14 September 2007

The Committee Secretary
Parliamentary Joint Committee on Corporations & Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Secretary,

Thank you for the opportunity to comment on the Joint Parliamentary Committee's inquiry into shareholder engagement and participation. The ISS Governance unit of RiskMetrics Group (formerly known as ISS Australia) provides governance research and advice to institutional investors in Australia and around the world. This submission therefore focuses on issues of potential concern to institutional shareholders in Australian companies, and addresses only those points raised in the inquiry terms of reference that appear to be of direct relevance to institutional investors.

1. **Barriers to the effective engagement of all shareholders in the governance of companies.**

Matters specific to listed infrastructure vehicles: Australian shareholders suffer few of the impediments confronting shareholders in other markets (such as the United States) to participating in the governance of companies. The one exception is institutional and retail investors in listed infrastructure vehicles, pioneered by Babcock & Brown and Macquarie Bank, which feature two significant barriers to shareholder engagement:

Long-term undisclosed management agreements: These entities (which usually incorporate a combination of 'stapled' trusts and companies) are typically managed by a subsidiary of their founder under long-term management agreements that are not disclosed, in their entirety, to the market (the ASX has recently changed its policy and will now no longer allow management agreements with a term of longer than 10 years; a number of already listed entities however have 25 year or open-ended (unlimited) management agreements). In addition, the payments due to the external manager under these management agreements on termination by shareholders or the board of directors are also not disclosed. The effect of these agreements is to lessen the credible threat of shareholders ever being able to remove the external manager responsible for the management of the listed entity; in other words, entrenching the manager.

Super-voting shares: Some of these listed infrastructure entities also incorporate special voting shares that are held by the external manager. These shares give the manager the power to appoint 75% or more of directors on the board, allowing the external manager to control the composition of the board meant to oversee the manager's activities. This power of appointment also creates additional problems, as the board is usually responsible for determining what fees the manager and its parent receive for activities such as investment banking services that are provided outside of

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management agreements. In some cases these extra services have amounted to hundreds of millions of dollars in a single year.

These barriers to shareholder participation, which are at present confined to the listed infrastructure sector, have developed under the ASX Listing Rules regime which is designed to handle the traditional listed companies and property trusts that make up the vast majority of listed entities in Australia. In some cases, such as the establishment of special voting shares, specific waivers from the Listing Rules regime have been required to allow these entities to be listed on the ASX.

It is not the intent of this submission to suggest the Committee recommend legislative change to address these issues, given the ASX Listing Rules remain the major source of shareholder rights in listed companies. In addition, a change to the Corporations Act may result in these entities simply transferring their country of origin, as many are already at least partly domiciled in jurisdictions such as Bermuda (reflecting the fact that these listed infrastructure entities frequently comprise two or three trusts and companies stapled together and traded on the ASX as a single security). However, it is important that the Committee is aware of these barriers to shareholder participation, given the scope of this inquiry and the fact that the Parliament, through the Corporations Act, has retained some oversight of the ASX's regulatory operations.

Listing Rule 10.14: Recent changes to ASX Listing Rule 10.14 have reduced shareholders' ability to control excessive levels of executive pay. Listing Rule 10.14 is the only binding vote shareholders possess on executive pay[1] and, prior to October 2005, the Rule required any equity received by a director under an incentive scheme to be approved by shareholders. This Rule was amended in October 2005 to exempt from the requirement for shareholder approval any equity securities granted to an executive director that were purchased on-market even if purchased using company funds. It has also emerged that the ASX had, prior to 2005, granted waivers from Listing Rule 10.14 allowing companies to grant large numbers of shares to executive directors so long as these were purchased on-market using company funds.

The ASX, as part of the recent review by the ASX Corporate Governance Council of its governance principles and recommendations, sought comments on the October 2005 change to Listing Rule 10.14. The comments received on the change have since been referred to the ASX for further review. Submissions by shareholders on Listing Rule 10.14 generally called for the on-market exemption to be abolished; submissions by executives of listed companies and bodies that advise executives of listed companies generally called for the rule to remain in its current form.

This matter is brought to the attention of the committee because the October 2005 amendment to Listing Rule 10.14 removed shareholders' ability to prevent related parties from acquiring shares in the company on terms not available to other shareholders. This has the potential to reduce the ability of shareholders to effectively engage with companies on governance matters related to remuneration, and serves as a barrier to shareholders protecting their interests. In addition, it is not clear what rationale existed to remove an existing shareholder right in this area, given shareholders have historically provided overwhelming support for most grants of equity for which shareholder approval has been sought, so long as the attached performance conditions have been sufficiently demanding.

As noted above in relation to infrastructure vehicles, this issue has been raised not to suggest legislative change, but because it is important that this matter be brought to the

[1] Binding votes are sometimes required by the related party transactions provisions in Chapter 2E of the Corporations Act and by the retirement benefits provisions in Part 2D.2. However, the vast majority of listed companies structure their executive and director remuneration in such a way that a shareholder vote is never required under Chapter 2E or Part 2D.2.

attention of the committee given the scope of this inquiry and the Parliament's oversight of listed market operators such as the ASX.

2. Whether institutional shareholders are adequately engaged, or able to participate, in the relevant corporate affairs of the companies they invest in.

The effect of the advisory vote on remuneration reports: Australia's institutional shareholders are increasingly involved in the governance of the companies in which they invest. This increased participation has been matched by an increasing willingness on the part of listed companies since the introduction of the non-binding remuneration report vote in 2005 to have a constructive dialogue with their institutional shareholders. From RiskMetrics' experience and discussions with our institutional clients, it appears that more companies are seeking to discuss governance matters – such as the election of directors and executive remuneration issues – than ever before. The willingness of companies to discuss governance issues appears to have been partly as a result of the non-binding vote, and partly because of increasing levels of interest on the part of institutional shareholders. These discussions are occurring at a high level - directors of many large and some medium-to-small listed companies now routinely meet with major shareholders and advisory groups to discuss governance issues ahead of annual general meetings.

RiskMetrics' direct experience of dialogue with companies on behalf of clients also indicates an increased willingness on the part of companies to discuss issues with, and listen to, shareholders. RiskMetrics routinely contacts companies ahead of potentially controversial resolutions and has found senior executives and directors of companies willing to take account of investor concerns to a far greater extent than they were prior to the introduction of the non-binding remuneration report vote.

Levels of voting at company general meetings are a reasonable (if imperfect) proxy for levels of institutional investor participation in governance, as they reflect the willingness of institutional shareholders to exercise their formal rights as shareholders. Since 1999, when a study found only 35% of all available shares were voted on director re-election resolutions at top 100 ASX-listed companies, turnout on all resolutions at top 100 companies has increased to 58.2% of all available shares in 2006. It is also worth noting that institutional shareholders are also increasingly willing to vote against management – in 2006, the average level of dissent by shareholders from the board recommendation on controversial resolutions was 21.2% for top 200 companies, up from 8.2% in 2005.[2] Equally importantly, however, the increased level of constructive dialogue between company directors and managers, and shareowners, is evidenced in the decline in the number of controversial resolutions put to shareholders, from 20% of all resolutions put to top 200 company shareholders in 2004 to 8.9% in 2006.[3]

3d) Best practice in corporate governance mechanisms, including voting arrangements.

Protecting the confidentiality of votes cast:

Under Chapter 6C of the Corporations Act (known as the 'tracing provisions'), ASIC, a listed company, or the responsible entity for a listed managed investment scheme may direct the holder of a relevant interest in the company's shares to disclose certain information. Of primary concern is the ability of a company to direct a custodian service provider to reveal how they have been instructed to vote shares at any particular meeting.

[2] A controversial resolution is one where one or more features deviate from accepted standards of good governance, such as those of IFSA, ACSI or the ASX Corporate Governance Council.
[3] All statistics are from RiskMetrics' annual Voting Outcome reports.

Under section 672B, a person who is so directed must disclose:

(a) the full details of their own relevant interests in the shares or interests in the scheme and the circumstances that give rise to that interest;

(b) the name and address of each other person who has a relevant interest in any of the shares or interests together with full details of the nature, extent and circumstances that give rise to the interest; and

(c) the name and address of each person who has given instruction about:

i) the acquisition or disposal of the shares or interests;

ii) the exercise of any voting or other rights attached to the shares or interests; or

iii) any other matters relating to the shares or interests;

together with the full details of those instructions.

A person is directed to make a disclosure under section 672B via section 672A(1). ASIC, a listed company or the responsible entity for a listed managed investment scheme may: (a) direct a member of the company or scheme; or (b) a person named in a previous disclosure under section 672B to make a disclosure under section 672B.

Thus, under section 672A(1) a custodian may be directed to give information in regards to shares it holds for its clients. Under s 672B(c), a custodian can be required to disclose any instructions it has received from the beneficial owner of the shares (e.g. a superannuation fund) or the beneficial owner's fund manager, as to how these shares are to be voted. As currently drafted, the section would require the disclosure of the identity of all beneficial owners of the relevant shares, each beneficial owner's precise holding, when the vote instruction was received by the custodian and the content of the vote instruction.

This provision, which has been part of the Corporations Act and its predecessors for more than 20 years, has recently been cited by firms working on behalf of the management of listed companies to seek information on institutional investors' voting instructions ahead of contested resolutions. This aspect of the provision appears to serve no broader interest that would benefit all shareholders.

In fact, forcing custodians to disclose how votes are cast at the individual account-holder level leaves it open to company managements to use the information to discriminate against shareholders (i.e. those who have voted against management-endorsed resolutions), for instance in future capital raisings by way of book build and private placement. There is anecdotal evidence from certain funds managers of this occurring.

The original – and still important – purpose of the tracing provisions was to enable companies to obtain insight into those who may be secretively building a significant shareholding interest, through interposed entities. The provision relating to voting instructions extends the reach of the information required to be disclosed beyond this purpose and does not serve the original intent of Chapter 6C. To the contrary, it reduces the propensity for a fund manager or superannuation fund to take a stand on a matter of principle, and vote against a board-endorsed resolution for fear of unfavourable treatment in the future.

The tracing provisions as they apply to voting instructions should be removed.

Amendment relating to 'record date': As a participant in the institutional investment industry, RiskMetrics has been involved with the Investment & Financial Services Association's (IFSA) Voting Roundtable on an industry project to address some of the structural impediments to institutional investors voting their shares. The Committee's

attention is drawn to IFSA's submission on proxy voting matters, and particularly the Roundtable's proposal to create an earlier 'record date' for determining voting entitlements for shareholder meetings – which RiskMetrics supports.

The Roundtable is proposing a single earlier record date to minimise the potential for a discrepancy between the votes lodged and the votes held on the record date, and to increase the opportunity for any discrepancies to be resolved prior to the meeting. The Roundtable's proposals are expected to require some regulatory change.

4. The effectiveness of existing mechanisms for communicating and getting feedback from shareholders.

The existing mechanisms for shareholders to communicate with companies and for companies to seek feedback from shareholders are generally sufficient. There is however one legislative change which would improve the effectiveness of the non-binding remuneration report vote as a feedback mechanism (see item 6 below).

6. The need for any legislative or regulatory change.

The introduction of the non-binding remuneration report vote, as noted above, has greatly increased the level of constructive dialogue between companies and shareholders. As the vote presently stands, however, there is nothing stopping the executives and directors whose remuneration is disclosed in the remuneration report from voting on the resolution. In companies where senior executives and directors have substantial shareholdings this allows the votes of executives to be counted on a vote designed to allow external shareholders to express their level of support for the company's executive remuneration policies and practices. Including the votes of executives who are beneficiaries of the remuneration policies described in the remuneration report (and who may be voting shares allocated under those policies) reduces the effectiveness of the vote as a way of expressing shareholders' views on a particular company's remuneration policies.

In order to improve the effectiveness of the non-binding vote as a feedback mechanism for shareholders and companies, the Parliament should amend section 250R of the Corporations Act by adding a sub-section stipulating that those currently serving directors and executives who are named in the Remuneration Report, and their associates, are not entitled to vote on the resolution. This could be achieved by way of the Listing Rules' concept of a 'voting exclusion statement' (LR 14.11) thereby allowing directors and executives to vote only as directed proxies for other shareholders. This would ensure that only the votes of non-management shareholders were counted on the remuneration report resolution. This recommended change is in addition to those proposed above.

RiskMetrics would be pleased to appear before the Committee to discuss this submission, and the issues raised by the inquiry in more detail. Should the Committee wish to discuss any of the issues raised in the above submission, please feel free to contact me on 03 9642 2062.

Yours sincerely,

Geof Stapledon