300A(1)(f), calls for directors to consider comments made on the remuneration report at the company's most recent AGM and explain whether those comments had been taken into account and either how they have been taken into account or why they have not been taken into account, where a resolution that the remuneration report for the last financial year be adopted was put to the vote at the company's most recent AGM, and at least 25 per cent of the votes cast were against adoption of that report.

Shareholders have many different reasons for how they cast their votes and there is no requirement for explanations to be provided. As a result, it will be difficult for companies to ascertain the key concerns that lead to the 'no' votes on a remuneration report. 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 a capital raising, and shareholders may seek to exercise a protest vote through the vote on the remuneration report. Companies also engage with proxy firms and other governance advisory bodies and institutional investors prior to the AGM on their remuneration report.

At the AGM, many different sorts of comments are made on the remuneration report, some of which are not connected in any relevant way to it, although the speaker might introduce their comments by reference to the remuneration report. It is quite common at AGMs for shareholders, in particular retail shareholders, to speak about consumer rather than shareholder issues, even though they preface their comments by reference to the remuneration report, while other shareholders, also under the guise of speaking to the remuneration report, have been known to speak at length on frivolous matters unrelated to remuneration (or any aspect of company performance).

At present, the lack of a threshold in the draft legislation has the effect of obliging companies to not only record all comments made at an AGM if brought up under the umbrella of the remuneration report, but also transcribe them and respond individually to each comment in the following year's remuneration report. Not only will this be extremely difficult at times, particularly where comments have no relevance to the remuneration report, but it will also add substantially

to the length of the remuneration report. Moreover, recording the AGM could act as a disincentive for some shareholders to speak, while encouraging others to speak on frivolous and unrelated matters.

The current drafting of the Exposure Draft will, therefore, as a matter of prudence, be interpreted as requiring all comments made at an AGM, regardless of relevance or repetition, to receive an individual response in the following year's remuneration report. Any shareholder who did not see their comment responded to individually in the following year's remuneration report could point to the legislation as a rationale for taking action against the directors.

The Productivity Commission commented during its public hearings on executive remuneration that it believed that companies had shown excessive zeal in the preparation of their remuneration reports with regards to meeting their statutory obligations under s 300A of the *Corporations Act 2001* (Cth). However, CSA is strongly of the view that this perspective disregards the fact that neither a company, nor its directors, can afford to be anything but meticulous in meeting statutory obligations in relation to the remuneration report, given that an offence based on these obligations is proposed to be an offence of strict liability.

CSA recommends that the drafting provide for *a high-level summary* of substantive issues raised on the remuneration report and an explanation of whether those issues have been taken into account and of either how they have been taken into account or why they have not been taken into account.

b) Potential for confusion in providing explanation of possible 'spill meeting' in the notice of meeting

The proposed 'two strikes' rule occurs where:

- a company's remuneration report receives a 'no' vote of 25 per cent or more at the AGM, obliging the company's subsequent remuneration report to explain whether shareholders' concerns have been taken into account, and either how they have been taken into account or why they have not been taken into account
- the company's subsequent remuneration report receives a 'no' vote of 25 per cent or more at the following year's AGM. Where this occurs, shareholders will vote at the same AGM on a separate resolution to determine whether the directors will need to stand for re-election within 90 days.

Given that a company will not know in advance of the relevant AGM if its remuneration report will receive a 'no' vote of more than 25 per cent, the effect of this provision is that a company must include in the notice of meeting explanations of different potential outcomes and different resolutions, which may or may not be put to shareholders. That is, the notice of meeting must include instructions and explanations on:

1. if the remuneration report attracts a 'no' vote of less than 25 per cent, the current board of directors remains in place
2. if the remuneration report attracts a 'no' vote of more than 25 per cent, shareholders will vote at that AGM to determine whether the directors will need to stand for re-election within 90 days. If this resolution does not pass with more than 50 per cent of eligible votes cast, the board of directors remains in place
3. if the resolution determining whether the directors will need to stand for re-election within 90 days passes with more than 50 per cent or more of eligible votes cast, then the 'spill meeting' must take place within 90 days.

Votes cast by proxy must be received at least 48 hours before the meeting (s 250B(1)). Given that the majority of investors, including institutional investors, vote by appointing proxies, and institutional investors represent the greatest percentage of shares, it means that the majority of votes are submitted prior to the discussion of the issues to which they relate at the AGM. As a

result, it is commonly believed that directors know whether resolutions will pass or not before an AGM. However, directors cannot always be certain whether the resolution on the remuneration report will attract a 'no' vote of more than 25 per cent before the meeting is held. CSA Members have, for example, experienced one proxy advisory firm recommending a 'yes' vote on the remuneration report, while another recommends a 'no' vote. This is extremely challenging for boards, as it goes to the core of the very real difficulty in addressing expectations concerning remuneration frameworks, as investors very often have different ideas on how remuneration should be structured. In other instances, CSA Members have experienced a misunderstanding of certain components of the remuneration frameworks by proxy advisory firms which has led to a large number of 'no' votes being received at the AGM from those proxy advisory firms unexpectedly recommending a 'no' vote. This has happened even when the boards and companies have engaged positively with the proxy advisory firms.

Importantly, given that the legislation provides that at least 28 days' notice must be given of a general meeting of a listed company's members (s 249HA(1) and (2)), and the cut-off for receipt of proxies is 48 hours, it is impossible for a board to know in advance of an AGM if the remuneration report will receive more than 75 per cent of eligible votes cast. Therefore, the notice of meeting will need to accommodate all possible outcomes that the legislation gives rise to. CSA is concerned that many shareholders will find the explanation of different processes, which may or may not eventuate, very confusing.

c) Potential for interested parties to seek to control the board through the use of the legislation

A substantial shareholder could well invoke the new legislation in order to effect a takeover of the board. For example, if a company was subject to a takeover offer by an investor who held a significant stake in the company and the takeover offer was rejected by the board, the shareholder could easily ensure that a 'no' vote of more than 25 per cent was achieved at the first AGM and could, without much effort, ensure that the remuneration report resolution gets more than 25 per cent of votes against it and the 'spill' resolution is passed That is, even if a shareholder has no genuine concerns with the remuneration framework of the company, the legislation could be used to seek control of the company. This is one of the unintended consequences of this legislation.

CSA is concerned that the legislation does not address the very real possibility that the 'two strikes' mechanism could be used to 'spill' a board, not because of concerns with remuneration, but in order to fulfil an unrelated purpose. The mere possibility of a 'spill' resolution could also be used as a tactic to create instability within a target company during a takeover bid.

d) Lack of an effective board

While the draft legislation provides that directors cease to hold office immediately before the 'spill' meeting, there is a strong possibility that directors could decline to stand for re-election at the EGM to be held 90 days after the second AGM. The lack of an effective board is likely to have a negative effect on the share price and shareholder value.

It is impossible to have all directors cease to hold office immediately before the meeting. This gives rise to there being no board and therefore no directors or chair to run the meeting. Moreover, if the meeting has to be adjourned for any reason (for example, evacuation in the case of fire) until a new meeting can be convened the company has no board. CSA notes that the Corporations Act, the Listing Rules and company constitutions universally provide that, where there is turnover of directors, the outgoing directors cease to hold office at the close of the meeting to avoid the company not having a board at any period. The appointment of new directors takes effect at the close of the meeting, and thus there is no gap.

Moreover, if directors are not re-elected at the EGM, identifying replacement directors may take time. (It is inappropriate for the remaining directors to re-appoint any of the directors who have failed to be re-elected at the EGM, irrespective of the skills and experience they can bring to the company's board.) The lack of an effective board is likely to have a negative effect on the share price and shareholder value at this point as well, creating further instability for the company.

While the draft legislation has provisions that force up to three directors who have been voted out to remain as directors in order to preserve the statutory minimum number of directors (if directors are not re-elected or choose not to stand for re-election) one of the ironic consequences could be that, if the chief executive is also the managing director, one of the three remaining directors would be the very executive with whose remuneration shareholders had concerns. Experience has shown that it is the managing director's remuneration that primarily focuses shareholder attention, rather than the remuneration of other executives.

Furthermore, if the directors choose not to stand for re-election, the current provision in the draft legislation that will force three directors to remain in place will have no effect. The current drafting refers to 'persons who gave the company signed consents to act … in anticipation of being appointed by such a resolution'. If directors choose not to resubmit themselves for re-election at the spill meeting, the company is faced with the possibility that there are insufficient directors to satisfy the Corporations Act requirements.

CSA recommends that the removal of directors from office cannot take place until the conclusion of the 'spill' meeting.

e) Death of voting by a show of hands and confusion as to results

CSA research over a decade shows that shareholder attendance at AGMs has been decreasing.[3] Even in circumstances of investor interest in and scrutiny of company performance in 2009, due to the exigencies of the global financial crisis, shareholder attendance at the AGM remained low. In 2009, only 0.3 per cent of shareholders in large companies (> $5b market capitalisation) and 7.3 per cent of shareholders in medium-sized companies in the ASX 200 ($50m—$5bn market capitalisation) attended the AGM. The percentage of shareholders attending the AGMs of Australia's largest companies (many of which have the largest retail shareholder bases) actually decreased from 1.5 per cent in 2007.[4]

Given the importance of ensuring that all shareholders are provided with the opportunity to vote on the resolution relating to the remuneration report, with its attendant very serious consequences, votes will no longer be able to be decided by a show of hands, given that the shareholders present at the AGM represent a tiny portion of total shareholders. The resolution on the remuneration report will need to be decided by a poll, in order to ensure that all votes lodged by proxy are also captured. At present, voting on a show of hands is frequently referred to by retail shareholders as the only means available to express a position to directors, and the Australian Shareholders' Association has long expressed a preference for voting in this fashion. However, the introduction of the legislation will see the death of voting by a show of hands on the resolution relating to the remuneration report.

Furthermore, it is not appropriate to put the 'spill' resolution to shareholders until the remuneration report resolution has been decided (that is, the resolution has been put to a poll, and all votes are properly counted and scrutinised).The results of that poll would not be known until some hours after the meeting and the chair cannot determine whether the 'spill' resolution must be put to the meeting until such time as the results are known. Because it is unlikely that

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[3] *2010 Benchmarking Governance in Practice in Australia, Survey results — May 2010*, Chartered Secretaries Australia

[4] There is no research on 2010 AGM attendance numbers currently available

the result of the remuneration report resolution would be known for some time after the poll has been held, then the board is faced with two alternatives, neither of which is attractive, One is to adjourn the meeting, and the other is to attempt to explain to shareholders that they will hold a poll that may or may not be valid (a contingent poll).

CSA recommends that a poll be mandated and that all directed proxies be taken into account as if they were direct voting.

f) Potential significant costs to shareholders

Finally, CSA notes that the requirement to hold an EGM within 90 days of the second AGM would give rise to significant expense for the company. It would also cause logistical difficulties, such as finding a venue at short notice (most AGM venues are booked one or two years in advance). There are also the costs of typesetting, printing and postage of the notice of meeting and proxy forms.

As companies that have received 'no' votes of more than 25 per cent in the first year cannot know in advance if the remuneration report will be passed with a majority exceeding 75 per cent at the second AGM, they will need to book the venue, audio visual equipment and catering in advance for an additional EGM within 90 days of the second AGM in anticipation of another possible 'no' vote, and risk losing any deposits, which are likely to be significant sums, in order to secure a venue for that potential EGM.

All of these costs are, of course, costs borne by shareholders.

2 The use of remuneration consultants

The draft legislation provides that companies that are disclosing entities will be required to disclose details relating to the use of remuneration consultants. In addition, remuneration consultants will be required to be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.

The draft legislation specifies that, in its remuneration report, a disclosing entity will be required to disclose the following details:

- the name of the consultant
- the name of each director who executed the contract under which the consultant was engaged
- the name of each person to whom the consultant directly gave the advice
- a summary of the nature of the advice and the principles on which it was prepared
- the amount and nature of consideration provided under the contract for the advice
- the nature of any other work the consultant did during the financial year for the company
- the amount and nature of consideration for the other work described above.

a) Definition of remuneration consultant

A new definition of 'remuneration consultant' is proposed, that includes anyone other than an officer or employee who provides advice 'relating to the nature and amount or value of remuneration for one or more members of the key management personnel for the company'. The drafting currently will capture a number of consultants who provide services to the company unrelated to the remuneration issues that the legislation is intended to address. For example, under the current drafting, companies will be required to disclose not just the names but all of the details listed above in relation to their accountants (including external auditors), lawyers and tax advisers, many of whom provide advice on remuneration-related issues.

CSA Members have serious concerns with the legislation capturing such a broad range of consultants. Under the current drafting, legal advice provided to a company, which is intended to be confidential and attract legal professional privilege, could unintentionally be waived. For example, a board of directors could well seek legal advice on the termination of the managing director. As termination relates to remuneration, the obtaining of this confidential advice would need to be disclosed. CSA contends that this is not a good governance outcome. Boards should be able to seek legal advice to satisfy themselves as to having applied due diligence to a range of issues, which in turn fulfils their fiduciary duties under the law.

CSA recommends that the drafting be amended to ensure that it has a narrow definition in terms of who it captures and that it no longer requires a summary of the nature of the advice and the principles on which it was prepared.

CSA also recommends that the drafting in the UK legislation provides a useful model, as it is limited to advice setting or changing the remuneration levels of key management personnel (KMP), and excludes general advice applicable to the broader employee base, including where the KMP participate on the same terms and conditions as other employees. It should also exclude operational or day-to-day advice required to implement existing board-approved remuneration policies.

b) Blurring of board and management responsibilities

The draft legislation dramatically reduces the efficiency of the human resources (HR) function in companies, as it proposes that it is an offence for a remuneration consultant to provide advice to

a person who is neither a non-executive director of the company nor a member of the remuneration committee.

In large companies, CSA notes that remuneration decisions are often 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 entire company, which by definition also includes themselves. This is usually the responsibility of the HR function but extends to executive management. The proposed legislation precludes the engagement of advisers by management, which in turn would have adverse effects on companies. For example, HR and executive management will contract remuneration consultants to provide advice on a range of issues. These can include assistance on the structure of remuneration, everyday advice about short-term and long-term incentive plans, retirement benefits, taxation, superannuation contributions, as well as queries on the operation of an employee share scheme (in which KMP will participate, as well as any other employees who choose to participate). There are also instances where remuneration consultants are engaged to provide tax, actuarial or superannuation advice that affect KMP — these are usually statutory benefits unrelated to the objective of the proposed legislation.

Under the proposed law, advice must only be provided to non-executive directors and not to the CEO or the HR team. As a consequence, the CEO will not be able to obtain advice about the remuneration of the KMP that report to the CEO (that is, his or her direct reports). HR personnel will be prohibited from liaising directly with remuneration consultants, which will preclude them from seeking immediate advice with practical (non-controversial) issues. This is an untenable position for any CEO or HR person. To limit the CEO's ability to seek advice and set remuneration is a significant hindrance to the company's ability to attract and retain talent and to properly undertake succession planning. To severely hamstring the HR functions in companies is not in the best interests of shareholders.

The proposed drafting in the Exposure Draft effectively removes the management function on many of the company's remuneration/benefits issues and places non-executive directors in the role of management.CSA does not support regulation that makes boards responsible for the remuneration of operational staff within a company.

It is also 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.

While CSA is of the view 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, the draft legislation goes well beyond this.

The draft provisions require the engagement contract to be executed only by non-executive directors, which blurs the boundaries between board and management responsibility. Moreover, this requirement is inconsistent with the requirement in s 127 of the Corporations Act for documents to be executed by the company secretary and a director or two directors. The requirement to provide the name of each director who executed a contract with a remuneration adviser in the remuneration report will not provide any useful information to shareholders, as given that only two directors need to sign the contract under s 127, they are likely to be the directors located closest physically. Furthermore, a consultant may also be engaged without signing a contract, either by email or verbally.

The draft legislation introduces a number of practical issues that pose a threat to corporate integrity. Most often the board or remuneration committee (through the chairman of the committee) seeks external advice through the company secretary (or in some cases through the relevant company executive for non-controversial advice). The advice is then filed in the board/committee records to evidence the proper discharge of the board/committee's duties. If the remuneration consultant is not allowed to provide the advice to the company secretary directly (even on a confidential basis), then the committee must rely on the non-executive director who receives the advice to distribute the advice to other directors and to necessary management members in order to maintain company records. Apart from the fact that the non-executive director is not a staff member involved in such day-to-day administration, there are other questions that arise.

For example, what happens when that non-executive director, who does not have an office at the company and does not maintain records on a company network, retires from the board? How does a company ensure continuity of knowledge and record retention? How does this provision affect discovery during litigation or in response to a regulator's notice to produce documents if the company executives are not aware that the advice is in existence? CSA notes that the draft legislation makes it an offence for a remuneration consultant to provide advice to a person who is neither a director nor a member of the remuneration committee. This means that the advice must be kept secret from all company employees (if the non-executive directors fail to forward the advice), which in turn ensures that the advice will not be kept with company records (or even be known to exist).

Moreover, breaches of these provisions will be offences. There is no other type of contract that companies enter into, be it for a large acquisition, financing facility, long-term supply contract or other arrangement critical to the economic health or governance of the company, including related party transactions, that is subject to such onerous restrictions.

Finally, CSA also notes that the requirement to disclose the nature as well as the consideration for work undertaken by a remuneration consultant is greater than the requirements of ss 300(11B) and 300 (11C) on disclosure of the amounts payable to an auditor for non-audit services (neither of these sections require the nature of the non-audit work to be disclosed).

CSA notes that the Australian Prudential Regulatory Authority has already dealt with the issue of a remuneration committee seeking external advice on remuneration issues which provides a model of how the legislation could work in giving the remuneration committee the discretion to seek independent advice without prescribing how it is to be done. *Prudential Practice Guide APG 510 — Governance*[5] provides that:

> 51. The Board Remuneration Committee, or in the case of a foreign ADI, the senior officer outside Australia, must:
> (a) have free and unfettered access to risk and financial control personnel and other parties (internal and external) in carrying out its duties; and (b) if choosing to engage third-party experts, have power to do so in a manner that ensures that the engagement, including any advice received, is independent.

[5] APRA, *Prudential Practice Guide APG 510 — Governance*, May 2006, Australian Prudential Regulatory Authority

Prudential Practice Guide PPG 511 — Remuneration, provides that:[6]

> 15. The Board Remuneration Committee may rely on administrative support from internal or external parties when conducting reviews. The Committee, in performing its duties, would typically seek information from relevant internal parties including, but not limited to, those responsible for risk management, human resource management and internal audit. APRA expects the Committee to ensure that there are processes in place to ensure advice from such parties is not influenced by conflicts of interest.
>
> **Use of external advisers**
> 19. If a Board Remuneration Committee engages external advisers, the governance standards require that the advisers be commissioned in a manner that ensures that their engagement, including any advice received, is independent. The Board Remuneration Committee will need to exercise its own judgement and not rely solely on the judgement or opinions of others.
>
> 20. Where a Board Remuneration Committee chooses to seek advice from a third party, there is a potential for conflicts of interest to arise where the third party provides, or may seek to provide, other advice or services to the regulated institution or its executives. In engaging an adviser, APRA expects the Committee not to engage an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution.

CSA strongly recommends that the Corporations Act not conflict with the requirements imposed on boards and remuneration committees by APRA, which is a government regulator that has consulted widely and whose prudential standards are acclaimed globally as a model of how to manage remuneration issues. ***CSA recommends*** that the APRA Prudential Practice Guides be followed as a model of how the legislation could deal with remuneration committees seeking independent advice from remuneration consultants in relation to *executive* remuneration.

CSA also recommends that the requirement for disclosure in the remuneration report be that boards disclose 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 also recommends that the original recommendations in the final report of the Productivity Commission could be reviewed as to how to approach the disclosure of advice received by the board from remuneration consultants on executive remuneration. Those recommendations are that:[7]

> ... companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers ... where an ASX300 company's remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key

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[6] APRA, *Prudential Practice Guide PPG 511 – Remuneration,* 30 November 2009, Australian Prudential Regulatory Authority. The information in this guide supports compliance with APRA's *Prudential Standard APS 510 Governance*, *Prudential Standard GPS 510 Governance* and *Prudential Standard LPS 510 Governance* (collectively referred to as the governance standards), which set out APRA's requirements in relation to remuneration.

[7] Productivity Commission, *Executive Remuneration in Australia Productivity Commission Inquiry Report*, Recommendations 10 and 11, No 49, 19 December 2009, Australian Government

management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company's remuneration report.

3 Prohibiting KMP from voting on remuneration matters

The draft legislation provides that KMP that are appointed as a proxy will be prohibited from voting undirected proxies on all remuneration-related resolutions.

Under the Accounting Standards, KMP include non-executive directors as well as executives. The vast majority of undirected proxies that are lodged, particularly by retail shareholders, appoint the chair as their proxy. By prohibiting the chair from voting the undirected proxies, these shareholders will be disenfranchised. Their choice to appoint the chair as their proxy to vote on their behalf is a vote of confidence in the chair and the board, yet the draft legislation will prevent the voting intentions of these shareholders from being realised. The proposed legislation denies the shareholder the right to exercise their vote, unless they can either physically attend the meeting or appoint another proxy to exercise that right for them.CSA queries how else shareholders who do have confidence in the board are to express that confidence if the right to appoint the chair as their proxy is taken from them.

The government is, in effect, opining either that shareholders:

- should direct all proxies and not have the choice to leave them undirected (yet the legislation does not demand this, and this has not been subject to public debate), or
- should not be able to express confidence in the board and appoint the chairman or any other director as their proxy.

It is instructive to examine the numbers of shareholders who will be disenfranchised. Below are some relevant figures of undirected proxies on remuneration reports received from retail shareholders during the 2010 AGM season. Of further relevance is that the companies in question are those with very large retail shareholder bases. These figures can be found on the ASX announcements platform.

- Company 1 — 27 per cent of all proxies lodged on the remuneration report resolution were undirected. The market value of those shares was $42 million.
- Company 2 — 35 per cent of all proxies lodged on the remuneration report resolution were undirected. The market value of those shares was $200 million.
- Company 3 — 22 per cent% of all proxies lodged on the remuneration report resolution were undirected. The market value of those shares was $77 million.

In addition, looking at the ASX 50 companies (many of which have very large retail shareholder numbers), while the percentage of the total undirected proxies lodged on the remuneration report was not huge as a percentage of all proxies lodged, the market value of them (and hence the large market value of shares that will be disenfranchised if the new rule comes into play) was very large indeed:

- Company A — The market value of all undirected proxies lodged on the remuneration report resolution was $2.2 billion.
- Company B — The market value of all undirected proxies lodged on the remuneration report resolution: $1.5 billion.
- Company C — The market value of all undirected proxies lodged on the remuneration report resolution was $785 million.
- Company D — The market value of all undirected proxies lodged on the remuneration report resolution was $695 million.
- Company E — The market value of all undirected proxies lodged on the remuneration report resolution was $358 million.

As can be seen from the figures above, the prevention of such large numbers of votes being cast introduces an unprecedented curtailment of shareholder rights in Australia. Shareholders should be rightly concerned that the government is seeking to diminish their rights in this fashion, and on such a scale.

CSA recommends that a similar approach should be taken as currently exists under Listing Rule 14.11 (the chairman's box), which maintains the shareholder right to appoint the chair as proxy, and vote on behalf of the shareholder.

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

Such an approach would ensure that shareholders:

- could continue to express confidence in the board by appointing the chair to vote on their behalf, even where the shareholder has not directed how the chair is to vote
- are not disenfranchised where they are happy to allow the chair to vote on their behalf.

Related parties

The definition of closely related party in the draft legislation refers to 'child' of the member, or member's spouse, and other family members who 'may be expected to influence … or be influenced by' the member. This definition would potentially include independent adult children, parents and siblings who have separate and independent financial plans to the KMP. To prohibit these people from voting their shares merely because a relative is a KMP of a company interferes with the exercise of private property rights.

CSA notes that the Productivity Commission report[8] acknowledged that:

> Extending this prohibition to the 'associates' of directors and key management personnel appears infeasible in practice. As many participants indicated, the term 'associates' could inadvertently preclude from voting some major company shareholders by virtue of them being defined as associates to the primary company. Even a tighter definition such as 'close associate' — defined in s- 9 of the Corporations Act — could inappropriately exclude relatives of directors or key management personnel who independently purchased shares in the company.

CSA recommends that the legislation provide that the closely related party definition be consistent with the definition of reportable interest that directors use for the purpose of notifying their interests to the market.

[8] *Productivity Commission, Inquiry Report, Executive Remuneration in Australia*, No. 49, 19 December 2009, p 371, Productivity Commission

4 Prohibiting hedging of incentive remuneration

The draft legislation provides that KMP and their closely related parties will be prohibited from hedging the KMP's incentive remuneration.

The ASX Corporate Governance Council *Corporate Governance Principles and Recommendations*, which are fully supported by all shareholder groups, provides a model for how the legislation should operate. The guidelines specify that:[9]

> Appropriately designed equity-based remuneration ... schemes should clearly prohibit entering into transactions or arrangements which limit the economic risk of participating in unvested entitlements under these schemes.

CSA notes that the draft legislation does not specify that it is *unvested* equity remuneration and vested equity remuneration that is subject to holding locks that must not be hedged.

CSA notes that executives should be free to hedge equity remuneration after it has vested and is no longer subject to a holding lock.

CSA also notes that it is unclear if the legislation will capture legitimate remuneration arrangements, such as income protection insurance. CSA is of the strong view that the Regulations should exclude certain forms of remuneration arrangements from the operation of the legislation, rather than trying to list on an inclusive basis all forms of remuneration that it will cover.

CSA recommends that the legislation clarify that it is the hedging of unvested equity remuneration and vested equity remuneration that is subject to holding locks that is prohibited.

CSA also recommends that the Regulations exclude certain remuneration arrangements, such as income protection insurance from the operation of the legislation, rather than try to list on an inclusive basis all forms of remuneration.

[9] Australian Corporate Governance Council, 'Principle 8: Remunerate fairly and responsibly', *Corporate Governance Principles and Recommendations with 2010 Amendments*, 2nd edition, 2010

5 No vacancy rule

The draft legislation provides for public companies being required to obtain the approval of their members for a declaration that there are no vacant board positions, should the number of board positions filled be less than the maximum number specified in the company's constitution. If agreed, the declaration lasts until the following AGM. Any appointment of a director made while the declaration is in place must be confirmed by a resolution of members at the following AGM, or the appointment lapses at the conclusion of that AGM.

a) Notice of meeting and nomination of candidates

The procedure in the constitution for the nomination of non-board endorsed candidates for many companies followed Listing Rule 14.3, which specifies a minimum nomination period of 35 business days before the date of the AGM, unless the constitution provides otherwise. Many companies sought a longer period of 45 business days in the company's constitution in the 2010 AGM season to ensure that the company has sufficient time to respond to any non-board endorsed nominations, including sufficient time for printing and mailing of the notice of meeting.

This is because the introduction of the 'no vacancy' rule ushers in a number of practical complexities. Shareholders will need to approve (by ordinary resolution) the board's decision to apply the 'no vacancy' rule to the election of directors at that same meeting. This gives rise to two possible outcomes, which need to be explained to shareholders in the notice of meeting as follows:

1. If shareholders agree that the 'no vacancy' rule should apply to the election, additional board positions will not be available. Non-board endorsed candidates for election to the board would need to satisfy the voting hurdles of a) the majority of votes cast on the election of that candidate to be in favour of that candidate's election, that is, an ordinary resolution); and more votes to be cast in favour of their election than at least one of the board-endorsed candidates seeking election or re-election (candidate vote comparison).
2. If, however, shareholders determine that the rule does not apply, candidates would be able to stand for board vacancies up to the maximum number of positions specified by the constitution. All candidates would only need to satisfy one voting hurdle, being an ordinary resolution in favour of their election.

A company that wishes to invoke the 'no vacancy' rule will not know in advance of a general meeting which of the two voting methods will apply to the election of directors at the meeting. This means that the voting procedure outlined in the notice of meeting will be more complex and difficult to explain to shareholders. The proxy directions given to shareholders will need to constructed so as to facilitate different possible outcomes. Given that the notice of meeting will already be complicated with instructions on different possible outcomes due to the 'two strikes' rule, CSA notes that the potential for shareholder confusion is extremely high. The resultant notice of meeting could well be longer than the remuneration report. Shareholders have already noted their dissatisfaction with a long remuneration report and CSA queries if they will be happy to receive long and complicated notices of meeting.

CSA Members also have a very real concern that this initiative will:

- encourage and facilitate single-issue individuals and special interest groups to nominate candidates for election as directors, or
- lead to companies appointing more directors up to the maximum limit permitted under their constitution in order to avoid the risk of single issue individuals or special interest groups nominating candidates for election. For example, if a company has a board of 10 directors with a constitution that permits a maximum of 16, the proposed provisions encourage an environmental group to nominate six nominees for vacancies, thereby providing them with a 'no cost' opportunity to have a significant amount of material included in the notice of meeting and then to dominate the AGM with their platform

through various presentations by the six nominees. The other scenario is a litigant (for example, an ex-employee) seeking to use this process as a means of ventilating their issues in a public forum in an attempt to maximise pressure on the company to resolve their litigation. CSA understands that these risks exist already but is concerned that the introduction of this new legislation and the publicity that will surround it will raise the awareness levels and heighten the risk of more non-board endorsed candidates nominating for reasons other than a genuine desire to join the board.

CSA recommends that new minimum requirements be introduced that any nomination for election as director be signed by at least the members specified in the Corporations Act as being entitled to give notice of a resolution that they propose to move at a general meeting of the company, that is, by 100 members or with those at least five per cent of the votes that may be cast at a general meeting.

b) Annual resolution on 'no vacancy' rule

CSA recommends that the legislation not require a company to put the 'no vacancy' resolution to shareholders annually. This is an onerous requirement and does not provide additional benefits. CSA notes that an annual resolution is not required for more controversial resolutions.

CSA recommends that the legislation provide for a three-year term of shareholder approval, which aligns with the time requirement for proportional takeovers.

c) Explanatory statement

CSA strongly opposes requiring each director to disclose his or her reasons in the explanatory statement when making the recommendation concerning the 'no vacancy' rule in the constitution, as this is contrary to the corporate law principle that the board acts as a whole and not through individual directors. The board is expected to make a single statement on all matters relating to the company. For this very reason, CSA notes that all the directors would likely provide the same reason, so the notice of meeting would contain repetitive disclosures.

CSA recommends that the legislation not require each director to disclose his or her reasons in the explanatory statement when making the recommendation concerning the 'no vacancy' rule in the constitution.

d) Lodgement of notice with ASIC

CSA also noted that the requirement to lodge with ASIC a notice of intention to obtain member approval to declare that there are no vacant board positions within 14 days after the board resolution is passed is an unnecessary administrative burden. Shareholders will not be monitoring ASIC lodgements. No other board resolutions need to be lodged with ASIC. Shareholders do, however, monitor the ASX announcements platform. The intention will be included in the notice of meeting which will be lodged at ASX and sent to shareholders in plenty of time before the meeting.

CSA recommends that the requirement to lodge with ASIC a notice of intention to obtain member approval to declare that there are no vacant board positions within 14 days after the board resolution is passed be deleted.

e) Voting records

CSA also notes that the legislation proposes a requirement to retain voting records relating to shareholder resolutions limiting board numbers for seven years. This is an onerous requirement which brings no additional benefit to shareholders.

CSA recommends that the requirement to retain voting records relating to shareholders resolutions limiting board numbers for seven years be deleted from the legislation.

6 Cherry picking

The current law requires all directed proxies held by the chair to be voted; however, non-chair proxy holders are not subject to the same statutory obligations.

The draft legislation proposes to require all proxy holders to cast all their directed proxies on all resolutions. The current ss 250A(4)(c) and (d) in the Corporations Act, dealing with the exercise of directed proxy votes by the chairman and by those other than the chairman, will be repealed. A new s 250A(4)(c) will require proxy holders to exercise all directed proxies. The new provision will not distinguish between the chair and other proxy holders.

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.

However, it is important to note that neither bill imposed a *blanket* obligation on all proxy holders. CSA is on the record as having supported this approach, as persons may be unwittingly 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 be detained on the way to the meeting, or may need to leave the meeting before the vote is taken). There is nothing in the law that requires a shareholder to attend and vote at a members meeting — shareholder voting is not compulsory.

CSA notes that the Explanatory Memorandum at p 57 indicates that there is an intention to address the concerns connected with imposing a blanket obligation on all proxy holders as follows:

> In the case that a proxy holder is not able to attend the meeting, all directed proxies would continue to default to the Chair. Non-Chair proxy holders would be provided with a defence if they did not vote directed proxies because they were not aware of their appointment, or they were unable to attend a meeting.

The primary issue appears to be a concern that directors and the company secretary might not vote the proxies they held, rather than that other proxy holders (that is, ordinary shareholders) might cherry pick. A shareholder could appoint a proxy and return the form to the company or registry and not notify the proxy holder, who would remain unaware they had been appointed a proxy. CSA is very strongly of the view that it would be unreasonable to expect a proxy holder, other than a director or company secretary (who will virtually always be attending the meeting) to vote proxies they are unaware of, and then to impose personal liability on such a person for failing to vote.

CSA supports the proposed legislation providing that any directed proxies default to the chair should the proxy holder be absent or unaware they hold the proxies, as the chair has an existing statutory obligation to vote all directed proxies. This addresses the concern that proxies are cherry picked without imposing the obligation on all persons, with the attendant problems this raises.

However, CSA believes that the government needs to do more than 'provide a defence' for proxy holders who did not vote directed proxies because they were unaware of their appointment or absent from the meeting. CSA also notes that the defence does not currently exist in the Exposure Draft of the legislation, only in the Explanatory Memorandum, although presumably the defence of 'not knowing' is provided by reference to the Criminal Code. CSA

queries how the defence of 'not being able to attend the meeting' could be covered by reference to the Criminal Code. Moreover, given that shareholder voting is not compulsory, CSA finds it extraordinary that not voting proxies held would be considered a criminal offence.

CSA recommends that, whether a proxy holder is or is not at a meeting, they are deemed to have voted their directed proxies (of which the registry has a record), even if they are unaware that they have been appointed as a proxy holder. In effect, this converts a directed proxy to a direct vote, with attached rights. This addresses the very real concern that it is an offence not to vote the directed proxies. Indeed, there is no longer a need to impose sanctions, as it removes the mischief.

The Explanatory Memorandum also notes on pp 59—60 that:

> It is important to ensure that company voting systems are effective in enabling shareholders to vote on a resolution without having to attend a meeting. Voting systems should be transparent and clearly reflect the views of those that own the company and should ensure that shareholder signals on a resolution are not muted.

CSA notes that direct voting is a solution to this problem, as it removes the intermediary between the shareholder and their vote being applied and there is no discretion which can be exercised by a proxy holder not to vote.

CSA also recommends that the Corporations Act be amended to provide for direct voting.

Alternative should CSA recommendations not proceed

Should our recommendations not be accepted, and the proposal to provide a defence to those proxy holders who are unaware they have been appointed as a proxy holder or who did not attend the meeting proceeds, then ***CSA strongly recommends*** that ASIC would need to prove that the person was aware they had been appointed or were present at the meeting, rather than have the proxy holder prove they were unaware or did not attend the meeting. That is, it would be essential that the legislation not apply a reverse burden of proof on proxy holders.

7 Persons required to be named in the remuneration report

Under the new law, remuneration disclosures will only be required for the KMP of the consolidated entity.

CSA supports this proposal.

CSA agrees that this measure will simplify the disclosures in the remuneration report, to enable shareholders to better understand the company's remuneration arrangements and will also reduce the regulatory burden on companies, while maintaining an appropriate level of accountability.