An MSCI Brand

20 January 2011

General Manager

Corporations and Financial Services Division

The Treasury

By email: executiveremuneration@treasury.gov.au

Thank you for the opportunity to comment on the exposure draft of the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011. Institutional Shareholder Services Inc. (ISS, formerly RiskMetrics) is the world's largest corporate governance advisory firm, providing governance research to institutional investors in Australia and around the world. This submission does not necessarily reflect the views of our clients.

In summary in relation to the proposed changes contained in the draft Bill:

- ISS **does not** support the introduction of the proposed 'two strikes' regime. Should the Government proceed with the proposed changes ISS does, however, have suggested changes to ensure it serves its stated purpose.
- ISS supports requiring disclosure of the principal remuneration advisors to listed companies. ISS **does not,** however, support the proposed additional disclosure requirements relating to fees received for services and the strict independence rules proposed in the draft Bill.
- ISS supports prohibiting members of key management personnel (KMP) – those persons whose remuneration is disclosed in the remuneration report – from voting on the remuneration report resolution and other resolutions directly related to their remuneration.
- ISS supports the proposed prohibition of hedging KMP incentive pay.
- ISS supports the proposed ending of the power of a board to declare there to be 'no vacancy' on the board in the face of a non-board endorsed candidate. There may, however, be a simpler mechanism available to prevent the declaration of 'no vacancy'.
- ISS supports the proposed ban on the 'cherry picking' of directed proxies.
- ISS supports the proposed changes to require the disclosure in the remuneration report only of those executives deemed to be KMP.

A more detailed discussion of some of the proposed changes is provided below:

The 'two strikes' proposal

As noted above, and in our submission to the Productivity Commission's inquiry into executive pay in Australia, we do not support the introduction of a 'two strikes' regime whereby a company that suffers a 25 percent 'against' vote on its remuneration report for two successive years would be required to submit to shareholders at the same annual general meeting at which the second remuneration report vote occurs a resolution declaring all board positions to be vacant.

This is because:

- Shareholders who disagree with their company's remuneration practices or with any other aspect of the directors' oversight of the company enjoy an existing right under the Corporations Act to put a resolution at a general meeting to remove one or more of the directors from office or call a general meeting at which such a resolution can be moved.[1]
- The automatic board spill provided for in the 'two strikes' test has the potential to dilute the non-binding vote's effectiveness as a feedback mechanism on remuneration practices. This is because

[1] Sections 249D(1), 249F(1) and 249N(1).

shareholders, confronted with the possibility of forcing a board spill as a result of voting against a remuneration report at a company where shareholders are generally satisfied with company performance and board oversight, may be unwilling to vote against the remuneration report.

- The present set of mechanisms available to shareholders in addition to the non-binding vote – director re-elections every three years and the ability to seek the removal of directors at any time (as noted above) – coupled with the proposed abolition of the 'no vacancy rule' already provide sufficient director accountability mechanisms.

Should the Government, however, decide to enact the two strikes proposals we submit that:

- The proposed requirement for an ordinary resolution to declare a board spill (following the second 25 percent against vote on a remuneration report) should be retained. This is because it avoids the potential for shareholders to accidentally spill the board.
- Amendments should be made to the Bill requiring a set period of not less than 20 business days following the AGM at which the spill vote occurs, during which the company must accept valid nominations for candidates seeking election to the board at the spill meeting to be held within 90 days of the AGM. If there is no mandatory requirement for a minimum nomination period for non-board endorsed candidates it is possible that companies could schedule the general meeting in such a way as to prevent non-board endorsed candidates being able to submit nominations to seek election at the meeting. Constitutions typically provide that nominations must be received within 35 to 45 business days of a general meeting and a listed company under the Act is required to give only 28 days notice of a meeting. A company where a spill resolution has been passed would under the existing proposal be able to prevent any external candidates seeking election at the spill meeting simply by convening it to be held within 70 days of the general meeting thereby not permitting sufficient time for non-board candidates to lodge nominations under the constitution.
- The Bill's proposed s. 250A(B) should be amended to remove the prohibition on members of KMP voting on the board spill resolution (see s. 250A(B), Note 1(a) of the exposure draft). It is not appropriate for KMP to be disenfranchised on a resolution relating to the composition of the board given the fundamental right enjoyed by all shareholders of listed companies (regardless of whether they are KMP or not) is to elect – and remove – directors.
- The proposed requirement in s. 300A(1)(g) for the remuneration report to include a formal response to an against vote of greater than 25 percent on the prior year's remuneration report should be removed. Requiring a formal response is unlikely to provide meaningful information to shareholders as it is in the interests of companies to respond to concerns raised in prior years in their remuneration disclosures and practices (and many companies already do so). A formal response requirement is likely to result in 'boilerplate' responses written by external advisors.

Disclosure of remuneration consultants

The proposed Bill would mandate disclosure of the identity and use of remuneration consultants, including disclosure of how they are appointed and the fees received for those services and any other services, as well as mandating that remuneration consultants be engaged by non-executive directors and report only to non-executive directors.

As noted above, we support requiring disclosure of the principal providers of remuneration advice to a company and note that many large companies already provide this disclosure as a matter of good practice. For example, of the 10 largest Australian companies listed on the ASX by market capitalisation as at January 2011, seven had disclosed the identity of external remuneration advisory firms in their most recent remuneration report. Requiring simple disclosure of the identity of principal advisors provides confirmation to shareholders that external advice has been sought, allows shareholders to review any potential conflicts on the basis of the identity of the external advisors and results in minimal additional costs for companies.

The proposed disclosure and independence from management regime for remuneration advisors under the draft Bill would, however, potentially impose significant additional costs and disclosure

obligations on companies – akin to the obligations imposed in relation to auditors – without any apparent consideration of the likely benefit to shareholders. Remuneration consultants are advisors to companies and the ultimate responsibility for remuneration decisions remains with the board of directors.

The proposed regime would not prevent a board from making bad remuneration decisions or even necessarily relying on potentially conflicted advice (as a board would still be able to receive advice on remuneration from management). Nor would the proposed regime prevent a board from simply disregarding advice from an external consultant. The draft Bill regime would, however, add a significant disclosure and compliance burden on listed companies without clear benefits. As such the proposed sections 206K, 206L and s. 300A(1)(h)(ii-vii) should not be enacted.

Proposed definition of 'closely related party'

The proposed definition of 'closely related party' contained in the exposure draft in relation to voting and hedging of incentives by KMP is a more far-reaching definition of related party than that presently contained in s. 228 of the Corporations Act. The present definition of related party under Chapter 2E of the Act insofar as it relates to family members is narrow and excludes relatives such as brothers- or sisters-in-law. Updating current ss. 228(2) & 228(3) to include the 'catch all' definition of family members in the proposed Bill (and expanding the definition of related party to include all members of KMP and not just directors) and extending this definition to include remuneration related matters would reduce the potential for confusion and remove a loophole under the current law that allows close family members of senior executives and directors to obtain financial benefits from the company without prior shareholder approval.

No vacancy

The Productivity Commission in its inquiry noted that the ability of company boards under many Australian company constitutions to declare 'no vacancy' regardless of the maximum number of directors allowed under the company's constitution presented an impediment to non board endorsed candidates to be elected. This is because a declaration of 'no vacancy' – only made during a contested board election – requires a non-board endorsed candidate to not only receive a majority but also to receive more votes than a board endorsed candidate. There does not appear to be any compelling reason as to why boards should have the power to arbitrarily fix the number of directors at a level below that specified in the company constitution in order to make it more difficult for a dissident candidate to be elected even if they receive majority support from shareholders.

As noted above we support amending the Corporations Act to remove the ability of a board to declare 'no vacancy'. There may, however, be a simpler mechanism than that proposed in Part 2 of the draft Bill: The Act could be amended to stipulate that only shareholders have the ability to set the maximum and minimum (not less than three as set out in the Act) number of directors on a listed company board by special resolution, and that the board is prohibited from limiting the size of the board where that would have the effect of denying the election of a nominee whose election to the board is supported by a majority of shares voted.

Please do not hesitate to contact me if you would like to discuss any aspect of this submission.

Yours sincerely

Martin Lawrence

Head of Australian and NZ research

ISS Governance

martin.lawrence@issgovernance.com