2010-2011

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

CORPORATIONS AMENDMENT (IMPROVING ACCOUNTABILITY ON DIRECTOR AND EXECUTIVE REMUNERATION) BILL 2011

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Parliamentary Secretary to the Treasurer, the Hon David Bradbury MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	*Definition*
AGM	Annual General Meeting
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
Corporations Act	*Corporations Act 2001*
KMP	Key Management Personnel
PC	Productivity Commission
RIS	Regulation Impact Statement

General outline and financial impact

General Outline

The Bill contains a range of measures to strengthen Australia's remuneration framework, and to implement many of the recommendations made by the Productivity Commission (PC) in its recent inquiry into Australia's remuneration framework.

In particular, the Bill contains measures to empower shareholders to hold directors accountable for their decisions relating to executive remuneration, to eliminate conflicts of interest in the remuneration setting process, and to increase transparency and accountability in remuneration matters.

The key measures include:

- strengthening the non-binding vote on the remuneration report, by requiring a vote for directors to stand for re-election if they do not adequately respond to shareholder concerns on remuneration issues over two consecutive years;
- increasing transparency and accountability with respect to the use of remuneration consultants;
- eliminating conflicts of interests that exist with directors and executives voting their shares on remuneration resolutions;
- ensuring that remuneration remains linked to performance by prohibiting hedging of incentive remuneration;
- requiring shareholder approval for declarations of 'no vacancy' at an AGM;
- prohibiting proxy holders from 'cherry picking' which proxies they exercise, by requiring them to cast all of their directed proxies;
- improving the readability of the remuneration report by confining disclosures to the key management personnel (KMP).

Date of effect: 1 July 2011.

Summary of regulation impact statement

Regulation impact on business

Impact: A Regulation Impact Statement (RIS) has been prepared in accordance with the Government's best practice regulation requirements.

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

Context of amendments

1.1 The Corporations Act requires a listed company to put its remuneration report to a non-binding shareholder vote at the annual general meeting (AGM).

1.2 Many submissions to the PC inquiry noted that the introduction of the non-binding vote has resulted in increased dialogue between companies and shareholders on remuneration issues. Anecdotal evidence suggests that some boards are responsive to the non-binding vote, and that the opportunity for shareholders to put forward their views is having a positive impact on remuneration polices.

1.3 However, some concerns have been raised with the non-binding vote. The Corporations Act currently does not set out any requirements where a board proceeds with its remuneration proposals despite a negative shareholder vote. This has prompted suggestions that the Corporations Act be amended to strengthen the vote by setting out consequences in the event that shareholders vote against the company's remuneration report.

1.4 Currently, if shareholders are dissatisfied, they have the power to vote to remove a director, although this is a somewhat extreme response, particularly if the director is having a positive impact on the value of the company.

1.5 It is not considered ideal to make the vote binding, as there are significant practical difficulties and costs associated with introducing a binding shareholder vote on remuneration. If a binding vote on remuneration was introduced, companies would not be able to finalise a contract with an executive until shareholder approval was obtained, and this is likely to create considerable uncertainty and delay, particularly if the company is looking to quickly secure a top executive. These concerns were highlighted in the PC's report. In addition, a binding vote could potentially be disruptive to the operation of the company, particularly if a deadlock arose between shareholders and management regarding the appropriate levels of remuneration.

1.6 Furthermore, the introduction of a binding vote for shareholders would represent a fundamental change to the directors' role and their capacity to manage the company. A binding vote on remuneration would absolve directors of their responsibility to shareholders on this issue, and would also undermine their capacity to make key decisions affecting the performance of the company. It could also affect the competitiveness of Australian companies and their ability to attract and retain top executives, particularly as other jurisdictions could offer executives greater certainty about their levels of remuneration.

Summary of new law

1.7 Under the new law, a 'two-strikes and re-election' process will be introduced in relation to the non-binding vote on the remuneration report.

1.8 The 'first strike' occurs where a company's remuneration report receives a 'no' vote of 25 per cent or more. Where this occurs, the company's subsequent remuneration report must 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.

1.9 The 'second strike' occurs where the company's subsequent remuneration report receives a 'no' vote of 25 per cent or more. Where this occurs, shareholders will vote at the same AGM to determine whether the directors will need to stand for re-election within 90 days. If this resolution passes with 50 per cent or more of eligible votes cast, then the 'spill meeting' will take place within 90 days.

1.10 This reform is intended to provide an additional level of accountability for directors and increased transparency for shareholders. Where a company faces significant 'no' votes over two consecutive years, and the company has not adequately responded to concerns raised by shareholders the previous year, it is appropriate for the boards of such companies to be subject to greater scrutiny and accountability through the re-election process.

1.11 This reform strengthens the non-binding vote and maintains the fundamental principle underlying Australia's corporate governance framework that directors are responsible for, and accountable to, shareholders on all aspects of the management of the company, including the amount and composition of executive remuneration.

Comparison of key features of new law and current law

New law	*Current law*
A 'two-strikes and re-election' process will be introduced where a company faces significant 'no' votes on its remuneration report over two consecutive years.	The Corporations Act does not set out any consequences where a board proceeds with its remuneration policies despite a negative shareholder vote.

Detailed explanation of new law

1.12 Under the new law, a 'two-strikes and re-election' process will be introduced, as set out below:

- where a company's remuneration report receives a 'no' vote of 25 per cent or more, the company's subsequent remuneration report must 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 ***[Schedule 1, Item 15, paragraph 300A(1)(g)]***;and

- where the company's subsequent remuneration report receives a 'no' vote of 25 per cent or more, a resolution must be put (known as the 'spill resolution') to shareholders at the same AGM. Notice of the spill resolution must be contained in the meeting papers for the AGM. If the spill resolution passes with 50 per cent or more of the eligible votes cast, another meeting of the company's shareholders (known as the 'spill meeting') must be held within 90 days. ***[Schedule 1, Item 9, section 250V]***

  - The separation of the 'spill resolution' and the 'spill meeting' is intended to ensure that shareholders are not discouraged from voting against the remuneration report, because they fear removal of certain board members. The 'de-linking' of these two resolutions ensures that shareholders are free to express their concerns on the remuneration report, and is intended to provide a clearer signal of shareholders' views on the remuneration report.

1.13 At the spill meeting, the range of directors required to stand for re-election are those individuals that were directors when the directors' report was passed at the most recent AGM (other than the managing director, who is permitted to hold office indefinitely without being re-elected to the office, pursuant to the ASX listing rules) ***[Schedule 1, Item 9, subsection 250V(1)]***. These directors cease to hold office immediately before the spill meeting. If none of these directors remain directors of the company and have been replaced by other individuals by the time of the

spill meeting, then the company is not required to hold the spill meeting. ***[Schedule 1, Item 9, subsections 250W(3) and (4)]***

1.14 If the company fails to hold the spill meeting within 90 days of the spill resolution being passed, each person who is a director of the company at the end of those 90 days commits an offence. However, this does not apply to a director appointed at a point in time that would not allow the requisite amount of notice for the meeting to be given under existing section 249HA. ***[Schedule 1, Item 9, subsections 250W(5) and (8)]***

1.15 The Bill provides a mechanism that is intended to ensure that a minimum of three directors remain after the spill meeting, as required by existing section 201A(2) of the Corporations Act. As the managing director is not required to stand for re-election, at least one director of the company should remain following the spill meeting. To reach the minimum of three directors, the remaining positions will be filled by those with the highest proportions of votes favouring their appointment cast at the spill meeting on the resolution for their appointment (even if less than half the votes cast on the resolution were in favour of their appointment). If two or more individuals have the same proportion of votes, the remaining director/s can choose which individual is appointed as a director, and this appointment must be confirmed at the company's next AGM. ***[Schedule 1, Item 9, section 250X)]***

1.16 Under the new law, if a director survives the spill meeting, their appointment continues uninterrupted ***[Schedule 1, Item 9, section 250Y)]***. This is intended to provide continuity and ensures that such directors do not obtain a 'fresh start' in terms of the duration of their appointment.

Application and transitional provisions

1.17 The new law will apply to resolutions on the remuneration report held after 1 July 2011. That is, the re-election resolution will be triggered where both strikes occur after 1 July 2011.

Chapter 2
Improving accountability on the use of remuneration consultants

Context of amendments

2.1 Remuneration consultants provide advice to companies on matters relating to remuneration arrangements, pay structures and performance hurdles, including strategic advice on how the levels of remuneration are benchmarked against industry standards. Some stakeholders have expressed concerns about companies engaging remuneration consultants to provide advice on director and executive remuneration.

2.2 A key concern raised by stakeholders is that remuneration consultants may be placed in a position of conflict if they are asked to provide advice on the remuneration of officers who might have the capacity to affect whether or not that consultant's services will be retained again (either for remuneration advice or other services the consultant may provide to the company). For example, a remuneration consultant may feel that remuneration advice that is unfavourable to the company executives may compromise their ability to obtain future work from the company. In addition, concerns have been raised that the use of remuneration consultants can 'ratchet up' remuneration levels.

2.3 While the advice of remuneration consultants may be influential in determining a company's remuneration decisions, the primary responsibility for remuneration arrangements rests with company directors.

Summary of new law

2.4 Under the new law, companies that are a disclosing entity will be required to disclose details relating to the use of remuneration consultants. In addition, remuneration consultants are required to be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.

2.5 This reform is intended to deliver greater transparency for shareholders, as they will be in a better position to assess potential conflicts of interests. It will also facilitate greater independence of

remuneration consultants by ensuring that their advice is provided directly to non-executive directors or the remuneration committee, rather than the company executives. It will also bring Australia into line with other key jurisdictions which require disclosure of the use of remuneration consultants.

Comparison of key features of new law and current law

New law	*Current law*
Companies that are a disclosing entity will be required to disclose details relating to the use of remuneration consultants. Remuneration consultants must be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.	Currently, companies are not required to disclose any details relating to the use of remuneration consultants. In addition, there is no requirement for remuneration consultants to be engaged by, and their advice provided directly to, non-executive directors or the remuneration committee.

Detailed explanation of new law

Disclosure relating to the use of remuneration consultants

2.6 Under the new law, a disclosing entity that is a company will be required to disclose, in its remuneration report, details relating to the remuneration consultant. In particular, the following details are required to be disclosed:

- the name of the consultant; and
- the name of each director who executed the contract under which the consultant was engaged; and
- the name of each person to whom the consultant directly gave the advice; and
- a summary of the nature of the advice and the principles on which it was prepared; and
- the amount and nature of consideration provided under the contract for the advice; and

- the nature of any other work the consultant did during the financial year for the company; and

- the amount and nature of consideration for the other work described above.

[Schedule 1, Item 15, paragraph 300A(1)(h)]

Engaging remuneration consultants

2.7 Under the new law, only non-executive directors can execute a contract to engage a remuneration consultant ***[Schedule 1, Item 5, sub-section 206K(2)]***. This requirement applies to a company that is a disclosing entity that engages a remuneration consultant ***[Schedule 1, Item 5, sub-section 206K(1)]***. A contravention of this requirement does not affect the validity of the contract with the remuneration consultant ***[Schedule 1, Item 5, sub-section 206K(4)]***.

Advice from remuneration consultants

2.8 The Bill requires remuneration consultants to provide their advice directly to the directors of the company (except executive directors, unless all of the directors are executive directors), or the remuneration committee, or both ***[Schedule 1, Item 5, sub-sections 206L(2) and (3)]***.

2.9 The Bill relies on the ordinary meaning of the term 'executive director'. An executive director is widely understood to be a full-time employee of the company who takes part in the daily management of the company, and is delegated control of the company's activities from the board of directors. This typically includes, for example, the chief executive officer and the chief financial officer. Specific comments are sought on whether a statutory definition of 'executive director' is necessary, and if so, how the term should be defined.

2.10 The Bill provides that a contravention of proposed sub-section 206L(2) is not an offence ***[Schedule 1, Item 5, sub-section 206L(5)]***. This is intended to ensure that a remuneration consultant is not criminally liable for a failure to prepare or produce their advice altogether (although a remuneration consultant may face civil liability, for example, a claim for breach of contract for their failure to do so). In contrast, where the remuneration consultant prepares the advice and provides it to a prohibited person, then the remuneration consultant will be guilty of a criminal offence ***[Schedule 1, Item 5, sub-section 206L(5)]***.

Application and transitional provisions

2.11 The proposed disclosures concerning the use of remuneration consultants apply in relation to remuneration reports for financial years starting on or after commencement (1 July 2011).

2.12 The proposed measures relating to the engagement of remuneration consultants apply to the execution of contracts on or after commencement (1 July 2011).

2.13 The proposed measures relating to the advice from remuneration consultants apply to advice given under contracts executed on or after commencement (1 July 2011).

Chapter 3
Prohibiting KMP from voting on remuneration matters

Context of amendments

3.1 Section 250R of the Corporations Act provides that a listed company must put its remuneration report to a non-binding shareholder vote at the AGM.

3.2 Concerns have been raised where directors and executives, whose remuneration is disclosed in the remuneration report, can also participate in the non-binding vote if they hold shares in the company.

3.3 As these directors and executives have an interest in approving their own remuneration arrangements, allowing them to participate in the non-binding vote may result in a higher approval vote on the remuneration report than might otherwise be achieved. This could distort the outcome of the non-binding vote and diminish its effectiveness as a feedback mechanism.

3.4 There is also a real, as well as perceived, conflict of interest that exists with directors and executives voting on their own remuneration packages.

3.5 Currently, the Corporations Act does not prohibit directors or executives from participating in the non-binding vote on remuneration. While section 224 of the Corporations Act prohibits related parties and their associates from casting a vote on related party transactions, it does not extend the prohibition to the non-binding vote contained in section 250R. Section 195 also provides that a director must not vote on a matter involving material personal interests, although an exception exists in relation to the director's remuneration.

Summary of new law

3.6 Under the new law, KMP and their closely related parties will be prohibited from participating in the non-binding vote. In addition, KMP and their closely related parties will be prohibited from voting undirected proxies on all remuneration related resolutions.

Comparison of key features of new law and current law

New law	*Current law*
Prohibit key management personnel (and their closely related parties) that hold shares from voting on their own remuneration arrangements, as part of the non-binding vote. Prohibit key management personnel (and their closely related parties) from voting undirected proxies on all remuneration related resolutions.	Key management personnel can participate in the non-binding vote, including by exercising undirected proxies.

Detailed explanation of new law

Non-binding vote

3.7 Under the new law, a KMP, their closely related party or any person acting on behalf of the KMP or their closely related party, must not cast a vote in the non-binding resolution on the remuneration report ***[Schedule 1, Item 8, sub-section 250R(4)]***.

3.8 An exception to this prohibition exists where the person is exercising a directed proxy (which specifies how the proxy is to vote on the proposed resolution) on behalf of someone other than the KMP or the closely related party ***[Schedule 1, Item 8, sub-section 250R(5)]***.

3.9 The Bill provides ASIC with the ability to provide relief from the prohibition, where it would not cause unfair prejudice to the interests of any shareholder of the listed company ***[Schedule 1, Item 8, sub-section 250R(6)]***. This is intended to provide flexibility in cases where the prohibition would lead to harsh or unintended outcomes. The written declaration made by ASIC is not a legislative instrument.

3.10 A vote cast in contravention of the prohibition does not affect the validity of the resolution. It is, however, taken to have not been cast and will not be counted in determining whether the resolution passed. ***[Schedule 1, Item 8, sub-section 250R(8)]***

Undirected proxies

3.11 Under the new law, a KMP or their closely related party that is appointed as a proxy must not exercise the proxy on a resolution connected directly or indirectly with the remuneration of a KMP, if the proxy is undirected (that is, if the appointment does not specify the way

the proxy is to vote on the resolution) ***[Schedule 1, Item 7, sub-section 250A(5B)]***.

3.12 The Bill provides ASIC with the ability to provide relief from the prohibition, where it would not cause unfair prejudice to the interests of any shareholder of the company ***[Schedule 1, Item 7, sub-section 250A(5C)]***. This is intended to provide flexibility in cases where the prohibition would lead to harsh or unintended outcomes. The written declaration made by ASIC is not a legislative instrument.

3.13 A vote cast in contravention of the prohibition does not affect the validity of the resolution. It is, however, taken to have not been cast and will not be counted in determining whether the resolution passed. ***[Schedule 1, Item 7, sub-section 250A(5D)]***

Application and transitional provisions

3.14 The proposed prohibition on KMP (and their closely related parties) voting in the non-binding vote applies in relation to voting on or after commencement (1 July 2011), irrespective of whether the remuneration report concerned relates to a financial year starting before, on or after 1 July 2011.

3.15 The proposed prohibition on KMP (and their closely related parties) voting undirected proxies in remuneration related resolutions applies in relation to voting on or after commencement (1 July 2011), irrespective of whether the matter that is the subject of the resolution relates to a time before, on or after 1 July 2011.

Chapter 4
Prohibiting hedging of incentive remuneration

Context of amendments

4.1 An important component of remuneration is 'incentive' remuneration (or 'at risk' remuneration). Incentive remuneration aligns the interests of management with the interests of shareholders. This is usually achieved by providing equity-based remuneration, for example, shares and options.

4.2 Currently, however, it is possible for directors and executives to 'hedge' their exposure to incentive remuneration. Typically, this involves the director or executive entering into a third party contract (such as trading in derivatives) to reduce their current exposure and mitigate their personal financial interest in the company's success.

4.3 The effect of hedging incentive remuneration is to 'de-link' remuneration from company performance. This practice is inconsistent with a key principle underlying Australia's remuneration framework that remuneration should be linked to performance. There is also a real, as well as perceived, conflict of interest with a director or executive entering into an arrangement where they stand to benefit if the company's share price falls.

4.4 In 2007, the Corporations Act was amended to require disclosure of the company's policy in relation to directors and executives hedging their incentive remuneration, and how the company enforces this policy. While this disclosure ensures that shareholders are informed about the company's policy on hedging incentive remuneration, it does not prohibit this practice.

Summary of new law

4.5 KMP and their closely related parties will be prohibited from hedging the KMP's incentive remuneration.

4.6 This measure will ensure that KMP, and their closely related parties, cannot undermine the purpose of their incentive remuneration, which is to align remuneration with performance.

Comparison of key features of new law and current law

New law	*Current law*
Prohibit key management personnel (and closely related parties) from hedging remuneration that depends on the satisfaction of a performance condition.	Key management personnel can hedge their exposure to remuneration, and must disclose the company's hedging policy in the annual report.

Detailed explanation of new law

4.7 Under the new law, a KMP or their closely related party must not enter into an arrangement (with anyone) that has the effect of limiting the KMP's exposure to risk relating to an element of the KMP's remuneration that depends on the satisfaction of a performance condition ***[Schedule 1, Item 5, sub-section 206J(1)]***.

4.8 The Bill provides a regulation making power to set out a non-exhaustive list of examples of the types of arrangements that would, and would not, be considered to be a 'hedge' that would limit a KMP's exposure to risk ***[Schedule 1, Item 5, sub-section 206J(2)]***. Comments are sought on the types of arrangements that should be included in the regulations for this purpose. For example, whether arrangements such as the purchase of income protection insurance should be captured or excluded from the prohibition.

4.9 A KMP that hedges their exposure to risk commits an offence ***[Schedule 1, Item 5, sub-section 206J(3)]***. The KMP also commits an offence where their closely related party hedges and the KMP was reckless as to the contravention ***[Schedule 1, Item 5, sub-section 206J(5)]***.

4.10 A closely related party of the KMP that intentionally contravenes this requirement commits an offence ***[Schedule 1, Item 5, sub-section 206J(6)]***.

Application and transitional provisions

4.11 The proposed prohibition on hedging applies to entry into arrangements on or after commencement (1 July 2011), irrespective of whether the remuneration was for services rendered before, on or after 1 July 2011.

Chapter 5
No vacancy rule

Context of amendments

5.1 The ‘no vacancy’ rule allows a board to declare that it has no vacant positions even though the maximum number of directors allowed by the constitution has not been reached. Where the board has declared there are no vacancies, people are prevented from nominating for election to the board. In this situation, a vacancy will generally only arise where an incumbent director is up for re-election or retires, or where the shareholders remove a director. However, whether a vacancy becomes available in reality will depend on whether the board wants to fill the position that has been vacated.

5.2 The ‘no vacancy’ rule provides boards with considerable power over the composition of the board. In practice, boards can use it to prevent outside nominees being voted onto the board. These people would then need to wait for a vacancy to arise and run against an incumbent director or a board-endorsed nominee, both categories which generally receive high favourable votes and are difficult for an outside nominee to defeat in a direct contest.

5.3 Shareholders currently have limited options to address concerns that their company’s board is operating ineffectively. For example, shareholders may be concerned the board is functioning in a ‘closed shop’ fashion, does not have sufficient independence from management, or fails to nominate and recruit new members with the right characteristics to ensure board decisions are made in the best interests of the company.

5.4 Similarly, shareholders’ powers under the Corporations Act to deal with directors who they do not believe are performing in their best interests extend only to the ability to vote the board member off the board. While this is a harsh and meaningful sanction, the reality for many shareholders, particularly smaller retail investors, is that the monetary costs of garnering sufficient support or calling an Extraordinary General Meeting can be prohibitive. Despite shareholders holding the ability to invoke the ultimate sanction against a director, the ‘no vacancy’ rule still enables boards to deny shareholders the opportunity to vote in a replacement. As such, the ‘no vacancy’ rule has been identified as inhibiting appropriate shareholder oversight of company boards.

Summary of new law

5.5 Public companies will be required to obtain the approval of its 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.

Comparison of key features of new law and current law

New law	*Current law*
Public companies will be required to obtain the approval of its 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.	There is no current law equivalent to this provision.

Detailed explanation of new law

5.6 Public companies will be required to obtain the approval of its members in order to declare at a company meeting that there are no vacant board positions, where the number of positions filled on the board is less than the maximum allowable under the company's constitution. If agreed, the declaration will be in force until the following AGM. ***[Schedule 1, item 27, section 201P]***

5.7 Notice of intention to obtain member approval to declare that there are no vacant board positions must be lodged with ASIC within 14 days after the board resolution is passed and notified to company members as part of the notice convening the meeting, along with an explanatory statement. The explanatory statement must set out the view of each director on the proposed resolution and information to assist members to determine whether the proposed resolution is in the company's interest. ***[Schedule 1, item 27, sections 201S, paragraph 201P(1)(c), section 201Q]***

5.8 Following passage of a 'no vacancy' resolution, boards may fill board positions through the year, but such appointments must be

confirmed by members at the following AGM, or the appointment lapses at the conclusion of that AGM. ***[Schedule 1, item 27, subsections 201P(3) and (4)]***

5.9 Where a company does not comply with the requirement for member approval of a 'no vacancy' declaration, but the company declares no vacancies at a general meeting, that declaration will be made void until the requisite shareholder approval is obtained, and any appointments of director made at the general meeting will be invalid. ***[Schedule 1, item 27, section 201U]***

5.10 Where a company prevents a person from putting themselves forward as a director at a general meeting on the basis that the board has instituted a 'no vacancy' rule, but that rule has not been agreed by members of the company, the person may institute Court proceedings against the company for loss or damage suffered as a consequence of not being able to be considered by the general meeting for appointment to the board. ***[Schedule 1, item 27, section 201U]***

Application and transitional provisions

5.11 The provisions will apply in relation to the setting of board limits on or after the date commencement (1 July 2011).

Chapter 6
Cherry Picking

Context of amendments

6.1 Proxies are used by shareholders that are not able to attend a company meeting but still wish to vote. The proxy rules in the Corporations Act can be found in Division 6 of Part 2G.2.

6.2 Shareholders can provide directed proxies (which specify how they wish to vote on a resolution) or undirected proxies (which enable the proxy holder to choose how to vote).

6.3 The current law requires all directed proxies held by the Chair to be voted, however, non-Chair proxy holders can choose which proxies to vote. This enables non-Chairs to not exercise votes that do not accord with their own views on a resolution, and to exercise only those votes that do support their position. This is called cherry-picking.

6.4 Cherry-picking impairs the transparency and effectiveness of shareholder voting. In essence, it enables the wishes of shareholders to be ignored and can result in outcomes that do not clearly reflect shareholder views on a resolution. It can also facilitate conflicts of interest of non-Chair proxy holders intruding into the voting process by persons who are prohibited from voting their own shares to influence the outcome on a resolution.

6.5 The Productivity Commission recommended the proposed new law in the context of member voting on remuneration reports, however there is no reason why it should not be applied to member voting more generally.

Summary of new law

6.6 Proxy holders will be required to cast all of their directed proxies on all resolutions.

Comparison of key features of new law and current law

New law	*Current law*
Proxy holders will be required to cast all of their directed proxies on all resolutions.	Proxy holders, other than the Chair, are not required to cast all of their directed proxies on all resolutions, but may choose which proxies to cast.

Detailed explanation of new law

6.7 The provisions currently at paragraphs 250A(4)(c) and (d) in the Corporations Act, dealing with the exercise of directed proxy votes by the Chair and by those other than the Chair, will be repealed.

6.8 A new provision, paragraph 250A(4)(c), will require proxy holders to exercise all directed proxies. The provision will not distinguish between the Chair and other proxy holders. [***Schedule 1, item 30, new paragraph 250A(4)(c)]***

Application and transitional provisions

6.9 The new provision will apply to polls demanded on or after the commencement of the provision, whether the proxy was appointed before, on or after that commencement (1 July 2011).

Chapter 7
Persons required to be named in the remuneration report

Context of amendments

7.1 Currently, the remuneration details of the KMP and the five most highly remunerated officers (if different) are required to be disclosed in the remuneration report in relation to the parent entity and the consolidated entity.

7.2 For large companies, the five highest paid officers are also likely to be key management personnel. In contrast, small companies may have fewer than five key management personnel, which can make the disclosure requirements somewhat onerous to apply.

7.3 In addition, there can often be overlap between the KMP of the parent company and the KMP of the consolidated entity.

Summary of new law

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

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

Comparison of key features of new law and current law

New law	*Current law*
Remuneration disclosures will be confined to key management personnel of the consolidated entity.	Remuneration disclosures apply to key management personnel of the consolidated and parent entities (and the five most highly remunerated officers, if different).

Detailed explanation of new law

7.6 The Bill amends paragraph 300A(1)(a) by requiring disclosures in relation to the consolidated entity only (or if consolidated financial statements are not required, the company) ***[Schedule 1, Item 10, paragraph 300A(1)(a)].***

7.7 The Bill also amends paragraph 300A(1)(c) by removing the requirement for the details of the five most highly remunerated officers to be disclosed ***[Schedule 1, Items 11 and 12, paragraph 300A(1)(c)]***.

Application and transitional provisions

7.8 The proposed measure applies in relation to remuneration reports for financial years starting on or after commencement (1 July 2011).

Chapter 8
Regulation impact statement

Background

8.1 In March 2009, the Government tasked the Productivity Commission (PC) to conduct a broad-ranging inquiry into the regulation of executive remuneration, to ensure that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed.

8.2 This inquiry came at a time when there was significant community concern that executive pay practices were excessive. While shareholder value fell as a result of the global financial crisis, executive pay was perceived to have remained unchanged, cementing the view that executives were rewarded for failure.

8.3 Highlighted as another area of concern is the widening gap between the remuneration of executives and other employees is a real and legitimate issue. Chief Executive Officer (CEO) remuneration at the 50-100 largest Australian listed companies increased between 1993 and 2007 by as much as 300 per cent in real terms.

8.4 The PC's final report was publicly released on 4 January 2010. The report examines issues such as trends in remuneration, current disclosure requirements and the role of boards' shareholders and institutional investors.

8.5 Following extensive public consultation, the report concluded that Australia's corporate governance and remuneration framework is ranked highly internationally. However, the report makes a number of innovative recommendations to further strengthen Australia's remuneration framework.

8.6 These recommendations are designed to improve board capacities, reduce conflicts of interest, encourage stakeholder engagement, improve relevant disclosure and support well conceived remuneration policies.

8.7 There are approximately 2000 listed entities that prepare an audited remuneration report. The PC's recommendations will impact of the way these companies structure their remuneration arrangements for company directors and executives.

8.8 In terms of direct impact on the community, the Australian Securities Exchange (ASX) 2008 Australian Share Ownership Study found that 41 per cent of adult Australians participated in the Australian share market. This ranks Australia among the leading share-owning nations in the world on a per capita basis. Only the United States, with 45 per cent of share ownership among households, ranks higher.

An overview of some of these recommendations is set out below.

Improving Board Capacities

8.9 The recommendation to amend the 'no vacancy' rule in the legislation is designed to improve board capacities, with the view to encourage shareholder democracy while maintaining operational flexibility.

Reducing Conflicts of Interest

8.10 The recommendations that are designed to avoid potential conflicts of interest and manage conflicts more effectively include:

- prohibiting company directors and executives from voting on the remuneration report or any resolutions related to those reports;
- barring executives from hedging unvested equity remuneration or vested equity subject to holding locks;
- disallowing company directors and executives from voting undirected proxies on remuneration reports or any resolutions related to those reports;
- requiring proxy holders, except in exceptional circumstances, to cast all their directed proxies on remuneration reports and any resolutions related to those reports.

Improving Relevant Disclosure

8.11 The recommendation to amend the legislation to reflect that individual remuneration disclosures be confined to the key management personnel of the company. This will reduce the regulatory burden of having to make disclosures for the top five executives as well.

Well-conceived Remuneration Policies

8.12 The recommendation is designed to provide shareholders with an opportunity to signal whether they support a company's remuneration policy. The 'two-strike' proposal will allow the practical application of the recommendation, while limiting the transaction costs of the regulation.

Identification of options, impact analysis, conclusions and recommendations

The 'No Vacancy' Rule

Problem

8.13 Some companies have a 'no vacancy' rule in their constitution (a document governing the internal operation of a company). This rule allows the board complete discretion to declare that it has no vacant positions even though the maximum number of directors has not been reached. This means that no one can nominate for election to the board except if an incumbent director is up for re-election, retires, or is removed by shareholders. In most circumstances, however, whether a vacancy will actually arise following one of these events depends on the board wanting to fill the position.

8.14 The 'no vacancy' rule gives boards a lot of power over their composition compared to shareholders. In practice, boards can use the rule to prevent outside nominees being voted onto the board. The lack of any checks and balances on the exercise of the 'no vacancy' rule, has lead to the perception that it supports low levels of contestability for board positions. It has also been identified as providing an avenue for boards to behave opportunistically in relation to membership and decision-making, including in regards to executive remuneration.

8.15 There is a wide perception that the regulatory system as a whole can facilitate remuneration outcomes that:

- misalign the interests of management and shareholders;
- were made in an environment in which boards have significant discretion;
- cannot be fairly contested by shareholders; and
- lack transparency and independence.

8.16 In its report, the PC identified the 'no vacancy' rule as contributing to these types of outcomes. This is because of its relationship to the way in which boards are constituted, particularly in relation to board renewal.

8.17 One of the most crucial board functions is to align the interests of shareholders and managers. To do this effectively, boards must have appropriate mechanisms to oversee executive performance. Remuneration arrangements play an integral role in achieving this. As such, it is vital that boards structure remuneration packages to provide incentives for executives to behave in the manner that will produce the best results for the company. Accordingly, it is important that shareholders have practical and workable mechanisms to improve the situation when they are not confident that the board is performing this task well enough, for example because it lacks independence from management, or does not nominate or recruit members with the right characteristics to ensure the best decisions are made.

8.18 The 'no vacancy' rule has been identified as a feature of the regulatory system which perpetuates these problems due to its potential use to block the election of 'new blood' and its effect in diminishing the impact of the shareholders' ultimate sanction of voting a director off the board.

Evidence

8.19 In its report, the PC referred to evidence which shows that many non-executive directors (NEDs) have a background as corporate senior executives. For example, in 2000, 35 per cent of NEDs were retired CEO's. The fact that many NEDs are drawn from this small group is supported by evidence showing that of board positions in the ASX 200, eight per cent are occupied by females which correlates with a similarly small number of females in these 'feeder positions'. The concept that NEDs are being drawn from a 'thin gene pool' creates greater potential for boards aligning too closely with management and lacking independence in decision making, particularly with regards to remuneration.

8.20 While this evidence highlights potential problems with there being an 'inertia' towards boards hiring internally or from a shallow pool of 'known quantities', there is little conclusive evidence that low levels of contestability for board positions and lack of effective shareholder oversight leads to excessive or unwarranted levels of executive remuneration. However, there is a strong perception that this is the case.

Objectives of Government action

8.21 The broad objectives of this proposal would be to:

- enhance current arrangements to enable greater contestability by reducing unwarranted barriers to entry for non-board endorsed nominees;
- improve shareholders oversight and influence over board composition; and
- provide encouragement for boards to improve board accountability and transparency to shareholders in relation to remuneration outcomes.

Options that may achieve objectives

Option A: Status quo

- Boards of companies that have a 'no vacancy' rule would still be able to unilaterally invoke the rule of their own volition. The rule can only be removed from the constitution by special resolution.

Option B: Require boards to seek shareholder approval to invoke the 'no vacancy' rule

- Boards would be required to seek shareholder approval to invoke the 'no vacancy' rule. Shareholders would need to pass an ordinary resolution before the board can declare it has no vacancies.

Option C: Require boards to seek shareholder approval to invoke the 'no vacancy' rule but enable boards to retain flexibility to appoint directors, and fill or leave casual vacancies, throughout the year subject to shareholder approval at the next AGM

- Companies would be required to seek shareholder approval to invoke the 'no vacancy' rule. However, if shareholders agree to declare no vacancies, the board would retain the flexibility to appoint additional directors throughout the year, or to fill or leave vacancies that might arise. Shareholders would then vote on any such appointments at the next AGM.

Impact analysis

Option A: no change

Shareholders

There will be no change for shareholders under this option.

- Boards will continue to have a large degree of control over their composition compared to shareholders. This is because boards can invoke the rule without any checks or balances, and it also has the potential to prevent the election of 'new blood' and entrench the positions of incumbent directors. This puts shareholders in a position where they have little opportunity to have effective input into the composition of their company's board, particularly where they may have lost confidence in the board or some of its members to make good decisions in relation to executive remuneration.

- The 'no vacancy' rule also has the potential to produce perverse consequences. For example, where one candidate for a board seat receives a 96 per cent favourable vote, and a competitor receives a 94 per cent favourable vote, only the first candidate will get a position despite the clear indication that shareholders overwhelmingly want both candidates on the board.

- Under this option, the only way the 'no vacancy' rule can be amended or removed from a company's constitution is by shareholders passing a special resolution. This would involve very high transaction costs for shareholders due to the need to mobilise the large number of dispersed retail investors and institutional investors needed to pass such a resolution, and the potential need to hold an Extraordinary General Meeting.

Companies

- There are no impacts for companies under this option. Boards that have the 'no vacancy' rule in their constitution will still be able to invoke the rule unilaterally. Boards would be able to continue to use the rule for any purpose they see fit, including to block the election of people they do not wish to attain membership. Boards would also retain complete flexibility to appoint new directors throughout the year, subject to approval of shareholders at the next AGM.

Government

There are no impacts for Government under this option.

Table 8.1 Option A

	Benefits	***Costs***
Shareholders		Limited practical ability to effectively influence the composition of boards when shareholders lack confidence in boards making optimal decisions about remuneration.
Companies	Boards have complete flexibility in regards to their composition. Might have beneficial effects for cohesiveness.	

Option B: Require boards to seek shareholder approval to invoke the 'no vacancy' rule

Shareholders

- Under this option, shareholders would be provided with a mechanism to have a greater say in board composition. They would be able to prevent boards from invoking the 'no vacancy' rule where it is contrary to their interests. Basically, shareholders would be placed in a position to decide whether they are happy for the board to determine whether its composition is appropriate, or whether the shareholders want to retain some flexibility and power over board composition throughout the year.

- This option would provide greater scope for shareholders to vote new directors on to the board. It would also make the threat of shareholders invoking the ultimate sanction of voting a director off a board more realistic.

- Given that this option would improve the power and influence given to shareholders, it would encourage boards to provide more information to shareholders to justify a resolution to declare no vacancies. This would help shareholders to make more fully informed voting decisions and would improve the accountability and transparency of boards.

Companies

- Under this option, boards could not invoke the 'no vacancy' rule without shareholder approval by ordinary resolution at the AGM. Where shareholders agree that there should be no vacancies, boards would lose the flexibility to appoint new directors throughout the year. This could cause the company to lose an opportunity if a good candidate became available.

- Where shareholders do not agree to the resolution, the board may look to increase its size or reduce the constitutional maximum to prevent shareholders voting in unendorsed candidates. This would not be an efficient or desirable outcome for companies or shareholders. However, it is considered that the practical likelihood of these circumstances eventuating is low because, traditionally, shareholders are conservative and tend to support their boards. For example, it would be exceptionally unlikely that a candidate without board endorsement would receive the '50 per cent plus one' votes needed to obtain a board position, or that a resolution to declare no vacancies would fail if put up by a board with the confidence of its shareholders

- It is unlikely this option would add measurably to cost or complexity for shareholders or the company. Shareholders vote on many resolutions at AGMs and this would simply add one more to that list. Companies may incur costs if they choose to provide shareholders with information about why they wish to declare no vacancies, however, it is considered these costs would be minimal and outweighed by the benefit to shareholders.

Government

- This option may involve some cost for government through the need for the Australian Securities and Investments Commission to monitor compliance with a new regulation.

- This option may also have benefits for government through improving board transparency and accountability, and enhancing corporate governance practices. This would lead to costs savings associated with the decreased need to implement more regulation and enforce regulatory breaches.

Table 8.2 Option B

	Benefits	***Costs***
Shareholders	Shareholders would have a mechanism to influence board composition without undue cost or practical obstacles. They would also be likely to receive more information from the company	
Companies		Boards lose flexibility to invoke the 'no vacancy' rule at will, or to appoint directors throughout the year.
Government	Some benefits through improved corporate governance.	Minor costs associated with monitoring and enforcing new regulation.

Option C: Require boards to seek shareholder approval to invoke the 'no vacancy' rule but enable boards to retain flexibility to appoint directors and fill or leave casual vacancies throughout the year.

Shareholders

- Under this option, shareholders would have a greater capacity to affect the composition of their company's board. The same considerations set out under Option B also apply to this option.

Companies

- Under this option, boards could not invoke the 'no vacancy' rule unilaterally. Shareholders would need to pass an ordinary resolution at the AGM agreeing to declare no vacancies. However, boards would still retain their flexibility to appoint directors throughout the year, subject to shareholder approval at the next AGM.

- The same considerations set out under Option B also apply to this option, except for the loss of board flexibility following the approval of a 'no vacancy' resolution.

Government

The same considerations set out under Option B also apply to this option.

Table 8.3 Option C

	Benefits	***Costs***
Shareholders	Shareholders would have a mechanism by which they can influence board composition without undue cost or practical obstacles. They would be likely to receive more information from the company.	
Companies	Boards retain flexibility to appoint directors between AGMs subject to shareholder approval at the next AGM.	Boards lose flexibility to invoke 'no vacancy' rule at will.
Government	Some benefits through improved corporate governance.	Minor costs associated with monitoring and enforcing new regulation.

Consultation

8.22 Extensive consultation was undertaken by the PC involving members of the public, companies, governance consultancy groups, and stakeholder groups representing a variety of interested parties including directors, company secretaries and shareholders. Over 170 written submissions were received and the PC also conducted hearings. It should be noted that the submissions received related to the PC's draft recommendation which is equivalent to Option B.

8.23 In general, the recommendation of the PC was supported by governance and management consultancy groups and investor groups, and was not supported by stakeholders representing the banking sector, directors, company secretaries, institutional investors, and business. However, many of the concerns were addressed by the PC in framing its final recommendation and are therefore no longer relevant. For example, the central concern was that boards would lose the flexibility over appointments throughout the year (raised by Chartered Secretaries Australia (CSA) and the Business Council of Australia (BCA), among others).

8.24 Other views on the draft recommendation conveyed in the submissions are set out below.

- Submissions from CSA and the Australian Institute of Company Directors, among others, conveyed the view that actions taken to improve executive remuneration practices are not an appropriate avenue for attempting to enhance board diversity.

  – However, it should be noted that the recommendation to adopt Option C is not aimed at improving board diversity. It is aimed at improving what is considered to be a deficiency in the present corporate governance framework. While there is little conclusive evidence that lack of shareholder influence has caused excessive executive remuneration, there is a strong perception that shareholders do not have a mechanism that enables practical action where there is concern that boards may be identifying too closely with executives when determining their compensation. The recommended action is designed to address this, not improve board diversity, despite the fact increased diversity would be a welcome by-product.

- Submissions from the BCA and some institutional investors, among others, expressed concern that boards would seek to increase their size or reduce the maximum size of the board in order to prevent election of non-endorsed candidates. These issues were addressed in the preceeding sections. The PC's Report did not consider them to be credible threats.

- Some submissions from the banking sector and institutional investors did not support the draft recommendation on the basis that boards were considered to be in a better position to determine the board's operational needs than shareholders.

  – As discussed above, the recommended action to adopt Option C takes into account the evidence presented to the PC which indicates that boards that have the confidence of their shareholders generally receive an extremely strong 'yes' vote (in the vicinity of 96 per cent) to resolutions at general meetings. It is anticipated that resolutions to declare no vacancies would be no different. As previously mentioned, this recommendation is primarily targeted at shareholders who have lost confidence in their board.

  – The PC's final recommendation included the ability for boards to retain the ability to appoint members between AGMs even where the 'no vacancy' rule was invoked at the AGM. This addition should ameliorate this concern.

- As mentioned above, several submissions expressed support for the PC's recommendation, including the Australian Shareholders Association, Regnan, the Australian Council of Super Investors, Mr Andrew Murray, Riskmetrics, the Hay Group, the Australian Human Resources Institute, and Guerdon Associates. This support was based on the recommendation enhancing the capacity of shareholders to hold boards accountable and result in a reduction in remuneration excesses, and the right of shareholders to choose who they wish to be represented by on the board.

Conclusion and recommended option

Recommended option: Option C.

8.25 It is considered that the 'no vacancy' rule in its current form places shareholders at a significant disadvantage compared to boards in relation to their ability to influence board composition. Option C is considered to provide a more appropriate balance between the power of shareholders and boards. Given this shift in power, this option is also considered to be likely to encourage boards to provide more information to shareholders.

8.26 The trend in corporate regulation over recent years has been to increase shareholder engagement and participation, and company transparency and accountability. As owners of the company, and given the agency problem faced by shareholders, it is considered that it should be within their power to decide whether they wish to trust the board to determine its optimal operational requirements, or whether they wish to retain some power in this regard. This is seen to be especially important where shareholders may have lost confidence in the board or some of its members.

8.27 It is considered that where boards have the confidence of shareholders, or can demonstrate good reasons to declare no vacancies, they should not face any difficulty in obtaining shareholder approval to do so. By contrast, a board that does not obtain approval probably lacks shareholder confidence. This is the type of situation in which it is appropriate for shareholders to have the capacity to demonstrate their views and effect change. As such, Option C is considered to provide an appropriate mechanism to increase the contestability of board positions in situations where they may otherwise have been unduly limited.

8.28 It would not be an efficient outcome if boards were to increase their size to the constitutional maximum or move a special resolution to

reduce the constitutional maximum in reaction to this option. However, this is not seen to be a consequence that would commonly eventuate. For instance, there does not appear to be a credible threat of someone the board considers unsuitable obtaining enough votes to get onto the board.

8.29 It is considered that the biggest problem with Option B is the lack of flexibility provided to boards to deal with situations that might arise during the year. For example, an excellent candidate may become available for board membership, the board may need additional skills, or the board may wish to take on an additional member to assist with succession planning or to provide a handover period prior to retirement of a director. It would not be appropriate to infringe unnecessarily on this operational flexibility. Option C addresses these concerns by enabling boards to retain the flexibility to deal with unexpected operational requirements, while providing shareholders with an appropriate and real mechanism to influence board composition in situations where they are not satisfied the board is acting in the best interests of the company.

The 'Two Strikes' Proposal

Problem

8.30 With the separation of ownership of a company from its management, there is potential for the mangers (the agents) to act in ways that would not necessarily be in the best interests of investors (the principals). As noted by the PC, the 'principal-agent' problem highlights the importance of establishing appropriate monitoring and incentive mechanisms relating to the remuneration-setting process. It also highlights the importance of ensuring that directors are subject to appropriate sanction through arrangements, such as the non-binding shareholder vote on remuneration, to enable the owners to signal their satisfaction or otherwise with board performance.

8.31 Section 250R of the Corporations Act provides that a listed company must put its remuneration report to a non-binding shareholder vote at the annual general meeting (AGM). Subsection 249L(2) also provides that the notice of the AGM must inform shareholders of the resolution on the remuneration report that will take place at the meeting.

8.32 Currently, subsection 251AA(2) of the Corporations Act provides that a listed company is required to disclose to the market the outcome of the non-binding vote, including the number of votes cast in favour of the report, those cast against the report and the number of abstentions on the report. ASX listing rule 3.13.2 requires the entity to do so immediately after the meeting has been held.

8.33 Some concerns have been raised with the non-binding vote, which has prompted suggestions that the Corporations Act be amended to strengthen the vote.

8.34 Many submissions to the PC inquiry noted that the introduction of the non-binding vote has resulted in increased dialogue between companies and shareholders on remuneration issues. Anecdotal evidence suggests that some boards are responsive to the non-binding vote, and that the opportunity for shareholders to cast a vote is having a positive impact on remuneration polices.

8.35 The PC concluded that while the evidence suggests that boards are generally responsive to 'no' votes, this is not universal. Anecdotal evidence points to some companies being unresponsive even to significant 'no' votes. The Commission found that nearly five percent of ASX 200 companies had received consecutive 'no' votes of 25 percent or more and the incidence of this appears to be rising in recent years.

8.36 The Corporations Act currently does not set out any requirements for when a board proceeds with its remuneration proposals despite a negative shareholder vote. If shareholders are dissatisfied, they have the power to vote to remove a director, although this is a somewhat extreme response, particularly if the director is having a positive impact on the value of the company.

8.37 As the PC's findings suggest, the current arrangements tend not to provide sufficient:

- power to shareholders if they are unsatisfied with the company's remuneration policies;
- incentives or consequences for unresponsive boards; and
- incentives on companies to respond to shareholder concerns.

Objectives of Government action

8.38 The key objective is to address the problems identified above, by providing a mechanism for shareholders to deal with companies that are unresponsive to their concerns on remuneration issues. This is expected to improve remuneration practices, enhance the accountability of company management and strengthen the non-binding.

Options that may achieve objectives(s)

Option A: Do nothing

8.39 Under this option, companies would not be required to formally respond to shareholder concerns on the remuneration issues. While boards receiving significant 'no' votes may face reputational consequences, there would be no legal requirement for boards to explain to shareholders how their concerns have been dealt with, or for directors to have their re-election expedited.

Option B: Two-strikes and re-election process

8.40 Under this option:

- where a company's remuneration report receives a 'no' vote of 25 per cent or more, the board would be required in the subsequent remuneration report to explain how shareholder concerns were addressed, and if they have not been addressed, the reasons why; and
- where the company's subsequent remuneration report receives a 'no' vote of 25 per cent or more, a resolution be put that elected directors who signed the directors' report for that meeting stand for re-election at an extraordinary general meeting. Notice of the re-election resolution would be contained in the meeting papers for that AGM. If it were to be carried by more than 50 per cent of eligible votes cast, the board would be required to give notice that such an extraordinary general meeting will be held within 90 days.

Option C: Introduce a binding shareholder vote

8.41 Under this option, a binding shareholder vote would be introduced in relation to executive remuneration. The vote would take place prior to each executive being appointed to the company.

Impact analysis

Impact group identification

8.42 Affected groups:

- shareholders and other parties with an interest in the company (for example creditors and employees);

- companies (including company directors and executives); and
- Government and regulators.

Assessment of costs and benefits

Table 8.4 Option A: Do nothing

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)		Shareholders do not necessarily receive an explanation from the company following a substantive 'no' vote, unless the company provides the explanation voluntarily.
Companies (including company directors and executives)	Companies will not be required to provide an explanation to shareholders and company directors will not be required to submit for re-election as a result of two consecutive 'no' votes.	
Government/regulators		

Table 8.5 Option B: Two-strikes and re-election process

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	Shareholders will be in a better position to hold directors accountable for the company's remuneration policies Strengthening the sanctions for not adequately responding to shareholder concerns on remuneration issues will lead to improved remuneration policies	

	Benefits	***Costs***
Companies (including company directors and executives)		In the unlikely event (less than 5 per cent) that the two-strikes process is triggered, there will be compliance costs for companies in providing an explanation to shareholders and holding an extraordinary general meeting. The costs associated with an extraordinary general meeting include, for example, sending notices and papers to members, however, these costs are difficult to quantify as they can vary significantly depending
Companies (including company directors and executives) continued		on a number of factors, such as the number of shareholders.
Government/regulators		

Table 8.6 Option C: Binding shareholder vote

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	Shareholders will be able to determine remuneration levels that they consider to be acceptable	A binding vote on remuneration would absolve directors of their responsibility to shareholders on remuneration issues, and would also undermine their capacity to make key decisions affecting the performance of the company. As a result, the accountability of directors would be diminished, along with the ability of shareholders to hold directors to account on remuneration issues and the company's overall operations

	Benefits	***Costs***
Companies (including company directors and executives)		Companies would not be able to finalise a contract with an executive until shareholder approval was obtained, and this is likely to create considerable uncertainty and delay, particularly if the company is looking to quickly secure a top executive. Executives would need to wait for the next AGM, which may take several months (or an extraordinary meeting at significant cost to the company and shareholders), before their terms could be finalised and their appointment confirmed A binding vote could be disruptive to the operation of the company, particularly if a deadlock arose between shareholders and management regarding the appropriate levels of remuneration The proposal could affect the competitiveness of Australian companies and their ability to attract and retain top executives, particularly as other jurisdictions could offer executives greater certainty about their levels of remuneration
Government/regulators		

Consultation

8.43 The Productivity Commission consulted extensively on options to strengthen the non-binding vote. As part of the consultation process, the PC consulted on an issues paper outlining preliminary issues and a discussion draft containing draft recommendations. Submissions were received were received from key stakeholders including companies, governance consulting firms, shareholder groups, remuneration consultants, proxy advisers, legal firms, unions, academics, retail shareholders and members of the public. In addition, the PC conducted a series of meetings and roundtables with a range of interested parties.

8.44 The PC found that companies receiving consecutive no votes of 25 per cent or more in 2008 and 2009 represent about five per cent of the ASX200.

8.45 A number of submissions supported the proposed 'two strikes' approach, including the Australian Council of Super Investors (ACSI), Regnan, and Andrew Murray, as a way to encourage board responsiveness to shareholder concerns. Other participants, such as CPA Australia, suggested introducing a 'two-strikes' test as a replaceable rule to give greater discretion to its application.

8.46 Other participants, including the Business Council of Australia, Chartered Secretaries Australia (CSA) and KPMG opposed the 'two strikes' proposal given the negative consequences that could arise from dismissing the entire board.

8.47 The PC gave careful consideration to the various issues raised by participants and therefore, changed the recommendation to the 'two strikes and resolution' variant to reduce the potential of an unnecessary extraordinary general meeting.

8.48 Further public consultation on the draft legislation implementing this reform is also scheduled for 2010.

Conclusion and recommended option

8.49 Option A is not preferred as it does not provide adequate sanctions in the event that companies do not appropriately respond to shareholder concerns on remuneration issues.

8.50 Option B is the preferred option, as it will address the problems identified above and provide an additional level of accountability for directors and increased transparency for shareholders. Where a company

faces significant 'no' votes over two consecutive years, and the company has not adequately responded to concerns raised by shareholders the previous year, it is appropriate for the boards of such companies to be subject to greater scrutiny and accountability through the re-election process. This option strengthens the non-binding vote and maintains the fundamental principle underlying Australia's corporate governance framework that directors are responsible for, and accountable to, shareholders on all aspects of the management of the company, including the amount and composition of executive remuneration.

8.51 Option C is not preferred, as there are significant practical difficulties and costs associated with introducing a binding shareholder vote on remuneration. If a binding vote on remuneration was introduced, companies would not be able to finalise a contract with an executive until shareholder approval was obtained, and this is likely to create considerable uncertainty and delay, particularly if the company is looking to quickly secure a top executive. Practically, decisions to engage a particular executive cannot await some future shareholder vote, as executives would need to wait for the next AGM, which may take several months (or an extraordinary meeting at significant cost to the company and shareholders), before their terms could be finalised and their appointment confirmed. These concerns were highlighted in the PC's final report. In addition, a binding vote could potentially be disruptive to the operation of the company, particularly if a deadlock arose between shareholders and management regarding the appropriate levels of remuneration.

8.52 Furthermore, the introduction of a binding vote for shareholders would represent a fundamental change to the directors' role and their capacity to manage the company. A fundamental principle underlying Australia's corporate governance system is that directors are responsible to shareholders for managing all aspects of the company's operations, including setting executive remuneration. A binding vote on remuneration would absolve directors of their responsibility to shareholders on this issue, and would also undermine their capacity to make key decisions affecting the performance of the company. As a result, the accountability of directors would be diminished, along with the ability of shareholders to hold directors to account on remuneration issues and the company's overall operations. It could also affect the competitiveness of Australian companies and their ability to attract and retain top executives, particularly as other jurisdictions could offer executives greater certainty about their levels of remuneration.

OTHER TECHNICAL AMENDMENTS

Prohibiting Directors and Executives Voting on Remuneration Reports and Voting Undirected Proxies

Problem

8.53 Currently, the Corporations Act does not prohibit directors or executives that hold shares in the company from participating in the non-binding shareholder vote on remuneration. While section 224 of the Corporations Act prohibits related parties and their associates from casting a vote on related party transactions, it does not extend the prohibition to the non-binding vote contained in section 250R. Section 195 also provides that a director must not vote on a matter involving material personal interests, although an exception exists in relation to the director's remuneration.

8.54 Concerns have been raised where directors and executives, whose remuneration is disclosed in the remuneration report, can also participate in the non-binding vote if they hold shares in the company.

8.55 As noted by the PC, the 'principal-agent' problem highlights the importance of establishing appropriate monitoring and incentive mechanisms relating to the remuneration-setting process. There is a real, as well as perceived, conflict of interest that exists with directors and executives voting on their own remuneration packages. As these directors and executives have an interest in approving their own remuneration arrangements, allowing them to participate in the non-binding vote may result in a higher approval vote on the remuneration report than might otherwise be achieved. This could distort the outcome of the non-binding vote and diminish its effectiveness.

8.56 In addition, where shareholders provide undirected proxies, the proxy holder has the discretion to determine how to vote. If shareholders do not appoint a proxy, the proxy defaults to the Chair of the board, who is required to vote all directed proxies. As a result, Chairs can exercise undirected proxies, even on resolutions that they are otherwise prohibited from participating in (for example, a resolution to increase the total pool of fees paid to directors). In its recent report, the PC noted that it is inappropriate that directors and executives engaged in the design of remuneration arrangements should then be able to use undirected proxies to mute the outcome of that vote.

Objectives of Government action

8.57 The objectives of Government action are to address the problems identified above by eliminating any conflicts of interests with directors and executives participating in the non-binding vote to approve their own remuneration arrangements.

Options to achieve objectives

Option A: No change

8.58 Under this option, the status quo would be maintained by continuing to allow directors and executives, that are named in the remuneration report, to participate in the non-binding vote on remuneration.

8.59 The existing system of corporate governance would continue to apply. An integral part of this framework is the duties imposed on directors both by the *Corporations Act 2001* and the common law. Directors must fulfil these duties in carrying out all aspects of their role, including setting executive remuneration. Generally, directors owe broad fiduciary duties to the companies they serve. They are required to act honestly, for the good of the company, and for a proper purpose.

Option B: Require disclosure of how key management personnel have voted in the non-binding vote on the remuneration report

8.60 Under this option, directors and executives named in the remuneration report would be required to disclose how they voted in the non-binding vote.

Option C: Prohibit key management personnel from participating in the non-binding vote on the remuneration report

8.61 Under this option, directors and executives that are named in the remuneration report, and their close family members (as defined in the accounting standards), would be prohibited from participating in the non-binding shareholder vote on remuneration (including by voting undirected proxies).

8.62 An exemption to this requirement is proposed where directors and executives are voting directed proxies for other shareholders (who are otherwise entitled to vote) in accordance with the directions on the proxy form. However, undirected proxies voted by the Chair would also be excluded.

Impact analysis

Impact group identification

8.63 Affected groups:

- shareholders and other parties with an interest in the company (for example creditors and employees);
- companies (including company directors and executives); and
- Government and regulators.

Assessment of costs and benefits

Table 8.7 Option A: Do nothing

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)		Maintains the conflict of interest that arises with directors and executives voting on their own remuneration packages, and can distort the outcome of the non-binding vote. The existing system of corporate governance (including directors' duties) would continue to apply.
Companies (including company directors and executives)		
Government/regulators		

Table 8.8 Option B: Require disclosure of how key management personnel have voted in the non-binding vote on the remuneration report

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	Greater transparency for shareholders.	While this option improves transparency, it maintains the conflict of interest that arises

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees) (continued)		with directors and executives voting on their own remuneration packages, and can distort the outcome of the non-binding vote.
Companies (including company directors and executives)		Companies would be subject to additional disclosure requirements in the remuneration report.
Government/regulators		

Table 8.9 Option C: Prohibit key management personnel from participating in the non-binding vote on the remuneration report

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	This option will eliminate the conflict of interests that arises with company management voting on their own remuneration, and strengthen the effectiveness of the non-binding vote.	
Companies (including company directors and executives)		Potential minor costs for companies in monitoring compliance.
Government/regulators		

Consultation

8.64 The purpose of the non-binding vote on the remuneration report provides shareholders with an opportunity to signal their support for the remuneration policy of a company. Numerous submissions to the PC, including CSA and Riskmetrics, raised the conflict of interest that arises when directors and executives vote on the remuneration report.

8.65 Origin drew a distinction between directors and executives voting on the remuneration report, contending that non-executive directors

should not be prohibited from voting their own shares on the report as their fees are approved directly by shareholders.

8.66 Guerdon Associates did not think that directors should be excluded from voting on the remuneration report as the Corporations Act does not allow directors and related parties to exercise votes on resolutions where they have a pecuniary conflict of interest.

8.67 The ASX supported the prohibition of key management personnel voting their shares where there is a direct conflict of interest.

Conclusion and recommended option

8.68 Options A and B are not considered ideal, as they maintain the conflict of interest that arises with directors and executives voting on their own remuneration packages, and can distort the outcome of the non-binding vote.

8.69 Option C is the preferred option, as it will address the problem identified above by eliminating the conflict of interest that exists with management voting on their own remuneration. It will also improve the effectiveness of the non-binding vote as a feedback mechanism for shareholders and companies.

Hedging Equity Remuneration

Problem

8.70 An important component of remuneration is 'incentive' remuneration (or 'at risk' remuneration). Incentive remuneration aligns the interests of management with the interests of shareholders. This is usually achieved by providing equity-based remuneration, for example, shares and options. Typically, incentive remuneration is provided in addition to any fixed or base salary. Incentive remuneration ensures that directors and executives, like shareholders, have a personal financial interest in the success of the company.

8.71 Currently, however, it is possible for directors and executives to 'hedge' their exposure to incentive remuneration. Typically, this involves the director or executive entering into a third party contract (such as trading in derivatives) to reduce their current exposure and mitigate their personal financial interest in the company's success.

8.72 The effect of hedging incentive remuneration is to 'de-link' remuneration from company performance. This practice is inconsistent with a key principle underlying Australia's remuneration framework that remuneration should be linked to performance. There is also a real, as well as perceived, conflict of interest with a director or executive entering into an arrangement where they stand to benefit if the company's share price falls.

8.73 In 2007, the Corporations Act was amended to require disclosure of the company's policy in relation to directors and executives hedging their incentive remuneration, and how the company enforces this policy. While this disclosure ensures that shareholders are informed about the company's policy on hedging incentive remuneration, it does not prohibit this practice.

Objectives of Government action

The objectives of Government action are to address the problems identified above by ensuring that executive remuneration aligns with shareholders interests and eliminating any conflicts of interests with directors and executives hedging their exposure to their incentive remuneration.

Options to achieve objectives

Option A: No change

8.74 Under this option, the status quo would be maintained by continuing to allow directors and executives to hedge their exposure to incentive remuneration.

Option B: Prohibit directors and executives from hedging their incentive remuneration

8.75 Under this option, directors and executives, and their close family members (as defined in the accounting standards) would be prohibited from entering into a transaction that would have the effect of hedging their incentive remuneration. Under this proposal, the current disclosure requirement would become redundant and would be repealed.

Impact analysis

Impact group identification

8.76 Affected groups:

- shareholders and other parties with an interest in the company (for example creditors and employees);
- companies (including company directors and executives); and
- Government and regulators.

Assessment of costs and benefits

Table 8.10 Option A: Do nothing

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)		Permits directors and executives to hedge their incentive remuneration which 'de-links' remuneration from performance.
Companies (including company directors and executives)		
Government/regulators		

Table 8.11 Option B: Prohibit directors and executives from hedging their incentive remuneration

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	This option will ensure that directors and executives cannot undermine the purpose of their incentive remuneration, which is to align remuneration with performance.	
Companies (including company directors and executives)	Companies will no longer need to comply with the current disclosure obligation relating to hedging.	
Government/regulators		

Consultation

8.77 The PC did not find evidence through consultations evidence that would enable an assessment of the extent to which hedging of unvested entitlements currently occurs. Two companies, Woolworths and BlueScope Steel, reported that they did not allow hedging of unvested equity.

8.78 Some participants, including the Financial Sector Union and ACSI, considered that hedging of unvested equity should be prohibited in the Corporations Act.

8.79 The Australian Institute of Company Directors (AICD) warned that black letter law might not prove effective given the complexities of hedging arrangements, and the difficulties in legislating for all possible vesting conditions and trading limitations.

8.80 CSA and Macquarie Group contented that executives should be permitted to hedge vested remuneration. CGI Glass Lewis and Guerdon Associates considered it reasonable to allow hedging of vested equity without holding locks.

8.81 The PC found that conflicts of interest in the voting system can arise where a person who may gain a material personal benefit from a resolution can influence the result of the resolution, either by voting their own shares or acting as a proxy holder.

8.82 Numerous submissions to the PC, including CSA and Riskmetrics, raised the conflict of interest present when those names in the remuneration report also vote on the report. Macquarie Group, BHP Billiton and the AICD felt that excluding executives would have little impact on the vote. The ASX supported the prohibition of key management personnel from voting when there is a direct conflict of interest.

8.83 Some organisations, for example, Origin and Guerdon Associates, have argued against excluding undirected proxies, on the basis that such a reform may disenfranchise retail shareholders.

Conclusion and recommended option

8.84 Option A is not considered ideal, as it permits directors and executives to hedge their incentive remuneration which 'de-links' remuneration from performance.

8.85 Option B is the preferred option. This proposal will strengthen the remuneration framework by ensuring that the interests of management are aligned with the interests of shareholders, and that remuneration is genuinely linked to company performance.

'Cherry-picking' Votes

Problem

8.86 Shareholders that are not able to attend a company meeting but still wish to vote can do so by proxy. Shareholders can provide directed proxies (which specify how they wish to vote on a resolution) or undirected proxies (which enable the proxy holder to choose how to vote). The current law requires all directed proxies held by the Chair to be voted, however, non-Chair proxy holders can choose which proxies to vote. This enables non-Chairs to not exercise votes that do not accord with their own views on a resolution, and to exercise only the votes that do support their position. This is called cherry-picking.

8.87 The practice of cherry-picking impairs the transparency and effectiveness of shareholder voting. In essence, it enables the wishes of shareholders to be ignored and can result in outcomes that do not clearly reflect shareholder views on a resolution.

8.88 This practice also facilitates the intrusion of conflicts of interests of non-Chair proxy holders into the voting process. This is because it

allows proxy holders, who are otherwise prohibited from voting their own shares on a resolution due to a conflict of interest, to influence the decision on a resolution through cherry-picking. This can mute a shareholder signal that would otherwise become apparent through the outcome on a resolution. This is especially problematic in relation to the non-binding remuneration vote.

8.89 In an environment where direct voting is not commonly used, cherry-picking is a particular problem. Shareholders who issue directed proxies would probably be surprised to learn that their votes may not be exercised in the manner they intend.

Evidence

8.90 There was little input received in submissions to the PC report on removing cherry-picking. However, in 2008 the Parliamentary Joint Committee on Corporations and Financial Services (the PJC) conducted an inquiry in shareholder engagement and participation. Its report, *Better shareholders, better companies*, included a recommendation that the *Corporations Act 2001* be amended to remove cherry-picking. Forty five submissions were received to the inquiry and the committee also conducted public hearings.

8.91 In the submissions received during the course of the inquiry, CSA indicated that there is a lack of transparency in the current proxy voting system and it does not provide shareholders with a guarantee that their voting intention will be reflected. The AICD also noted that there should be a mechanism to reflect the views of all shareholders

Objectives of Government action

8.92 The objectives of Government action in relation to cherry-picking are to:

- increase the transparency of the voting system;
- increase the effectiveness of shareholder voting to prevent shareholders becoming disenfranchised;
- enable shareholder views to be accurately reflected, especially in relation to the non-binding remuneration report vote; and
- prevent conflicts of interest influencing the voting process in a manner that is contrary to shareholder wishes.

Options to achieve objectives

Option A: No change

8.93 Under this option, non-Chair proxy holders would continue to be able to cherry-pick votes from the directed proxies they hold.

Option B: Require non-Chair proxy holders to exercise all directed proxies if they choose to exercise one vote

8.94 Under this option, non-Chair proxy holders could choose not to vote any directed proxies, however, if they choose to vote one they must vote them all. Consequently, a proxy holder could still influence the outcome of a vote by not casting votes if the majority of proxies do not support their view on a resolution.

Option C: Require non-Chair proxy holders to exercise all directed proxies

8.95 Under this option, non-Chair proxy holders would be placed in the same position as Chair proxy holders: they would be required to exercise all directed proxies.

8.96 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.

Impact analysis

Option A: no change

Shareholders

8.97 There would be no change for consumers (shareholders) under this option. Cherry-picking would still be allowed to occur, meaning that the views of shareholders would potentially not be reflected in the voting on a resolution.

Companies

8.98 There would be no change for companies under this option. Proxy holders would still be able to cherry-pick votes to influence the outcome of a voting process in accordance with their wishes. Director or executive proxy holders could still cherry-pick proxies despite the fact

they might be prevented from exercising their own votes on a resolution due to the existence of a conflict of interest.

Government

8.99 There would be no change for the Government under this option.

Option B: Require non-Chair proxy holders to exercise all directed proxies if they choose to exercise one vote

Shareholders

8.100 This option would be unlikely to result in any real improvement for shareholders. Proxy holders would only be likely to exercise all directed proxies if the majority align with their view on a resolution. As such, conflicts of interest would still be able to influence shareholder votes, meaning that the signal on a resolution would not be accurate.

Companies

8.101 This option is unlikely to result in any practical change for business. If a non-Chair proxy sought to influence the voting process, they would simply assess whether the majority of directed proxies align with their view on a resolution, and then choose whether to vote all the directed proxies accordingly.

Government

8.102 This option is likely to result in costs for the Government associated with monitoring compliance and taking any necessary enforcement action.

Option C: require non-Chair proxy holders to vote all directed proxies

Shareholders

8.103 This option would result in an improvement for shareholders. Preventing cherry-picking would ensure that outcomes on resolutions more clearly reflect the views of shareholders. It would increase the transparency of the voting process and the ability of shareholders to participate in the running of their company. It would also ensure that shareholder signals on remuneration votes are accurate.

8.104 This option could also produce flow-on effects such as greater information flow to shareholders about resolutions on which they can vote.

Companies

8.105 This option would require non-chair proxy holders to be vigilant to ensure they vote all directed proxies. A defence for not voting directed proxies would be provided if a proxy holder was not aware of their appointment, or could not attend the meeting.

8.106 This option would limit the potential for proxy holders to bring personal conflicts of interest to bear on the voting process. As such, companies may choose to provide more information to shareholders about the resolutions they are able to vote on in order to ensure their voting is well informed. It would also increase the impact of the two-strikes proposal to promote greater accountability.

Government

8.107 This option could involve costs for the Government, through the monitoring of compliance and the potential need for enforcement action.

Consultation

8.108 Cherry-picking of directed proxies is an issue that has received attention from both the PC and PJC. The PC's inquiry received 170 submissions and the PJC received 45 submissions, and both also conducted public hearings.

8.109 This recommendation is generally not considered to be controversial, which is reinforced by the fact that it did not receive a great deal of commentary in submissions. However, in general, submissions supported the removal of cherry-picking on the basis that shareholder views on a resolution should be accurately reflected and that there should be efficacious voting mechanisms for shareholders that cannot attend a meeting.

8.110 Support for removing cherry-picking was given by the Australian Bankers Association, Mercer, Hay Group, Perpetual, the Financial Sector Union of Australia, the Australian Shareholders Association, Macquarie, Mr Andrew Murray, and Regnan, among others. This support was primarily provided on the basis that shareholders are entitled to expect that their shares will be voted as they direct.

Conclusion and recommended option

Recommended option: Option C.

8.111 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. Voting systems should not enable the views of those that are otherwise prohibited from voting due to a conflict of interest to influence a final decision if this is contrary to the wishes of shareholders.

8.112 The only option that achieves these outcomes is Option C. It will increase the transparency and effectiveness of shareholder voting, and provide better signals to the company on remuneration reports. As such, it will couple well with the two-strikes proposal making it more likely that boards will be held accountable.

Coverage of Management Personnel

Problem

8.113 Under section 300A of the *Corporations Act 2001* (the Corporations Act), all listed companies, including financial institutions, are required to prepare a comprehensive remuneration report which accompanies the Annual Director's report.

8.114 The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) introduced the requirement for listed companies to disclose the remuneration of directors and senior management in relation to both the listed company and consolidated entity. This means that the remuneration of the five most highly remunerated executives, as well as the key management personnel of both the parent and consolidated entity must be disclosed.

8.115 As the PC noted in its report, the contemporary usefulness of this requirement is questionable as it was introduced when there was no coherent interaction between the Corporations Act and the Australian Accounting Standards.

8.116 Currently, the practical problem with this requirement is that for large companies, the five highest paid group and company executives are also likely to be key management personnel. In contrast, small companies may have fewer than five key management personnel. This makes the disclosure requirements quite onerous to apply.

8.117 Also, the requirement to include disclosures from both the parent and consolidated entities means that a lot of the time the remuneration report has an overlap of information.

8.118 Many participants in the PC's consultations signalled little interest in remuneration details beyond the CEO.

Objective of Government action

8.119 The objective of Government action is to address the problem identified above by:

- ensuring that the regulatory machinery in regards to remuneration reports is contemporary and straightforward for users.

Options to achieve objective

Option A: No change

8.120 Under this option, the status quo would be maintained. The Corporations Act requires that all listed companies disclose the remuneration of the five most highly remunerated executives, as well as the key management personnel of both the parent and consolidated entity in the annual remuneration report.

Option B: Individual remuneration disclosures in the annual remuneration report are confined to the key management personnel of the consolidated entity.

8.121 Under this option, the Corporations Act will be amended to require that all listed companies disclose the remuneration of the key management personnel of the consolidated entity in the annual remuneration report.

Impact Analysis

Impact group identification

8.122 Affected groups:

- shareholders and other parties with an interest in the company (for example creditors and employees);
- companies (including company directors and executives); and
- Government and regulators.

Assessment of costs and benefits

Table 8.12 Option A: Do nothing

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	Shareholders are able to view the remuneration details of the key management personnel and the top five executives in both the parent and consolidated entity.	Maintains the overlapping of remuneration information, which makes the remuneration report bulky and complex for the shareholder to view and understand.

	Benefits	***Costs***
Companies (including company directors and executives)		Disclosure of this information is costly to companies. Additionally, it has the potential to require companies to disclose the remuneration information of employees who do not affect the management of the company.
Government/regulators		Currently, the regulator has to ensure that the company complies with the disclosure requirements.

Table 8.13 Option B: Require disclosure of the remuneration of the key management personnel of the consolidated entity

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	While this option requires fewer disclosures, it ensures that the remuneration information disclosed meets shareholders needs. They will be able to easily view the remuneration of the key management personnel in the parent entity without having to sift through overlapping information as in the status quo.	Potential to decrease transparency, as this option requires fewer disclosures. However, it is unlikely that the remuneration of individuals who affect the management of the company will not be disclosed.
Companies (including company directors and executives)	Under this option, meeting the remuneration disclosure requirements will be less costly and complex for companies to disclose. Additionally, irrelevant or overlapping information will not have to be disclosed.	
Government/regulators	The regulator will not have to ensure that all the relevant personnel are	

	Benefits	***Costs***
Government/regulators (continued)	captured in the remuneration disclosures, as under the status quo. Rather, it will only have to ensure that the key management personnel of the parent entity is disclosed.	

Consultation

Shareholders

8.123 The Australian Shareholders Association (ASA) contended that the disclosure of remuneration of the top five most highly remunerated executives, as well as the key management personnel of both the parent and consolidated entity is of interest to shareholders. The ASA sees the definition of key management personnel too narrow as a company may have an individual that may fall into the category of key personnel without being part of management, and be the highest paid individual within the company.

8.124 In contrast, the Australian Council of Super Investors (ACSI) recognised the arguments for rationalising references to the five highest paid executives in company reports to 'key management personnel' in accordance with Australian Accounting Standards Board (AASB) standard 124 (being individuals who may be able to influence their own pay or materially affect the management of the company).

Companies

8.125 Submissions received by the PC, including submissions from BHP Billiton, the Joint Accounting Bodies, CGI Glass Lewis and Guerdon Associates questioned the need for inclusion of the five highest paid group and company executives as well as the key management personnel in the remuneration report. BHP Billiton suggested that the Corporations Act be aligned with the Australian Accounting Standards.

8.126 The Institute of Chartered Accountants supports the removal of the top five executive disclosures in order to focus disclosure of detailed information on individual 'key management personnel' as defined by AASB standard 124.

8.127 The AICD supports amending the requirements to Option B on the basis that it will help reduce complexity and cost associated with report preparation, as well as help with the readability of reports.

8.128 KPMG submitted that shareholders were not interested in remuneration disclosure beyond the individual directors and the CEO.

Conclusion and recommended option

8.129 The remuneration report should focus on the individuals who may be able to influence their own pay or materially affect the management of the company. Accordingly, it is recommended that the Corporations Act should be amended to reflect that individual remuneration disclosures be confined to key management personnel of the consolidated entity. The additional requirement for the disclosure of the top five executives of the parent entity should be removed.

8.130 On balance, the minor technical amendment to the regulatory framework will be to the benefit of both shareholders and companies.

8.131 This amendment will reduce regulatory burden and simplify the complexity of disclosures in the remuneration report, while maintaining corporate accountability.

Remuneration consultants

Problem

8.132 Remuneration consultants provide advice to companies on matters relating to remuneration arrangements, pay structures and performance hurdles, including strategic advice on how the levels of remuneration are benchmarked against industry standards. Some stakeholders have expressed concerns about companies engaging remuneration consultants to provide advice on director and executive remuneration.

8.133 Currently, an information asymmetry exists, as there are no mandatory disclosure requirements relating to the use of remuneration consultants. However, this information is necessary to ensure that shareholders and other users are aware of the role remuneration consultants have played in influencing the company's remuneration arrangements, and to ensure that users are able to assess the independence of the remuneration consultant's advice.

8.134 A key concern raised by stakeholders is that remuneration consultants may be placed in a position of conflict if they are asked to provide advice on the remuneration of officers who might have the capacity to affect whether or not that consultant's services will be retained again (either for remuneration advice or other services the consultant may provide to the company). For example, a remuneration consultant may feel that remuneration advice that is unfavourable to the company executives may compromise access to future work. In addition, concerns have been raised that the use of remuneration consultants can 'ratchet up' remuneration levels.

8.135 As noted by the PC, it is common for boards to seek external advice on remuneration matters. Boards, especially from larger companies, generally seek information from a range of consultants when determining remuneration packages. According to a survey by a corporate governance advisor, 67 percent of boards seek independent advice on CEO remuneration. Another survey indicated that 83 percent of boards seek independent advice when negotiating contracts with CEOs.

8.136 It is noted that, while the advice of remuneration consultants may be influential in determining a company's remuneration decisions, the primary responsibility for remuneration arrangements rests with company directors.

Objectives of Government action

8.137 The objectives of Government action are to address the problems identified above by:

- increasing the transparency of the remuneration setting process by addressing the current information asymmetry;
- enabling shareholders to make an informed assessment about the independence of the remuneration consultant's advice; and
- minimising potential conflicts of interests in the remuneration setting process.

Options to achieve objectives

Option A: No change

8.138 Under this option, the status quo would be maintained by not requiring any disclosure on the use of remuneration consultants.

Option B: Require listed companies to disclose the use of remuneration consultants and require any remuneration consultants used by the company to be engaged by, and report to, the board of directors or the remuneration committee

8.139 Under this option, listed companies would be required to disclose details such as the remuneration consultant used, who appointed the consultant, who the consultant reported to and the nature of other work undertaken for the company by the consultant, the amount the consultant was paid for the remuneration advice and other (non-remuneration related) services to the company, the basis on which the consultant was paid, a summary of the nature of the advice received and the methodology employed in formulating the advice.

8.140 In addition, any remuneration consultants used by a listed company would be required to be engaged by, and report to, the board of directors or the remuneration committee rather than company executives, to minimise potential conflicts of interests.

Impact analysis

Impact group identification

8.141 Affected groups:

- shareholders and other parties with an interest in the company (for example creditors and employees);
- companies (including company directors and executives); and
- Government and regulators.

Assessment of costs and benefits

Table 8.14 Option A: Do nothing

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)		Shareholders will not be in a position to make an informed assessment about the independence of the remuneration consultant's advice, and remuneration consultants will continue to be placed in a position of conflict which may impact on the integrity of their advice and ultimately, the remuneration levels of company executives.
Companies (including company directors and executives)	Listed companies will not be required to provide additional disclosures in the remuneration report.	
Government/regulators		

Table 8.15 Option B: Require listed companies to disclose the use of remuneration consultants and require any remuneration consultants used by the company to be engaged by, and report to, the board of directors or the remuneration committee

	Benefits	***Costs***
Shareholders and other parties with an interest in the company (for example creditors and employees)	Greater transparency for shareholders, as they will be in a better position to assess potential conflicts of interests. It will also facilitate greater independence of remuneration consultants by ensuring that their advice is provided to the board rather than the company executives. In addition, greater transparency on the role of remuneration consultants could potentially lead to better accountability of company management and better remuneration policies.	
Companies (including company directors and executives)		Listed companies will be required to provide additional disclosures in the remuneration report.
Government/regulators		

Consultation

8.142 The PC consulted extensively on this issue and found that although companies are not required to disclose their use of remuneration consultants, some choose to do so, for example, BHP Billiton, Iluka Resources and Woodside Petroleum.

8.143 Submissions made to the PC by Mercer reported that the lines of reporting for remuneration consultants can easily be blurred. The PC found that in Australia, companies and remuneration consultants are mindful of the potential for conflicts of interest. The top two companies providing remuneration advice to boards in Australia also provide advice

to management on remuneration, and to both the board and management on other areas more broadly.

8.144 Suggested changes to the process of engaging remuneration consultants included introducing a requirement:

- that remuneration consultants be engaged directly by the board (Fidelity International, KPMG, Oppeus);
- that remuneration consultants advise only the board or management, but not both (CGI Glass Lewis and Guerdon Associates); and
- for boards to have clearly defined and disclosed systems and procedures to address any potential conflicts of interest (Guerdon Associates, KPMG, PricewaterhouseCoopers, Regnan).

8.145 Overwhelmingly, it was found that increasing disclosure on the use of remuneration consultants would help shareholders identify the extent to which the consultants provide advice to the board or remuneration committee, and assess whether the remuneration decisions that boards and remuneration committees make are based on 'independent' advice. This was supported by Riskmetrics, ACSI, CGI Glass Lewis, Guerdon Associates, and the AICD.

Conclusion and recommended option

8.146 Option A is not considered ideal, as it does not address the current information asymmetry that exists in the current framework. As a result, the remuneration setting process will not be transparent, shareholders will not be in a position to make an informed assessment about the independence of the remuneration consultant's advice, and remuneration consultants will continue to be placed in a position of conflict which may impact on the integrity of their advice and ultimately, the remuneration levels of company executives.

8.147 Option B is the preferred option. This option will deliver greater transparency for shareholders, as they will be in a better position to assess potential conflicts of interests. It will also facilitate greater independence of remuneration consultants by ensuring that their advice is provided to the board rather than the company executives. It will also bring Australia into line with other key jurisdictions which require disclosure of the use of remuneration consultants.

Consultation

8.148 The PC has conducted extensive consultation in the preparation of this report which commenced in March 2009, including informal consultations, roundtables and public hearings. An issues paper was released in early April 2009 and a Discussion Draft was released on 30 September 2009. The PC received 170 submissions, 105 prior to the release of the Discussion Draft and a further 65 in response to the Discussion Draft.

8.149 The public consultation process undertaken in relation to the inquiry included a range of stakeholders comprised of industry group representatives, professional bodies and consultants, among others. Key stakeholders that were consulted as a part of this process included:

- the Australian Institute of Company Directors;
- Australian Shareholders' Association;
- BHP Billiton;
- Macquarie Group;
- Regnan;
- Mercer;
- RiskMetrics;
- Freehills;
- the Australian Council of Trade Unions;
- academic researchers;
- Australian Council of Super Investors;
- the professional accounting bodies;
- Australian Prudential Regulation Authority; and
- the Treasury.

8.150 The PC has also conducted public hearings which were held in Sydney, Melbourne and Brisbane in June and July to discuss the report prior to the release of the Discussion Draft. A second round of public hearings was held from October to November.

8.151 The PC report addresses the issues raised by stakeholders in the extensive consultation process. Stakeholder views were considered in order to further understand how the proposed reforms would impact on a number of related areas of corporate governance. In addition, the PC found that consultation was valuable in understanding the need for awareness of the potential for unforeseen consequences and to ensure proportionality among companies of widely differing sizes.

8.152 Treasury's consideration of the policy issues was informed by the Productivity Commission's report and consultation process. Treasury did not directly consult with stakeholders.

Implementation and review

8.153 The preferred options identified above will be progressed through amendments to the *Corporations Act 2001*.

8.154 When any legislation is drafted to give effect to the amendments to the Act, the Government will undertake further consultation on the Bill.

8.155 The Australian Securities and Investments Commission is the corporate regulator responsible for enforcing all parts of the Corporations Act, including any changes implemented through amendments in the Act.

8.156 If the ASX decides not to amend the Listing Rules in line with the relevant PC recommendations, the Government may opt to amend the legislation further. Any changes would be reflected in a revised Regulatory Impact Statement.

8.157 In addition, the PC has recommended a post-implementation review within five years to evaluate the outcomes of the Government's response. This is to ensure that there are no unintended consequences. The Government accepts this recommendation and will instruct Treasury to conduct the post-implementation review.

Index

Schedule 1: Amendments

Bill reference	*Paragraph number*
Item 5, sub-section 206K(2)	1.24
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