Level 7, Suite 3,
3 Spring Street,
Sydney NSW 2000
Australia

Tel: 61 2 9270 2900
Fax: 61 2 9270 2999
www.GuerdonAssociates.com
ABN 67 112 483 940 ACN 112 483 940

Guerdon Associates
Equity and Executive Pay

19 January 2011

Mr. Geoff Miller
General Manager Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Miller,

Re: Exposure draft of the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Thank you for the opportunity to comment on the exposure draft of the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 and associated materials.

Our submission includes brief background on Guerdon Associates, feedback regarding specific aspects of the Bill, our recommendations, and summary concluding remarks.

## Guerdon Associates

Guerdon Associates is Australia's largest independent[1] executive remuneration consulting firm. Consulting staff are located in Melbourne and Sydney, with additional support located in offices in Chennai, India (database management and administration) and San Francisco (technology support).

## Aspects of the draft Bill supported

There are several aspects of the draft Bill that Guerdon Associates support unchanged. These are:

- Prohibiting hedging on incentive remuneration
- Requiring shareholder approval for declarations of "no vacancy"
- Simplifying the disclosure requirements in the remuneration report to KMP for consolidated entities

## The two strikes rule

The concept of the two strikes test recommended by the Productivity Commission was an intelligent approach to respond to concerns that occasionally some boards have not responded adequately or promptly to

[1] Independence is defined as a specialist provider of consulting services to boards to minimise conflicts of interest that may result from being a broad based supplier of multiple services to both management and boards.

shareholder dissatisfaction with executive pay, while also ensuring the vote remains non-binding for practical application.

However, in its current draft form the legislation requires amendment because:

- *A minority will dictate to the majority on how the company be managed.* The trigger for a spill resolution is two consecutive non-binding votes of 75% or less in favour of the remuneration report. That is, a spill motion is to be considered despite the majority expressing satisfaction with remuneration governance, and presumably wanting this standard of remuneration governance maintained.
- *There is a practical difficulty that the Bill may perversely reduce the number of votes cast against remuneration reports.* The spill resolution would be required to be included in the notice of meeting after only one minority vote against the remuneration report. Several institutional investors have suggested to us that investors who may be tempted to send a shot across a board's bows by casting a non-binding vote against the remuneration report will not be so eager if this could trigger a spill motion which could adversely impact on the company's market price.

Cherry picking of proxies

Under new section 250A(4)(c), the Bill proposes that the existing provisions requiring the board chairman to vote directed proxies would be repealed, and replaced with a new provision that requires all proxy holders to exercise all directed proxies on a poll. This new law would apply to all resolutions, not just to proxy votes cast in respect of remuneration reports.

Shareholder voting is currently not compulsory. That is, there is nothing in the current law that requires a shareholder to attend and vote at a members' meeting. However, under this amendment, if a shareholder appoints a proxy, whether or not the person appointed has agreed, the proxy will be compelled to attend the relevant meeting and vote on any poll conducted at the meeting.

Hence, in its current form, this aspect of the legislation is unworkable.

To make voting procedures more effective, we suggest legislative amendments to encourage listed companies to implement electronic voting procedures, rather than impose compulsory voting obligations on all proxies. This was recommended by the Productivity Commission, yet has not been acted upon.

Remuneration adviser disclosure requirements

Guerdon Associates supports disclosure regarding remuneration consultants. However, the Exposure Draft requirements are unworkable.

Peripheral advisers contracted to provide general advice to management impacting KMP remuneration are caught up in the net of disclosure, with a host of unintended consequences (see comments on process prescription below). So, in accord with well-tested UK regulation, we suggest that the Bill be made more workable by requiring the disclosure of only those advisers who provide material advice.

The disclosure of the nature of advice and the principles underlying the advice has raised client concerns that sensitive or commercial issues may have to be disclosed, e.g. termination payments for KMP who do not yet know they are to be terminated, incentive advice associated with acquisitions or mergers that are market sensitive, etc.

Incomplete disclosure on material and conflicted sources of advice

The Bill's requirements regarding remuneration adviser disclosure do not go far enough.

The draft legislation does not require all material sources of KMP remuneration advice to be disclosed. It focuses instead on detailed disclosure of external advisers who may or may not be conflicted and the nature of the advice, whether or not it is material.

Therefore, if a board decides commissioning external advice is all too hard, there is no disclosure required of how they arrived at their policy and decisions, who in management provided them with advice in lieu of external advice, and how they managed the conflict of interest that this would entail.

The legislation as it stands will require the names of external advisers and the nature of their advice to be disclosed. But what of the names of advisers and the nature of the advice when advice is received from management? Did the board receive advice from their secretariat, CEO or human resources manager? Did the nature of their advice include the level and structure of the adviser's own pay?

Hence, we suggest that the Bill go further, and require the disclosure of all providers of material remuneration advice, whether they are external or internal. This also follows tested UK regulatory practice, which has been shown to have beneficial consequences.

Legislation is too prescriptive on process

No-where else in the Corporations Act is there such a specific prescription for entering into contractual services as is proposed in the draft sections 206K and 206L. No such prescriptions are made in relation to far more

material considerations such as acquisitions, financing facilities and covenants, or any other contract critical to the financial health or governance of the company, including audit.

Examples of the prescriptive impact include:

- *Requiring non-executive directors to be administrators:* Company secretaries and human resources managers cannot receive consultant reports even as a "mailbox" for distribution of other board papers. This purely administrative function is forced "upstairs" to a non-executive director. The time consumed in collating reports, seeking management opinion on externally provided papers and redistribution will add considerably to the remuneration committee chairman's workload, and reduce directors' availability to attend to material matters.
- *Less effective and complete advice with potential material consequences:*
  - Consultants currently undertake a lot of the legwork in seeking out detailed performance, remuneration, company strategy and KMP job scope data through liaison, meetings and discussions with management. They typically ask why specific alternatives have not been considered. Their process would be severely constrained if any aspect of these discussions could be construed as KMP remuneration advice. Directors would not have the time, information or inclination to take the place of management for this interaction.
  - Furthermore, drafts of advice could not be shared by consultants with management for critical review of unintended consequences prior to finalisation of the advice to directors, if such draft advice is seen as providing advice in contravention of sections 206L(3) and (4). As a consequence, advice could be potentially misleading, result in sub-optimal pay structures, or directors would have to act as postboxes to forward draft advice to management and to receive their comments.
- *Inability by non-KMP to commission external work that impacts both KMP and non KMP employees:* Non-KMP company management will not be able to engage external advice on routine matters that are in some way related to the "nature and amount or value of [KMP] remuneration". This routine work would have to be commissioned and received by board directors. Examples may include: the valuation of equity instruments for expensing and determining grants/allocations to employees, such as shares and options provided to KMP and non-KMP personnel; the accounting treatment of remuneration vehicles provided to KMP as well as non-KMP personnel; the purchase of salary surveys containing information relevant to non-KMP personnel as well as KMP personnel; the legal interpretation of equity plan rules that apply equally to KMP and non-KMP, etc.

If enacted, the draft legislation will result in a significant increase in the workload of directors who seek external advice. In addition, any external

advice received will be of poorer quality due to limited interactions between the board appointed external adviser and management, for fear of criminal sanctions and non-compliance with 206L.

In short, the prescriptions regarding executive remuneration contractual services are unworkable.

The result will be that boards of directors will no longer use external advisers. Directors will become more reliant on the most conflicted source of advice – management.

The ED proposals will probably result in the proportion of ASX200 boards relying exclusively on advice from management on what management should be paid increasing from 30% to 90%. Any increased reliance on management rather than independent, expert external advisers for KMP remuneration advice will result in correspondingly poorer corporate governance outcomes for shareholders.

We suggest the constraints and prescriptions on boards to manage remuneration be replaced by disclosure of the process for managing remuneration, with an emphasis on how conflicts of interest are managed.

This maintains the freedom for the board to act as they see fit for discharging their fiduciary duties, with additional transparency for better accountability.

Recommendation 1 - two strikes rule

*Amend 250U(a) and 250U(b) to require at least 50% of votes cast be against the adoption of the remuneration report in consecutive remuneration report votes*.

Guerdon Associates suggests that the trigger be increased to two consecutive 50% or greater "no" votes on the remuneration report. This will reflect a "majority" view.

This higher trigger point will reduce the likelihood that institutional investors will "pull back" on expressing dissatisfaction with executive remuneration. In addition, at this level of dissatisfaction, it is likely that there are other serious governance concerns such that a significant proportion of investors may welcome a board spill. This is unlikely to be the case where the no votes on the remuneration report are less than 50%, resulting in unnecessary cost, distraction from pressing material matters, and dissatisfaction on remuneration matters becoming less transparent as a result of institutional investors pulling back on the 2nd vote.

Recommendation 2 – Disclose all sources of material advice and how conflicted advice is managed

*Replace the draft 206K and 206L with the requirement to disclose:*

*a. The name of any person who provided the board or board remuneration committee with material KMP remuneration advice and the nature of their advice*
*b. External adviser fees for advice contracted by non-executive directors and management, respectively*
*c. The potential and actual conflicts of interest associated with advice received and how the board, committee or individual non-executive director managed these potential and actual conflicts of interest*

Our recommended approach requires all sources of material advice to be named, whether they are external or internal. Recommendation 2(a) currently exists in the UK Companies Act, Schedule 7A (2)(1)(b) and Schedule 7A (2)(1)(c).

Guerdon Associates' recommendations acknowledge the reality that the principal-agent problem cannot be eliminated. That is, there will always be a conflict of interest between shareholders and those to whom they delegate the task of managing their capital. Instead, our recommendations are focused on disclosure on how these conflicts are managed, which does not feature in the draft Bill.

Recommendation 3: Favour principle over prescription by allowing freedom to contract services with better disclosure

*Amend 300A(1)(h)(ii) to replace the word "director" with "person".*

Recommendations 2 and 3 do away with the prescriptions of the draft law in how to contract for and receive advice, while acknowledging that disclosure quantifying external advice conflicts should be retained.

Importantly, taken together, recommendations 2 and 3 ensure shareholders would have a more holistic view of conflicts and how these are managed, which is lacking in the current draft Bill.

Recommendation 4: Cherry picking

*Amend 250A(4)(c) to require votes to be lodged as directed by proxy holders who attend the AGM, rather than require all proxy holders to attend the AGM and vote.*

This amendment requires nominated proxies to vote as directed if they attend the AGM. We acknowledge that this does not resolve the potential for cherry picking, but note that there is no evidence put forward as to its prevalence. Hence our next recommendation.

Recommendation 5: Electronic voting

*Provide regulation that facilitates electronic voting in accord with Productivity Commission recommendation 14.*

Facilitating electronic voting will ensure votes are lodged as shareholders intend, while having greater potential for efficiency, validity and timeliness.

Concluding comments

The draft Bill's amendments to prohibit hedging on incentive remuneration, practically manage declarations of "no vacancy", and simplify the disclosure requirements in the remuneration report to KMP for consolidated entities are commendable and should find broad support.

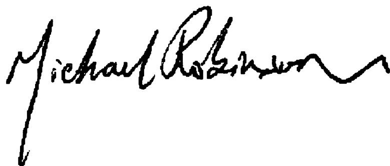
The intelligence of the two strikes rule to allow practical management of executive pay with accountability for how well pay is managed is threatened by setting the threshold for a board election spill too low. In addition, having a minority's opinion outweigh a majority with potentially material consequences to shareholder value can pervert both the transparency and accountability of remuneration governance. A simple lifting of the threshold can resolve this.

Guerdon Associates has a major concern with the Bill's prescription of how and to whom services be contracted, and how these services are to be delivered. Addressing this by reverting to the principle of disclosing material advisers, conflicts of interest and how these conflicts are managed will result in greater transparency and accountability. Our recommendation builds on and extends the UK's experience in a way that we believe will result in better remuneration governance.

Lastly, we acknowledge the potential that cherry picking has for corrupting the voting process. But requiring proxies who have no say in their appointment to attend an AGM and vote is clearly unworkable. Work to facilitate electronic voting instead holds more promise for improving all aspects of the voting process.

Guerdon Associates will be pleased to assist Treasury further if required.

Yours sincerely,



Michael Robinson
Director