

January 20, 2011

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Submission – Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Egan Associates¹ understands that the intent of the draft Bill is to strengthen Australia's remuneration framework. We acknowledge that, following the GFC and some highly publicised remuneration incidents, a sense of community outrage emerged at perceived "disproportionate" reward practices in some companies. Not isolated to Australia, this phenomenon is causing debate in many western economies. This in turn has given rise to a vocal view that control in the form of legislation is required to constrain the level of reward offered at the most senior levels of management. While supportive of a range of initiatives to ensure executive remuneration is managed appropriately, it is our view that legislation intended to address the inappropriate behaviour of a relatively small number of companies, could result in unintended consequences for the majority of well managed and responsibly governed corporations.

Key Focus of Egan Associates Submission

Our review of the draft bill reveals a number of concerns. Accordingly, this submission outlines the specific points that might prove problematic and offers constructive suggestions for their resolution.

Two key concerns form the basis of our submission:

1. The companies affected by the proposed legislation
2. The level and concentration of influence on the voting patterns of shareholders

Time constraints have not permitted a response regarding the independence of remuneration consultants and their advice.

¹ Egan Associates has 30 years experience in advising boards and management on remuneration matters .Details can be found at www.eganassociates.com.au

1. Companies Affected by the Legislation

Table 1 shows the market capitalisation of the 300 largest publicly listed companies on the ASX. The aggregate is approximately A\$1,250 billion with an average just above A\$4 billion for these 300 corporations (December 31, 2010). Of particular relevance is the distribution, which reveals that the ASX top 50 account for 77% of this total and the ASX 100 for 88%.

Table 1: Market Capitalisation of ASX 300

Ranking	Aggregate Market Capitalisation in \$,000m	Average Market Capitalisation in \$,000m	% of ASX 300
ASX 50	960,839	19,217	77%
ASX 51 - 100	141,664	2,833	11%
ASX 100	1,102,503	11,025	88%
ASX 101 - 200	103,607	1,036	8%
ASX 201 - 300	41,459	415	3%
ASX 300	1,247,568	4,159	100%

With 77% to 88% of all of corporate Australia's listed investments in the hands of 50 to 100 companies, it is Egan Associates' view that almost all of the benefits sought by the legislation could be achieved by focussing on just these companies. It could be argued that imposing this legislation on smaller companies will create another level of cost and administrative burden with only limited effect.

Recommendation:

1. Focus the scope of the legislation on the top 50 – 100 corporations.

2. The Degree of Influence on Voting Patterns

The "Two Strikes" rule - Section 250U – and the Advice on remunerating key management personnel for disclosing entities – Section 206K - needs to be considered in light of two key factors operating in corporate Australia. First, the voting patterns at the annual general meetings of the top companies in Australia are influenced heavily by the opinion of proxy advisers, who are not subject to the proposed legislation. Indeed the voting patterns of shareholders are much less influenced by **the advice** of remuneration advisers who are subject to the proposed legislation. Second, the "two strikes" rule might provide an untoward opportunity for a concentration of power in the hands of a small block of shareholders. We raise these two issues because they are at the heart of providing true democracy and influence to average investors who have raised many of the concerns about executive remuneration the proposed legislation is meant to address.

Proxy Advisers

There are a handful of key proxy advisers in Australia. Elementary research shows that these advisers probably conduct up to 200 reviews each year. These advisers to large institutional investors must cover the full gamut of corporate accounts in their reviews. They provide advice which holds significant weight and influence on the outcomes of annual general meetings. Yet there is no requirement for these advisers to be independent, to have their access to management or boards limited, for their fees or remuneration to be disclosed or for their methodology or expertise to be reported in company reports.

Remuneration advisers on the other hand are plentiful in supply in Australia, although in reality there are probably around 20 or so advisers used by ASX 300 companies. On average, an adviser might have 20 clients for which to conduct a comprehensive KMP remuneration review in any one annual reporting season cycle. (Several companies engage more than one consultant for their remuneration advice in order to ensure the advice they receive is reasonable). Remuneration advisers provide advice on how to best align the interests of the management team within an organisation with those of shareholders. They provide advice on ways to motivate (reward) management to deliver better results for shareholders. As important and topical as their work is, these advisers provide advice on a very small aspect of a company's strategy. In terms of influence, they have very little influence on the voting patterns of shareholders or key institutional investors. Yet their advice is about to be subject to a disproportionate amount of scrutiny and they are about to be restricted in how they conduct their research in order to provide that advice, particularly if the Board's KMP adviser is potentially limited solely to the provision of that advice on reward strategy and implementation to their client.

The Power of A Concentrated Block of Shareholders

What is also important to consider is the issue of democracy within the voting among the Top 300 companies in Australia. The proposed legislation allows for a spill of all directors by a vote of 25% or more of eligible shareholdings at an annual general meeting. An examination of the realities of voting rights reveals how easy it would be for a very concentrated minority of shareholders to control corporate Australia by exercising the increased powers granted under this legislation. Table 2 highlights the ownership of the top 20 shareholders across the ASX 300. In each category, the top 20 shareholders of corporate Australia control around 70% of share ownership.

Table 2: Distribution of Top 20 Shareholders

	75th Percentile	Median	25th Percentile	Average
ASX 50	80%	72%	58%	68%
ASX 51- 100	86%	76%	63%	71%
ASX 100	82%	75%	59%	69%
ASX 101-200	85%	77%	66%	75%
ASX 201-300	80%	71%	59%	68%
ASX 300	83%	74%	62%	71%

Given that indicatively between 50% and 60% of shareholdings are voted at AGMs, the top 20 shareholders (typically large investment funds and institutional investors) will therefore hold total power over the remuneration arrangements for these companies. Their vote will determine whether or not the remuneration arrangements for a company are implemented.

We believe that also relevant to the above deliberations in providing an appropriate voice to the majority of shareholders as distinct from those with the greatest shareholding are the number of shareholders in the top 300 listed entities. The table below sets out the distribution of shareholders and the average number of shareholders in the relevant categories referred to in the table above.

Table 3: Distribution of Total Number of Shareholders

	75th Percentile	Median	25th Percentile	Average
ASX 50	186,007	106,082	52,433	210,502
ASX 51- 100	57,792	22,048	12,821	36,982
ASX 100	114,125	54,026	20,834	123,742
ASX 101-200	12,805	6,946	3,484	10,911
ASX 201-300	7,363	4,512	2,709	7,759
ASX 300	29,271	9,146	3,803	47,585

The above, in our judgement, reveals that the majority of shareholders will have an extremely limited influence on the practical application of the proposed legislation.

The top 20 shareholders already have the power to cause a progressive spill of a board, they can vote down each and every director every three years as their directorship comes up for renewal. What the *'two strikes'* legislation will do is to give added sting to this concentrated power of a select shareholder group.

What is more alarming though is that this concentrated shareholder block will also be able to use the excuse of remuneration design as a means of forcing the spill of an entire company board (should they so choose). The average 'mum and dad' shareholder, or the average self funded retiree who might have a strong view on remuneration arrangements in the companies of which they are shareholders will rarely if ever have the collective shareholding to influence the actions of the *'institutional investor'*. Such power will always rest in the hands of large investors and institutions. So rather than providing power and influence to the majority of individual investors, those in the community who expressed concerns, this legislation would formalise the placement of that power in the hands of a small number of shareholders. This proposed legislation does not offer a democratic outcome for the average investor.

In summary, the proposed legislation provides an untoward opportunity for:

- a. A minority of shareholders to trigger a board spill. Given most AGM's experience voter turn-out between 45% and 60%, it is possible for a 12.5% holding to cause a spill, if only

50% of shareholdings are voted or have provided their proxies in advance.

- b. Institutional investors to cause a board spill that may or may not be related to remuneration. Proxy advisers may proffer recommendations for a “No” vote because the company is perceived as failing to support a policy or position advocated by the advisory body. Many institutions are bound by instructions from trustees to accept the recommendations of their proxy adviser(s).
- c. An elevation of remuneration matters above others that might be regarded as more crucial to company performance and sustainability, such as two years of declining profits, or eroded market share.

Recommendations:

1. Legislation should provide that at least 50% of shareholdings or the votes of at least 25% of eligible shareholders be required to trigger the “two strikes” rule.
2. The top 100 ASX companies be required to publish their previous 2 year remuneration report votes in the current years’ remuneration report. Included in this report would be the steps taken to address investor concerns (including those raised by proxy advisers) about remuneration or the rationale for not doing so. This would ensure all investors are aware of the current ‘*state of play*’ regarding remuneration in these companies. It would allow for a more considered vote on remuneration reports.
3. Given the degree of influence on the exercise of voting rights that proxy advisers have, require proxy advisers to publish their recommendations (and the basis on which they were determined) on voting on the remuneration report as well as voting on other matters arising from a ‘notice of meeting’ prior to the AGM, so it is evident to all investors, large and small, what issues are of concern to these proxy advisers. This will overcome the issue of directors not knowing how proxy advisers have framed their advice.
4. Require proxy advisers to alert companies to their position and have a right of reply prior to their advice being forwarded to their clients.
5. Require the directors to reveal whether they have accepted their remuneration adviser’s recommendations in relation to the KMP review.

Egan Associates work commitment has not provided us with adequate time since the release of the draft legislation to address our view in relation to Sections 206K, 206L and 300A(i)(h) which specifically appear to restrict unnecessarily the ability of the board and remuneration advisers to work effectively with management in ensuring that shareholders have the benefit of the best solutions in addressing the complex area of KMP reward. We will in the coming weeks post our response on the company's website www.eganassociates.com.au.

Yours sincerely



John V Egan