Chapter Four – Improving corporate accountability mechanisms

4.1 This chapter discusses the shareholder decision-making and accountability aspect of engagement. Shareholder voting on director appointments and other resolutions at company meetings is an important tool for shareholders to ensure the accountability of company boards. The following discussion examines issues raised during the inquiry concerning possible deficiencies and potential improvements to the framework for corporate governance accountability. In broad terms, these issues fall into two categories:

- the efficacy and integrity of different voting mechanisms; that is, the vote lodgement and recording process; and
- the capacity for shareholders to exercise their voting entitlements effectively.

Voting mechanisms

4.2 Aside from voting in person at an annual general meeting (AGM), the mechanics of which are fairly straightforward, there are two mechanisms for lodging and recording absentee votes: via proxy representatives or direct absentee voting. Issues of concern relating to these voting mechanisms are examined below.

Proxy voting integrity

4.3 In the absence of a direct voting system (discussed later at paragraph 4.32), appointing a proxy is the only mechanism for a shareholder to lodge a vote when absent from the AGM. The previous government's CLERP 9 reforms to sections 250B and 250BA of the Corporations Act allow proxy votes to be submitted electronically and an amendment to section 250A permits proxies to be appointed by electronic means as well.[1] If utilised, electronic proxy voting will reduce the extent of paper handling involved in the process.

4.4 Despite these improvements, though, the committee was informed that the system still contained deficiencies that could potentially interfere with proxy voting intentions being properly reflected in the outcomes of votes. A number of further recommendations for reform were made to the committee.

Roundtable concerns on proxy voting

4.5 During 2006 and 2007, Investment and Financial Services Association (IFSA) held two roundtables on the proxy voting system. Participants included a number of

1 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004.

contributors to this inquiry: the Association of Superannuation Funds of Australia (ASFA), the Australian Council of Super Investors (ACSI), the Australian Custodial Services Association, the Australian Institute of Company Directors (AICD), the Australasian Investor Relations Association and Chartered Secretaries Australia (CSA).[2] Roundtable participants were concerned about the integrity of the proxy voting system, which they attributed to a number of 'key risks', including:

- the absence of an audit trail for lodged proxy votes;
- time constraints;
- the role of intermediaries/custodians; and
- paper-based manual processing.[3]

4.6 IFSA reported that the following recommendations emerged from the roundtable process:

1. Superannuation trustees and fund managers should request that issuers receive their proxy votes electronically;
2. ASIC should clarify the lawfulness of issuers accepting electronic proxies without amending the company constitution;
3. An electronic proxy voting capability should be developed to provide an audit trail from issuers to shareholders and other intermediaries;
4. Parliament should amend the Corporations Act to extend the record cut-off date to five business days before the meeting, allowing time to reconcile votes lodged against actual holdings; and
5. The ASX should consult with industry to develop a template for the standard disclosure of proxy voting results including the proportion of issued capital voted.[4]

4.7 Some of these suggestions were elaborated on during the committee's hearings. In particular, IFSA described the relationship between disclosing proxy voting activities and having an audit trail as being particularly important:

> …a superannuation fund or investment manager is unable to confirm whether their voting instructions have been accepted by share registry service providers.
>
> …

2 Mr John O'Shaughnessy, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 3.

3 Mr John O'Shaughnessy, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 3

4 Mr John O'Shaughnessy, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 4.

> Increasingly, fund managers and superannuation trustees are being more transparent and reporting openly to their constituents about their proxy voting activity. This process will have more meaning where the existence of an audit trail from the issuer back to the lodgement agent (e.g. a custodian) is in place.[5]

4.8 From an implementation perspective, IFSA suggested that establishing an electronic voting system is relatively straightforward:

> ...it is not rocket science. It is really building on what is already there. A lot of companies do have some electronic interface but, unfortunately, there are still faxes sitting behind some of that. There might be an electronic interface between, let us say, the first two or three people in the proxy voting chain but then somewhere along the line that electronic processing breaks down and turns into a manual process. It may be between a custodian and a registry or it may be somewhere else in the chain. What we are trying to say is that the only way you will get real-time audit trails so that people can have confidence in the votes they have lodged and know that they were the votes that have been recorded at the other end—they have effectively voted in that way—is through some kind of real-time electronic system.[6]

4.9 It also indicated that cost was not an impediment to introducing an electronic scheme, instead blaming inertia for a disappointing take-up:

> ...we have not had any participant in the roundtable actually say to us, 'The cost of this is prohibitive.' I think what you are seeing is inertia rather than a case of somebody having actually looked into this thoroughly and worked out that this is a massive overhaul of perhaps what they have already got.[7]

4.10 As reflected in IFSA's second roundtable recommendation, the committee heard of concerns that electronic proxy voting may be unlawful if not provided for in the company constitution, despite the CLERP 9 reforms. In their evidence Australasian Investor Relations Association supported IFSA's recommendation that ASIC clarify it would not take action against companies offering electronic proxy voting although it is not explicitly provided for in the company constitution.[8]

4.11 IFSA's recommendation to move the record cut-off date stems from the narrow 48 hour window of time currently available to reconcile lodged votes against voting entitlement. They argued that inevitable last-minute reconciliations increased

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5 IFSA, *Submission 16*, p. 4.

6 Mr Martin Codina, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 5.

7 Mr Martin Codina, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 11.

8 Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 73.

the likelihood of errors when processing proxy votes.[9] IFSA's submission suggested the following amendment:

> …the Roundtable recommends an amendment to regulation 7.11.37(3) of the Corporations Regulations 2001 to extend the record cut-off date to "5 business days before the deadline for receipt of proxy appointment set by the company". The Roundtable also supports the adoption of the ASX Listing Rule definition of "business day" for this purpose.
>
> This will provide sufficient time for the reconciliation process to occur such that a more effective audit can be undertaken between the registered holder (custodian) and share registry service provider to ensure that all votes lodged are received and voted as instructed.
>
> In the event of any discrepancy or uncertainty, this will also allow for the relevant share registry service provider to contact the registered holder (custodian) and for the custodian to then contact the relevant clients who provided the voting instructions.[10]

4.12 Treasury indicated that the idea of extending the cut-off date 'may be a very valuable reform', but that it had not been raised with Treasury directly and they had not had the opportunity to consult with industry on the matter.[11]

Committee view

4.13 The committee agrees that the integrity of the proxy voting system could be improved if more companies established an electronic proxy voting capability that provides a clear audit trail. Evidence suggests that the cost is not prohibitive, while processing votes via a paper-based system is outdated and prone to error. The Australian Securities and Investments Commission (ASIC) should confirm that companies are able to do this without amending their constitutions and institutional investors should pressure the companies they invest in to allow electronic proxy voting. The committee is also of the view that changing the record cut-off date might limit mistakes caused by hasty reconciliations. This suggestion should be considered by the government, subject to consultation with industry.

Recommendation 12

4.14 ASIC should clarify that companies are permitted to receive proxy votes electronically where it is not provided for in the company constitution.

Recommendation 13

4.15 The government should consult with industry on amending the record cut-off date.

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9 IFSA, *Submission 16*, p. 5.

10 IFSA, *Submission 16*, p. 6.

11 Mr Matthew Brine, Treasury, *Committee Hansard*, Canberra, 15 April 2008, p. 72.

4.16 The committee also considers that the disclosure of proxy voting results should be clear to investors, but it does not support mandating a standard template for achieving this. Institutional investors should continue to press companies for improved disclosure in instances where they are unsatisfied with current practices.

Cherry picking

4.17 Cherry picking refers to the practice where a proxy holder has been directed to vote some directed proxies in favour of a motion and some against, but chooses to only exercise those votes that serve their own interests.

4.18 Chartered Secretaries Australia argued that there is lack of transparency in the proxy voting system. They said that appointing a proxy temporarily transfers voting rights to another party, which does not of itself guarantee that the voting intention of the shareholder will be reflected in the way the appointee exercises that right.[12]

4.19 AICD proposed a minor amendment to the Corporations Act to ensure that meeting chairs be required to vote in accordance with the wishes of the shareholder/s on whose behalf he is voting.[13] However in a later submission to the inquiry they downplayed the potential for cherry picking by chairs:

> Shareholders who direct their proxies to the chairman can be confident that their voting preferences will be exercised by the chairman at the meeting. It is regarded as a good practice for chairmen to exercise their proxies as instructed. If a chairman did not exercise proxies and this inaction improperly influenced the outcome of a vote, then the resolution may be open to challenge in the courts on the grounds that the chairman was in breach of duty.
>
> AICD is not aware of any systemic problem of 'cherry picking' of votes by chairmen.[14]

4.20 Section 250A(4) of the Corporations Act stipulates that the meeting chair is required to vote the proxies they hold as directed, but the provision leaves other proxy holders the option to withhold some votes and cast others. An exposure draft of the Corporations Amendment Bill (No. 2) 2006 proposed an amendment to provide that these non-chair proxy holders still have the discretion not to vote directed proxies, but that if they do then they must vote them all, rather than voting them selectively.[15] This bill was not presented to the parliament prior to the 2007 federal election.

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12 Chartered Secretaries Australia, *Submission 8*, p. 6.

13 AICD, *Submission 25*, p. 54.

14 AICD, *Submission 35*, p. 4.

15 Explanatory Memorandum, Exposure Draft Corporations Amendment Bill (No. 2) 2006, p. 9.

Committee view

4.21 The committee notes that a proposed legislative amendment intended to prevent cherry picking proxy votes has not been presented to the parliament. The committee recommends that the Corporations Act be amended as per the proposal in the exposure draft of the Corporations Amendment Bill (No. 2) 2006.

Recommendation 14

4.22 The government should amend the Corporations Act to prevent non-chair proxy holders from cherry picking votes.

Integrity of close results

4.23 The committee also heard concerns about the confidence shareholders can have over the integrity of close votes. ACSI noted that currently 'there is no requirement for independent verification of votes cast at a accompany meeting'. They recommended that members – subject to meeting certain threshold requirements – be able to call for an independent report on a poll.[16] In response to a question on notice from the committee, they suggested that a recount of a disputed ballot be triggered at the request of five per cent of shareholders. In their response ACSI also suggested that 'proxy forms regarding director elections should be held for the length of their term [three years] in case there is a dispute raised during the tenure of the relevant director'.[17]

4.24 Riskmetrics indicated that a review process conducted by an 'independent arbiter' would be preferable to the only avenue currently available, which is to complain to ASIC after the result has been declared. They supported ACSI's suggestion of the five per cent threshold for triggering an independent review. Riskmetrics also suggested that those with an interest in the voting outcome should not be able to oversee its implementation.[18]

Committee view

4.25 With regard to contested results, the committee received no evidence justifying legislative change. It is of the view that until it can be demonstrated that ASIC's responsibility for responding to complaints about company voting processes is carried out deficiently, then this mechanism for resolving such disputes should remain. However, the committee is of the opinion that to assist in the investigation of contested votes companies should be required to maintain voting records for a reasonable period after the ballot has been held.

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16 ACSI, *Submission 11*, pp 2-3. This would reflect recent changes to the UK Companies Act.

17 ACSI, *Submission 36*, p. 1.

18 Riskmetrics, *Submission 42*, p. 2.

Recommendation 15

4.26 ASIC should periodically and systematically audit companies' vote recording and storage practices to ensure transparency and establish whether further regulation is required.

Vote renting

4.27 Vote renting describes the process where an investor borrows shares in order to secure voting rights to influence the outcome of a company vote.[19] A discussion of securities lending occurred in the previous chapter from paragraph 3.122 onwards. In evidence to the committee, the Australian Shareholders' Association (ASA), IFSA and Australasian Investor Relations Association all expressed their opposition to the practice.[20] In response to a question on notice, ASA explicitly supported its prohibition.[21]

4.28 Australasian Investor Relations Association told the committee that the practice further complicated companies' already difficult task of identifying who holds voting rights at any given time:

> …beneficial ownership tracing [under s672B of the Corporations Act]…just gives you an angle on who has a relevant interest. That does not necessarily mean that that tells you who has voting authority. …Some fund managers may have voting authority on some of the shares that they hold in a company. With other shares, the client—in the case of my example, a superannuation fund client—may actually retain voting rights. So it is difficult enough to get a clear enough picture of who actually holds voting rights, retains them and exercises them without any added complication of some of those shares being lent out to a third party who is not even disclosed through this beneficial ownership tracing process.[22]

4.29 The committee notes that the Future Fund Management Agency does not lend securities for voting or any other purpose.[23]

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19 Technically, shares are purchased with an agreement to re-sell at a later date.

20 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 27; Mr Martin Codina, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 7; Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 73.

21 ASA, *Submission 38*, p. 2.

22 Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 73.

23 Mr Paul Costello, *Committee Hansard*, Senate Finance and Public Administration Committee, 28 May 2008, p. 111.

Committee view

4.30 The committee shares the view of a number of contributors to this inquiry that vote renting should not be permitted. Paying for the voting entitlements attached to securities to achieve a desired voting outcome in no way contributes to good corporate governance. The committee is of the opinion that institutional investors should advise their fund managers not to engage in this practice and this policy should be clearly expressed to members. It also holds the view that the government should investigate an appropriate regulatory framework for ensuring that voting rights are retained by stock lenders.

Recommendation 16

4.31 The government should investigate the most appropriate regulatory framework for ensuring that stock lenders retain the voting rights attached to the lent shares.

Direct voting

4.32 An obvious mechanism for bypassing the proxy voting system and its associated deficiencies is to enable absentee shareholders to vote on resolutions directly. However, the inquiry was told that despite its advantages companies had not been greatly supportive of direct voting. According to CSA, only 13 per cent of the top 200 publicly listed companies had amended their constitutions to allow direct voting.[24]

4.33 This failure to implement direct voting on a larger scale is not due to it being a new concept. For example, a June 2000 report by the Companies and Securities Advisory Committee titled *Shareholder participation in the modern publicly listed company* discussed the benefits of direct voting and recommended that the government encourage its adoption by expressly providing for it in the Corporations Act.[25]

4.34 CSA commented that 'it is no longer necessary to appoint an intermediary'.[26] They stated that direct voting would remove problems associated with proxy voting:

> Many retail shareholders have no idea that, if they appoint a proxy and that proxy is not the chair of the meeting, their proxy is not obliged to exercise their intention. Direct voting removes all the problems with that; there is no need to change the act. This is an example of a way that we can encourage

24 CSA, *Submission 33*, p. 3.

25 Companies and Securities Advisory Committee, *Shareholder participation in the modern publicly listed company: Final Report*, June 2000, p. 75.

26 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 2.

> better engagement and a better relationship and not involve regulatory change.[27]

4.35 They indicated that companies can adopt direct voting without regulatory change; all that is required is for the company constitution to provide for it.[28] In evidence to the committee, CSA speculated that the stumbling block of obtaining constitutional change is preventing many companies from adopting direct voting:

> From a practical viewpoint, in most cases to establish a framework where you can have direct voting you are likely to need to change your constitution. Changing your constitution is usually a fairly big deal. It is a special resolution. Ordinarily … [you] would tend to wait until [you] had a group of things that were not urgent but were in the category of 'good things to do but not pressing' to put a resolution maybe next year or the year after next.[29]

4.36 Treasury confirmed that there were no legal impediments to companies implementing direct voting. They too suggested that inertia may be a more relevant factor limiting its use:

> Our long-time understanding is that there has been no legal obstacle to the adoption of direct voting mechanisms by Australian companies. We have liaised with Chartered Secretaries Australia on this issue for a number of years, and they have put out advice to companies containing some draft provisions they might include in their constitution to facilitate direct voting. I think it is correct to say that there has not been a great take-up of that initiative. It may be that companies are more comfortable with the traditional approaches to corporate decision making. We are not aware of any regulatory obstacles to the development of that type of framework.[30]

4.37 AICD noted that direct voting could encompass voting by post, fax or electronic means.[31] Global Proxy Solicitation proposed that shareholders be allowed to vote via telephone.[32]

4.38 Although AICD supported its implementation to provide shareholders with another voting option, they cautioned that direct voting would not necessarily overcome the problem of complex share ownership arrangements.[33] This issue is discussed in further detail at paragraph 4.52. They also noted that the logistics of

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27 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 4.

28 See also Companies and Securities Advisory Committee, *Shareholder participation in the modern publicly listed company: Final Report*, June 2000, p. 72.

29 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 5.

30 Mr Matthew Brine, Treasury, *Committee Hansard*, Canberra, 15 April 2008, p. 73.

31 AICD, *Submission 35*, p. 3.

32 Global Proxy Solicitation, *Submission 27*, p. 3.

33 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 61.

processing large numbers of votes from institutions would need to be addressed, 'whether it be for direct voting platforms or proxy voting technology platforms'.[34]

4.39 During the committee's public hearings, a proposal to incorporate direct voting into the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations, to operate on an 'if not, why not' basis, was put to witnesses. Both ASA and CSA offered their support for this initiative.[35]

Committee view

4.40 Widespread implementation of direct voting would overcome many of the problems associated with proxy voting as identified during the inquiry. Companies should be encouraged to amend their constitutions to provide for direct absentee voting, which could be assisted by the ASX Corporate Governance Council including an 'if not, why not' provision on direct voting in its Corporate Governance Principles and Recommendations.

Recommendation 17

4.41 The ASX Corporate Governance Council should include an 'if not, why not' provision on direct voting in its Corporate Governance Principles and Recommendations.

Exercising voting entitlements

4.42 The committee received a number of submissions that raised issues pertaining to shareholders' ability to establish an informed voting position on matters subject to a vote at company meetings, and to exercise this entitlement in a way that ensures accountability and improves corporate governance outcomes. These issues included:

- the benefit of company meetings in providing information on which voting positions are reached;
- the role of intermediaries in determining voting positions; and
- the effectiveness of shareholder voting on board representation and executive remuneration.

Company meetings informing voting

4.43 As referred to in the previous chapter at paragraph 3.71, there are concerns that the voting process does not currently enable the information conveyed at company AGMs to inform the voting decisions of shareholders. Low attendance at

34 AICD, *Submission 35*, p. 3.

35 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 28; CSA, *Submission 33*, p. 4.

AGMs dictates that most votes have been lodged by proxy prior to discussing resolutions at the meeting.

4.44 CSA suggested separating the deliberative and decision-making (voting) functions of AGMs to better allow the former to inform the latter, reflecting the original purpose of company meetings: discuss, deliberate and vote. They proposed that this 'decoupling' be achieved by opening voting on resolutions at the commencement of the meeting and allowing it to remain open for a specified period of time after the meeting had closed. In their discussion paper *Rethinking the AGM*, CSA wrote that 'informed' decision-making would be facilitated:

> Decoupling the deliberative and decision-making functions of the AGM would enable shareholders, particularly retail shareholders, to have the opportunity, even if they are physically unable to attend the meeting, to reflect on the questions posed at the AGM, the directors' responses to those questions and any other issues that were raised on the day, prior to voting.[36]

4.45 CSA proposed postponing closing the polls one or two weeks after the meeting, giving institutional investors a reasonable opportunity to consider their position. While CSA preferred the option of mandating this proposal through the Corporations Act, they also suggested that it could be incorporated into the ASX's Corporate Governance Principles and Recommendations and implemented on an 'if not, why not' basis.[37]

4.46 Mr Stephen Mayne also proposed keeping proxy voting open until after the AGM. He claimed that allowing shareholders to vote on resolutions following reports of the AGM debate would give the deliberations greater significance. Mr Mayne said:

> The board is fully aware of the voting situation before the debate even begins at the AGM and only a very small proportion of resolutions ever go to a poll. This situation is akin to having a political leaders television debate after the polls have closed – particularly given the tiny proportion of retail and institutional shareholders who actually attend the AGM.[38]

4.47 He also argued that some companies hold their AGM at inconvenient times when seeking to avoid scrutiny on a controversial resolution. Mr Mayne suggested that companies hold evening meetings in the major capitals to improve attendance rates.[39]

4.48 The 100 member rule and other issues relating to shareholder engagement at company meetings were discussed in Chapter Three from paragraphs 3.64 to 3.91.

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36 CSA, 'Rethinking the AGM', *Discussion Paper*, Additional information provided to the committee, 2008, p. 9.

37 CSA, 'Rethinking the AGM', *Discussion Paper*, Additional information provided to the committee, 2008, p. 10.

38 Mr Stephen Mayne, *Submission 18*, p. 2.

39 Mr Stephen Mayne, *Submission 18*, pp 3-4.

Committee view

4.49 The capacity for shareholders to make informed voting decisions would be greatly enhanced by allowing them to vote after the close of a company AGM. Accordingly, the committee is of the view that the government should give CSA's proposal careful consideration and should consult with relevant stakeholders. If mandating postponed voting is not considered to be appropriate, the requirement could be included in ASX's Corporate Governance Principles and Recommendations on an 'if not, why not' basis.

Recommendation 18

4.50 The government should consult with industry on the implementation of postponed voting after the close of company AGMs.

Institutional arrangements: proxy voting by custodians

4.51 As referred to in the previous chapter, complex share ownership arrangements involving institutional investors, fund managers and custodial share owners means that the responsibility for determining voting positions is often delegated to intermediaries. This raised a number of issues for the committee to consider:

1. How and when institutional investors, as beneficial share owners, choose to exercise their voting rights,

2. The role of proxy advisory services in assisting institutional investors to reach voting positions; and

3. Whether the tracing provisions in the Corporations Act discourage institutional investors from actively exercising their voting rights.

Delegated voting

4.52 The delegation of voting rights to intermediaries means that the extent to which beneficial share owners determine voting positions varies. The complexity of share ownership arrangements often renders ascertaining a beneficial owner's position on a vote a difficult task. AICD explained the effect of this complexity on determining proxy voting positions:

> The person who votes is the registered shareholder, that being the custodian. The custodian has to go to the fund manager, in turn the fund manager has to go to the institutional shareholder—and he may have a dozen institutional shareholders. The manager has to work out which institutional shareholders he is holding what shares for, and the institutional shareholders might be in, say, Australia or the US.[40]

40 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 61.

4.53 The committee notes that IFSA standard no. 13 requires members to vote on all resolutions and for public retail offer schemes to publish their proxy voting record. The standard also requires schemes to establish guidelines under which proxies are voted.[41] This means that while institutional investors may exercise their voting rights via custodians, the extent to which this represents a 'hands on' approach is dependent on each fund's policy on proxy voting.

4.54 The proposition that members of superannuation funds or other managed funds should themselves have an input into their institution's voting policy did not receive support. For instance, IFSA stated that it was unnecessary, complex and inefficient for institutional investors to seek advice from members on voting intentions:

> ...the principles of a collective investment vehicle, be it superannuation or otherwise, are such that you join like-minded people with regards to the type of investment portfolio that you go in. And then the principle is that either the trustee or the company director has an obligation under law to act in the best interests of either the member of a superannuation fund or the direct investor. Part of that is to clearly disclose the type of investment portfolio that one is going into. To take the informed consent back to the final investor would put complexity into the system which would take out a lot of the efficiencies of the collective investment.[42]

4.55 It added that it was most appropriate for voting instructions to be negotiated between each fund manager and the institutional investor in the context of the fund manager's stated guidelines on exercising proxy votes. The outcome of these discussions would mandate the matters over which institutional investors wanted to exercise voting control, and those over which they are content to leave voting to the discretion of the fund manager.[43]

4.56 ASFA described the prospect of superannuation funds securing consent from their members for particular voting positions as 'challenging'.[44] Regnan described it as 'unworkable in practice' and unnecessary in the context of superannuation funds' responsibility to maximise returns in accordance with the *Superannuation Industry (Supervision) Act 1993*.[45]

The role of proxy advisory services

4.57 The breadth of investments held by institutions means that they do not possess the resources to consider all the company resolutions they are presented with for

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41 Mr John O'Shaughnessy, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 3.

42 Mr John O'Shaughnessy, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 6.

43 Mr Martin Codina, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 6.

44 Mr Ross Clare, ASFA, *Committee Hansard*, Canberra, 15 April 2008, p. 33.

45 Mr Erik Mather, Regnan Governance Research, *Committee Hansard*, Sydney, 16 April 2008, p 49.

voting. Consequently, institutional investors regularly delegate this function to specialist firms providing advice on assessing corporate governance.

4.58 The committee heard concerns that the absence of capacity that makes proxy advice necessary also means that it is often followed without independent review. AICD claimed that the increasing demand on proxy advisory services from institutional investors was leading to inaccurate reports being released to the market:

> They are trying to assess the results of numerous companies in a very short period. Sometimes they are pretty desperate in trying to get these reports out. I do not think they have the physical resources to sit down with each of the companies and review the reports that they are putting out. One of the roles of the AICD is to talk to them, talk to the institution or institutional investors, and work this through. I do not think the problem is so dire that we need legislation, but I certainly think we need a lot more dialogue and a lot more understanding of our respective positions.[46]

4.59 CSA also complained of errors of fact contained in proxy advisory services' reports on companies. Given the potential influence these reports can have on institutional investors, CSA called for greater transparency and consultation with companies:

> …there is a need for greater transparency in the decision-making processes that [the] advisory services undertake, as well as standards and methodology. Further, we believe that governance would be improved if proxy advisory services were to engage with the companies they report on, particularly if they are about to make an adverse finding on a company. We believe that the report of the proxy advisory service should be made available to the company, at least to check for factual errors before it is released to the general public.[47]

4.60 The Business Council of Australia (BCA) also complained about inaccuracies preceding voting recommendations. They suggested that 'proxy advisory firms should … be contacting companies to discuss their results and allowing companies adequate opportunity to provide explanations'.[48]

Effect of the Corporations Act tracing provisions

4.61 The ability of companies to force custodial share owners to disclose institutions' voting instructions was also cited as discouraging institutional investors to engage. Under s672B(c) of the Corporations Act (the 'tracing provisions'), custodial share owners may be directed to disclose voting instructions of the beneficial owners of the shares, including fund managers.

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46 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, pp 60-61.

47 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 2.

48 Business Council of Australia, *Submission 29*, p. 8.

4.62 Riskmetrics claimed that this provision extends beyond the original intent of the tracing provisions; to enable companies to identify 'those building a significant shareholding interest through interposed entities'.[49] Its potential effect is to enable companies to discriminate against institutional shareholders who vote against management, which discourages them from taking a stand against board positions. At the committee's hearing they suggested that:

> There appears to be no compelling reason as to why the management of listed companies should be able to compel custodians to reveal this information, and it may discourage institutional investors from engaging with listed companies or voting their shares for fear that they may lose access to the company if they are known to have voted against management.[50]

4.63 Riskmetrics recommended that the 'tracing provisions as they apply to voting instructions should be removed'.[51]

Committee view

4.64 The committee recognises that although it is impractical for fund members to have a direct input on voting of company resolutions, it is important that institutional investors such as superannuation funds declare their voting policies to members, upon which they can determine their choice of fund if so desired. Institutional shareholders should engage with companies by exercising their discretion on important votes. The committee is also of the view that institutional investors should seek to clarify, with company boards, the basis for adverse voting recommendations given by proxy advisory services.

4.65 With regard to the tracing provisions as they apply to voting instructions, the committee will continue to monitor developments in this area.

Voting on directors

4.66 As discussed previously, the accountability of the board to shareholders is an important facet of shareholder engagement. ASX Listing Rule 14.5 requires an election of directors to be held every year.[52] However, contributors to the inquiry suggested that there were two significant impediments to shareholders exercising this function:

1. the problem of director entrenchment and an absence of 'new blood' on company boards; and

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49 Riskmetrics, *Submission 13*, p. 4.

50 Mr Martin Lawrence, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, p. 45.

51 Riskmetrics, *Submission 13*, p. 4.

52 ASX Limited, *Submission 14*, p. 5.

2. a lack of useful information on which to base board voting decisions.

4.67 ASX Listing Rule 14.4 requires that directors hold office for no more than three years without re-election. The ASX Corporate Governance Council's Corporate Governance Principles and Recommendations states that board renewal 'is critical to performance, and directors should be conscious of the duration of each director's tenure in succession planning'.[53]

4.68 Despite this, ACSI told the committee that the 'director's club' is 'well and truly alive':

> …in the last year or two, 70 per cent of new appointments to S&P/ASX 100 companies are directors who already occupy a directorship in another S&P/ASX 100 company. I think the issue really goes to the heart of how hard and how far a company is looking beyond the usual suspects to make a real effort to broaden the gene pool. I think that is the real challenge.[54]

4.69 Riskmetrics explained the impediment to new board appointments created by the no vacancy rule:

> …a company's constitution will say, 'We can have up to 10 directors,' but the board will make a policy that says, 'We are only going to have five.' Then I nominate [you] to stand for the board. You stand for the board and the board makes the decision that there is no vacancy. You are still put forward for election but in order to defeat an incumbent you have to get a supermajority, basically—you have to score more absolute votes than they do to win, which is very tough.[55]

4.70 In contrast, AICD emphasised the importance of balancing the need for experience with the need to bring in new people. They told the committee that a board comprised of people without previous experience would 'be in a lot of difficulty', so the task of introducing new people on to company boards had to be undertaken methodically.[56] AICD recommended that nomination committees 'publish their methodologies for selecting and appointing directors on company websites for the benefit of shareholders'.[57]

4.71 ACSI also cautioned against imposing unwanted candidates on boards, due to the risk of undermining 'collegial decision making'.[58]

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53 ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations*, 2nd Edition, August 2007, p. 18.

54 Mr Michael O'Sullivan, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 62.

55 Mr Dean Paatsch, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, p. 55.

56 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 61.

57 AICD, *Submission 25*, p. 37.

58 ACSI, *Submission 36*, p. 2.

4.72 While supporting greater diversity at board level, Nowak and McCabe warned of the risks associated with new appointments as a consequence of 'emerging hedge fund activism':

> While the increased competition for director appointment which this entails may be useful in increasing diversity there is a proviso in that hedge fund representatives may represent the particular interests of the funds rather than the interest of all shareholders, especially where there is divergence in time frames and taxation implications of decisions. This trend needs to be carefully watched.[59]

4.73 The other difficulty in enforcing accountability on company boards is the problem of shareholders developing specific voting positions on directors with the company information available to them. Riskmetrics told the committee that it is difficult for shareholders to hold individual board members to account:

> From the outside, it is a very hard thing for an institutional shareholder to work out, for each individual director, the answer to the question, 'Is this individual director a great guy on a board that is a dud?'[60]

4.74 The problem of a lack of information on board candidates was also raised. Nowak and McCabe contended that unless investors are able to attend the AGM, proxy voting decisions are made without the benefit of adequate information on the resolutions. On director elections they noted that: 'At present there is often no information beyond the named person who is nominated or has been renominated'. They proposed that companies provide objective data on director candidates to give shareholders some basis for their decision.[61] AICD agreed that it is 'reasonable to expect' companies to provide information on proposed candidates for election in their notice of meeting.[62]

Committee view

4.75 The committee is of the opinion that the choices shareholders make on company directors should be based on proper information about their experience and qualifications for the role. It is not appropriate for shareholders to be confronted with the name of potential candidates in the notice of meeting without further information.

4.76 Although the election of board candidates is a matter for companies and their shareholders, the committee also maintains the view that board patronage and dominance by an entrenched few is unhealthy for the good corporate governance of any company and contrary to the interests of shareholders. The committee is of the opinion that the process for nominating and electing directors in Australia could be

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59 Nowak and McCabe, *Submission 5*, pp 3-4.

60 Mr Martin Lawrence, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, p. 55.

61 Nowak and McCabe, *Submission 5*, p. 2.

62 AICD, *Submission 25*, pp 38-39.

substantially improved in many companies to ensure better quality candidates are appointed to company boards. To begin to rectify the shortcomings in this area the committee suggests that ASIC should develop a best practice guide to company constitutional recommendations and practice governing the nomination and election of directors.

Recommendation 19

4.77 ASIC should develop a best practice guide to company constitutional recommendations and practice governing the nomination and election of directors.

Voting on remuneration

4.78 Shareholders' entitlement to express their views on the remuneration paid to company executives is seen as an important expression of shareholder accountability on corporate governance. However, the committee received evidence that shareholder engagement on remuneration was potentially being undermined by the following:

- the ability of shareholder-directors to vote on their own remuneration packages;
- a recent amendment to Listing Rule 10.14 on shareholder approval for share grants purchased on market; and
- a lack of transparency about external management agreements.

Non-binding vote on the remuneration report

4.79 The previous government's CLERP 9 reforms amended the Corporations Act to facilitate shareholder participation in the setting of executive remuneration packages. New section 250R(2) of the Corporations Act provides the opportunity for shareholders to vote on the director's remuneration report tabled in accordance with s300A. Although the vote is non-binding, it offers shareholders the opportunity to engage with directors on executive remuneration issues. New section 250SA requires the chair to allow shareholders a reasonable opportunity to comment on or ask questions about the remuneration report.

4.80 The committee took evidence indicating that the remuneration vote had been a major catalyst for engagement between institutional shareholders and company boards.[63] Riskmetrics agreed that in conjunction with increasing interest from institutional investors, the non-binding vote had encouraged companies to become more willing to engage on corporate governance matters.[64]

63 See for example Mr Phil Spathis, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 59.

64 Riskmetrics, *Submission 13*, p. 3.

4.81 The non-binding nature of the vote raises interesting questions about how company boards might respond to an adverse result. Given the short history of the reform there is not much precedent for it, though Telstra provides an obvious example. At its 2007 AGM 66 per cent of shareholders' votes were against Telstra's remuneration report. The board proceeded with its executive remuneration package as it was originally presented.[65] AICD indicated that the Telstra board had maintained that its remuneration package was appropriate despite shareholder opposition and that shareholders subsequently have the option of removing all or part of the board if they feel sufficiently aggrieved at having their remuneration vote discounted.[66]

4.82 ACSI indicated that courage would be required to subsequently vote out a board that had ignored shareholders' views expressed in a non-binding remuneration vote:

> …a number of institutional investors … who were very brave about non-binding votes for remuneration who may be less brave about tipping out the directors of Telstra in a period when Telstra is such a key player in what might be major government policy delivery and a lot of other issues.[67]

4.83 They told the committee that ACSI would prefer to resolve remuneration issues with Telstra than vote out the directors.[68] This reflects the Business Council of Australia's approach to influencing corporate governance issues more broadly, as was described in paragraph 3.6 of the previous chapter.

4.84 The major concern with the remuneration vote was the ability of shareholder directors to vote on their own remunerative arrangements. For instance, Riskmetrics asserted that the purpose of assessing the opinion of external shareholders on the company's remuneration policies is undermined by including the votes of directors.[69] Particularly in companies where directors have substantial shareholdings, they claimed that these votes can be significant:

> There have been a number of instances where … the remuneration report has been voted up, it has been approved, where it would not have been had shareholders associated with directors and key management personnel not voted.[70]

4.85 Riskmetrics and ACSI both recommended an amendment to the Corporations Act to exclude directors, executives and their associates from voting on the report, which would better reflect support amongst shareholders with no direct interest in

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65 See for example Blue, T. 'Telstra directors face savage pay retribution', *Australian Financial Review*, 10 November 2007, p. 38.

66 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 66.

67 Mr Michael O'Sullivan, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 66.

68 Mr Michael O'Sullivan, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 67.

69 Riskmetrics, *Submission 13*, p. 5.

70 Mr Martin Lawrence, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, p. 53.

remuneration issues.[71] Although ASA supported this measure, they added that consideration would need to be given to the issue of how open proxies voted by the Chair are to be treated.[72]

4.86 Treasury indicated in evidence that these concerns had not previously been raised with the department, though officials said that 'it is probably an issue that needs to be examined into the future'.[73]

4.87 ACSI also raised concerns about the potential for undisclosed conflicts of interest stemming from connections between remuneration consultants and company management. They recommended that company annual reports be required to include information on the appointment of remuneration consultants.[74]

Executive share remuneration

4.88 Some contributors opposed an amendment to Listing Rule 10.14 that occurred in October 2005. As a consequence of the change companies are no longer required to seek shareholders' approval to grant shares as part of a director's remuneration package, if they are purchased on market. Listing Rule 10.14 currently states that an entity must not allow directors or their associates to 'acquire securities under an employee incentive scheme without the approval of holders of ordinary securities of the acquisition'. It adds that the rule does not apply to securities purchased on market.[75]

4.89 According to Riskmetrics, the on market exemption was much wider than that anticipated; that is, to have enabled share purchases through salary sacrificing arrangements without the requirement for shareholder approval. They told the committee that shareholders were only discovering that shares had been granted on generous terms well after the event, both as a consequence of the amendment and due to waivers granted by ASX prior to the change.[76]

4.90 Riskmetrics also speculated that the exemption had the potential to be misused:

> We are really concerned about a nightmare scenario where, say, a smaller listed company raises money in a general placement and, having forewarning of, say, a great drilling result, uses some of that general placement money to buy shares on market for its key executive team. That

71 ACSI, *Submission 11*, p. 6; Riskmetrics, *Submission 13*, p. 5.

72 ASA, *Submission 38*, p. 5.

73 Mr Bede Fraser, Treasury, *Committee Hansard*, Canberra, 15 April 2008, p. 76.

74 ACSI, *Submission 11*, p. 3.

75 ASX Listing Rule 10.14, accessed on 26 May 2008 at: http://www.asx.com.au/ListingRules/chapters/Chapter10.pdf

76 Mr Dean Paatsch, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, pp 48-50.

> is a nightmare governance scenario where, effectively, shareholders' money is underwriting insider trading. In the current scenario, we think that basically you should not be able to buy those shares on market without shareholder approval for genuine insiders like that. We just think it is a fundamental governance precept that is being ignored.[77]

4.91 ACSI recommended that:

> …the current version of [ASX Listing Rule] 10.14 should be revised to require shareholder approval of any acquisition of securities by a director outside of a genuine salary sacrifice arrangement.[78]

4.92 The ASX informed the committee that the amendment had not altered the purpose of the rule, which is to prevent the dilution of shareholder value caused by the issuing of securities. They stated:

> …it is difficult to justify shareholder approval where directors' securities are purchased on-market. This is because shareholders are arguably in the same position as if the director has been paid a larger cash salary and used the money to purchase shares on-market. In both scenarios, the value of existing investors' share holdings is unaffected.[79]

4.93 In response to concerns about the potential conflicts of interest, ASX commented:

> It is recognised that directors may face a potential conflict of interest in approving a new issue or on-market purchase of securities. However, ASX notes the ASX Corporate Governance Council commentary which states that a director should not be involved in determining their own remuneration. The Principles and Recommendations also contain guidance relating to the composition of the board remuneration committee, which is an additional mechanism for managing conflicts of interest.[80]

4.94 The ASX stated that, following a recent review of Listing Rule 10.14, they had 'formed the view that this rule is working effectively as ASX intended, and that no changes are required'.[81]

4.95 The committee notes reports that the issue of share-based remuneration for non-director executives will be included in the government's review on directors' corporate governance responsibilities.[82]

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77 Mr Dean Paatsch, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, p. 49.

78 Mr Phil Spathis, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 59.

79 ASX Limited, *Submission 37*, p. 1.

80 ASX Limited, *Submission 37*, p. 1.

81 ASX Limited, *Submission 37*, p. 1.

82 Durkin, P. 'Executive share issues to face vote', *Australian Financial Review*, 30 April 2008, p. 1.

External management agreements

4.96 Finally, Riskmetrics stated that shareholder participation in listed infrastructure vehicles is impeded by a lack of transparency over long-term external management agreements. They submitted that these contractual arrangements, the details of which are lodged with the ASX, are not disclosed. The agreements include the remuneration paid to external managers, payments that may fall due to them on termination, and potentially, special voting shares that enable external managers to control the composition of the board.[83] In evidence to the committee Riskmetrics indicated that these entities have argued against disclosure on the basis of commercial-in-confidence considerations, but noted that such agreements must be disclosed in the United States.[84] They did not recommend legislative change but implied that the issue could be addressed by the ASX through its Listing Rules.[85]

4.97 The ASX informed the committee that, in conjunction with ASIC, it was considering a listing rule change to require issuers to disclose the terms of management agreements in a concise, user-friendly summary. At the time of writing, ASX had circulated a draft guidance note setting out these requirements for public comment.[86]

Committee view

4.98 The non-binding remuneration report vote provides an excellent opportunity for shareholders to express their views to the board via a vote, without taking the more drastic measure of replacing the board itself. The committee is of the view, though, that this initiative has the potential to be undermined by the influence of shareholder directors voting on their own remuneration. This is particularly relevant where directors have a substantial holding. Accordingly, the committee considers that the Corporations Act should exclude them from participating in this vote.

Recommendation 20

4.99 The government should amend the Corporations Act to exclude shareholder directors from voting on their own remuneration packages either directly or by directing proxies.

4.100 On the matter of Listing Rule 10.14, the committee recognises that the rule is designed to prevent the dilution of shareholder value through share issues to directors. In this context, the exemption for shares purchased on market is reasonable. However, the committee acknowledges concerns about the potential for improper activities that may stem from the exemption. The committee therefore suggests that the government

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83 Riskmetrics, *Submission 13*, pp 1-2.

84 Mr Martin Lawrence, Riskmetrics, *Committee Hansard*, Canberra, 15 April 2008, pp 47-48.

85 Riskmetrics, *Submission 13*, p. 2.

86 ASX Limited, *Submission 37*, p. 2.

examine this issue as part of its green paper review on corporate governance regulations.

4.101 The committee is similarly of the view that the non-disclosure of external management agreements should also be considered as part of the green paper review.

Recommendation 21

4.102 The government examine the on market exemption to Listing Rule 10.14 and the disclosure requirements pertaining to external management agreements as part of its green paper review of corporate governance regulations.

Mr Bernie Ripoll MP

Chairman