Corporate Governance midyear report

AUGUST 2010

In this issue:

Remuneration: consider the consequences

Remuneration has always been a hot topic for companies and their investors. While it appears Australia's strong governance regime helped protect it from the remuneration excesses evident in many international markets, the events of the Global Financial Crisis (GFC) did bring to light various structural problems. Pleasingly the increased scrutiny of global financial markets that followed the financial crisis has resulted in various moves to further strengthen remuneration practices.

In response to the GFC, the 2009 G-20 London Summit[1] discussed executive remuneration, the Financial Stability Board implemented Principles for Sound Compensation Practices[2], and Australia too focused on various legislative changes. To date Australia has seen amendments to the Corporations Act[3], an extension of the Australian Prudential Regulation Authority (APRA) governance standards[4] and the Government's acceptance of various recommendations made by the Productivity Commission into Executive Remuneration.

While AMP Capital Investors acknowledges that the remuneration practices of some Australian companies can be improved, we do caution against the unintended consequences that may follow from the implementation of new hard and soft rules.

What is the aim of remuneration?

Remuneration should be simple – in theory all that is needed is a fair pay structure that rewards, motivates and aligns good employees. For publicly listed companies the ideal remuneration structure would encourage employees to behave like owners. Unfortunately the reality is far more complicated. Each company and each owner is different, and as such there are few straightforward answers to questions such as – What does fair remuneration look like for the employee or the employer? What motivates? What is a good employee? How is this measured? etc.

For many years, AMP Capital has analysed the remuneration structures of the companies we invest in, taking many factors into consideration when determining the degree to which structures are aligned with shareholder interests.

Performance measures

When considering remuneration issues, focus most likely turns to performance hurdles as these measures often provide the clearest insight into the degree of alignment between the interests of management and those of our clients (shareholders).

Australian companies use a range of performance hurdles, be they share price measures, accounting measures or some form of operational/production target. While each type of hurdle has its merits, companies and shareholders would both concede that there is no perfect tool. Unfortunately accounting measures and operational/production targets may leave themselves open to manipulation and may not always translate into the share-price performance experienced by shareholders. For this reason AMP Capital has a preference for performance hurdles that include a measure of long-term relative Total Shareholder Return (TSR). As a performance hurdle, relative TSR is not only closely aligned with shareholder interests, but also has the added benefit of being easily defined, measured and communicated.

AMP Capital acknowledges there are critics of the relative TSR measure who liken it to a share-market lottery, or cite cyclicality, the lack of an appropriate peer-group and the fact that negative returns may still see rewards, as major concerns. However, AMP Capital argues that no other measure provides the same degree of alignment with shareholder interests. Criticisms of the TSR measure can be substantially addressed by using traditional options (which require an increase in the absolute share-price before delivering real value to the executive) and longer (e.g. three-year) performance measurement periods (as these smooth performance volatility within the peer group).

While relative TSR may not be a perfect measure in all circumstances, it is often the best of those available. AMP Capital strives to invest in those companies that will provide our clients with the best long-term returns. In our opinion relative TSR provides the greatest alignment with that objective.

Unintended consequences

AMP Capital acknowledges the difficulty boards have when formulating remuneration structures to successfully please everyone. Remuneration is not simple and selecting the ideal performance measure is just one of the many remuneration challenges boards of directors are faced with today.

Given the complexity of remuneration, it is vital a degree of caution is exercised when proposing any changes. A range of 'dilemmas' need to be taken into account and a perceptive and knowledgeable board will have the skills to balance the many and varied conflicts and potential outcomes.

Interestingly, many of the so-called 'problems' now associated with remuneration structures appear to have emerged as 'unintended consequences' resulting from solutions to past problems. It appears in their haste to address certain issues, companies and regulators have at times created a whole new set of problems.

At a time when progress is being made on new rules and regulations for remuneration, consider some of the many issues regulators and boards must seek to balance:

- Where termination payments are limited to 'one times base pay' – a board would need to resist pressure to increase base pay, as this would necessarily reduce the motivation provided by at-risk pay structures. Similarly, if a higher tax is introduced on cash incomes over, say, $1m – boards will need to resist the pressure to provide more remuneration via equity.
- Where performance hurdles are based simply on increasing earnings-per-share (EPS) – boards will need to curtail the risk this will lead to more short-term behaviour rather than long-term capital investment – or even of acquisitions being made, regardless of their merit? Similarly, if performance hurdles are all accounting based – boards need to be careful this won't lead to focus on such measures, to the exclusion of share-price measures - as what gets measured gets done.
- If an entire large incentive grant vests at a very specific hurdle, and nothing vests below that hurdle (i.e. cliff-vesting) – boards will need to monitor behaviour where there's a chance of erratic risk-taking by the CEO as they seek to ensure a particular hurdle is met. Again, this short-term behaviour may be contrary to the company's best long-term interests.
- Where options vest automatically on a change of control – boards will consider possible motivation to accept whatever takeover bid is made for the company, regardless of whether the offer is fair or not. Here the definition used to determine a 'change in control event' is crucial.
- Where the performance hurdles of long-term incentives are well out of reach – rather than motivate a CEO to perform – boards will try to ensure the CEO doesn't attempt to lock-in the reward simply by moving to a new employer who has agreed to a sign-on package that includes the 'buy-out' of their incentives.
- If 'hold-till-retirement' locks are placed on the CEO's equity holdings – boards will need to be careful a well performing CEO won't seek to lock in rewards by bringing forward retirement. Likewise, where a CEO has a significant amount of pay 'at risk' – a good board will need to ensure the CEO does not become risk averse, particularly as retirement approaches.
- On the flip-side, if a board can be spilled when the company receives a 'higher than 25%' against vote in two consecutive years – shareholders need to ensure this doesn't lead to a disproportionate focus on 'remuneration' at the expense of vital issues such as strategy, risk-management and environmental, social and other governance issues.

Companies grapple with these dilemmas and unintended consequences daily, highlighting the difficulties faced when attempting to formulate a remuneration structure that will be 'right' for everyone.

Remuneration: is there an easy answer?

Given the complexity of remuneration issues, it is vital companies have boards with the necessary skills and experience that enables them to find the path through these minefields. Boards are then encouraged to provide shareholders with the clearest possible disclosure and rationale for the remuneration practices they have adopted. Ideally, armed with this clear information shareholders will then be in a better position to determine the appropriateness of their company's remuneration practices.

When reflecting on the problems associated with remuneration's 'unintended consequences' and 'performance hurdles' one does become more acutely aware of the dilemmas faced by companies. There are no one-size-fits-all solutions. For precisely this reason AMP Capital will often engage with investee companies to seek a greater understanding of factors that will impact each company's remuneration practices.

Unfortunately when it comes to remuneration there are few easy answers.

> "It appears in their haste to address certain issues, companies and regulators have at times created a whole new set of problems"

Gender diversity – does it matter?

As the world emerges from the global financial crisis much soul-searching is taking place. How could these disasters have been averted? Why did company boards not see this coming? Were boards poorly skilled or did they just not ask the right questions?

In seeking answers to these questions, focus has turned to board structure while board diversity has been discussed for many years, this issue is only now gaining prominence, particularly with regards to gender diversity.

Companies are waking up to the benefits of gender diversity; studies have shown that companies with a higher proportion of women have better financial performance[5] - possibly due to the fact these companies have access to a larger part of the available talent pool and are also able to employ individuals who reflect a substantial part of their consumer base.

In this article AMP Capital considers the 'what', 'why' and 'how' of gender diversity on the boards of Australian companies. What does the picture look like? Why are there so few women directors and why does it matter? And finally, how can female representation be improved?

Women representation on Australian boards

In March 2009, the Australian Government's Corporations and Markets Advisory Committee (CAMAC) tabled a report on Diversity on Boards of Directors. Since that time discussion on board diversity has gained momentum and there is wide agreement that women are relatively under-represented on the boards of listed public companies in Australia.

Gender workplace statistics

- Women make up 45.3% of the workforce[6]
- 10.7% of executive Managers in the ASX200 are women[7]
- 8.3% of board directors in ASX200 are women[8]
- 2% of chairs in the ASX200 are women[9]
- ASX200 women executive managers earn 28.3% less than their male peers[10]
- Female graduates earn $3,000 p/a less than male graduates[11]
- Women working full time earn 18% less than men working full time[12]

Source[13]: Australian Government: Equal Opportunity for Women in the Workplace Agency (2010)

In contrast to the Australian statistics, a study of US Fortune 500 companies conducted by Catalyst Census[14] showed in 2009, women held 15.2 percent of board seats. It also showed, in both 2008 and 2009, almost 90 percent of companies had at least one women director, but less than 20 percent had three or more women serving together.

“Gender diversity is essential otherwise business is missing out on invaluable checks and balances”

– David Gonski, company director

Why have so few women become corporate leaders?

While social policies now generally encourage gender equality, the fact remains women tend to take on more domestic duties and family commitments than their male counterparts[15]. The experience of women is at odds with the dominant model in the business world which equates leadership with unfailing availability and total geographical mobility at all times (“anytime, anywhere”)[16]. This ‘business’ model also presupposes a linear career path, with no space for careersbreaks or rejection of a geographical move.

Combined with women’s greater focus on their home and families, the 2007 McKinsey Report: Women Matter proposes that other factors which appear to hold women back from reaching board positions include:

- the self-fulfilling prophecy of a ‘lack of experience’
- the low numbers of women in chief and senior executive positions means the pool from which many seek to draw women board members is smaller than desired
- a lack of inclination to ‘self-promote’ means many women don’t reach the executive positions from which board members are usually drawn, and
- it appears harder for women to find mentors to assist in career development.

Why more women?

When companies have a diversity of perspectives this can assist the quality of decision making as it reduces a tendency towards complacency or unwillingness to consider new ideas or options[17]. This is important as women now have a major influence on the majority of purchasing decisions, even those traditionally considered to be in the domain of men e.g. new car purchases.

Gender diversity is also seen as an asset for the corporate image as it helps unite the company with its employees, shareholders and customers[18]. Many investment analysts assessing a company’s social criteria will also take its gender balance into consideration.

Most importantly however, having more women on boards has been linked with a positive impact on performance. The Catalyst Fortune 500 study found the companies with the highest percentages of female board directors outperformed their competition by at least 53% for return on equity, by 42% on average for return on sales and by 66% for return on invested capital[19].

A Curtin University study of ASX companies also showed there was a positive association between women directors and economic and social performance. The study suggested that “women board members often come from more ‘social’ organisational roles – for example, not-for-profit organisations or charities and as such are more inclined than men to ensure codes of ethics are in place and enforced, which can protect against misuse of shareholder funds[20].” The study went on to say “having more women on boards may also help ensure that economic activities are balanced against environmental and social requirements. Such balance might be a result of the greater relational capabilities of women, who work to see that all stakeholder requirements and concerns are addressed – not just those that are economic in nature.”

At a recent CEDA luncheon[21], leading Australian company director, David Gonski, categorically stated that “gender diversity is essential - otherwise business is missing out on invaluable checks and balances.”

How should the imbalance be addressed?

Many methods have been discussed on how to increase the representation of women on boards. The Australian Government’s CAMAC committee opposed the often suggested setting of specific gender targets (quotas) as a means to increase diversity, suggesting instead:

- mentoring programs
- adoption of more accommodating employment practices at executive level, and
- opportunities to gain experience in not-for-profit or public sector entities.

The CAMAC Committee considered a more robust and open approach to board appointments and initiatives to encourage the development of women in executive management are the most effective ways to foster a governance culture that embraces diversity in the composition of corporate boards.

The ASX’s Governance principles will also have a major impact with the recent draft showing an acknowledgement that diversity is an economic driver of competitiveness for companies and requires companies to publish gender data and to set gender objectives[22]. Specifically, the new guidelines will require companies to disclose in each annual report the measurable objectives for achieving gender diversity set by the board in accordance with the diversity policy and progress towards achieving them (Recommendation 3.3). In addition, it will be recommended companies disclose in each annual report the proportion of women employees in the whole organisation, women in senior executive positions and women on the board (Recommendation 3.4).

As focus on this issue intensifies, it is anticipated the transparency of the board selection process will need to be improved and more shareholders will need to consider taking on a greater role in addressing the gender imbalance when engaging with the companies they invest in.

Has progress been made?

A major initiative recently launched by the Australian Institute of Company Directors involves some of Australia's most senior company chairmen and directors in a program to increase the numbers of women on ASX 200 boards[23].

When announced it was envisaged that the ASX 200 Chairmen's Mentoring Program would involve 56 chairmen and senior directors of major companies who would work with 63 highly talented and qualified women in a twelve month mentoring relationship. The program aims for women to develop connections with influential business leaders, gain knowledge and skills and to assist in achieving director appointments and increase their understanding of how listed company boards work. It will also be of great value to mentors and put them in contact with highly qualified women with enormous potential as ASX 200 company directors.

The ASX gender policy (discussed above) will begin to focus minds, as will the work of several other interest groups in Australia include Women on Boards, the Australian Businesswomen's Network and Chief Executive Women.

The bottom line

Before addressing the issue of gender imbalance there needed to be an acceptance of the problem, now the contribution made by women directors is becoming more widely understood and appreciated. In general, many now suggest women are more thorough, more questioning, more risk averse and more likely to bring a new perspective to discussions and decision making. If this is indeed the case, it is possible that with more women on company boards the global financial crisis may have played out quite differently.

The positive impact women have on company performance means their contribution is now rarely disputed. Rather than questioning the benefits of gender diversity, discussion now focuses on how the progress of women into senior positions can be accelerated. Initiatives such as company-based flexible work-options and mentoring programs may have an immense payback as women will be less inclined to 'opt-out' of corporate life.

The Government's Equal Opportunity for Women in the Workplace Agency (EOWA) report[24] concludes that ensuring equal opportunity at all levels of business is no longer about simple equity and fairness. It is a business imperative and if these issues are not actively managed by business leaders, the chronic waste of female talent will continue to slow business down.

Reported perceptions about women's contribution in the boardroom[25]

Positives – the EOWA report states women can:

- add diversity and atypical thinking, which helps avoid 'group think'
- increase the variety of perspectives and thus the likelihood more creative and innovative solutions will be considered
- add 'emotional sensitivity'
- be extremely conscientious, with stronger emphasis on preparation
- often be younger than their male counterparts – thereby bringing age and gender diversity
- be better communicators and better at relationships, thus more likely to engage constructively with shareholders and other stakeholders
- be more inclined to challenge conventional wisdom, pay more attention to detail and thoroughly explore alternatives
- be less confrontational – seeking to resolve issues rather than fight about them
- be more principled, and
- be more likely to consider being a NED as a 'career', in contrast men are more likely to see the NED role as a retirement job.

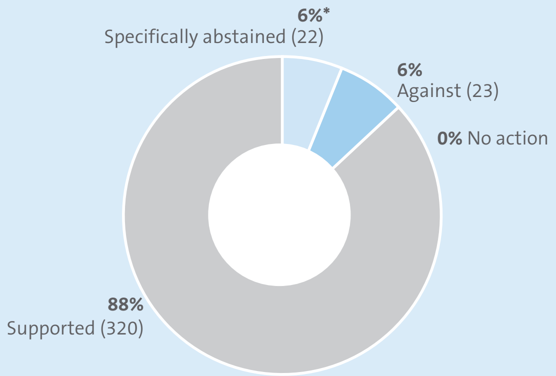
Negatives – the EOWA report states women can:

- be seen as less collegial – having fought their way through the glass ceiling they may have a tendency to self-promotion
- show a persistence that sometimes becomes 'pushy'
- have less experience, potentially leading to a lack of insight and 'gut feel'
- tend to focus on risk and governance issues when faced with management issues as they are generally less able to fall back on management experience to offer insights and solutions, and
- be encouraged to act like women but can then be patronised for doing so.

Source: Agender in the boardroom (2008), Australia Government: Equal Opportunity for Women in the Workplace Agency (EOWA)

AMP Capital Investors proxy voting statistics:

1 January to 30 June 2010



Voting: January-June 2010
AMP Capital Investors voted on 365 resolutions at 83 company meetings

* includes resolutions on which AMP Capital Investors was excluded from voting eg participated in share issues

AMP Capital's shareholder activism

AMP Capital is actively committed to encouraging good corporate governance in the companies in which it invests.

While our lodgement of proxy votes has an impact on governance, we believe the letters we write and our meetings with company directors are a more constructive and successful form of shareholder activism.

In the first half of 2010 AMP Capital wrote 22 governance-related letters to company chairmen. We continue to be pleased with the positive response to these letters – with many companies addressing our specific concerns and improving governance practices in subsequent years. In addition, many company chairmen have accepted our invitation to discuss governance matters further, meeting with us personally to discuss issues of concern. This influence has been constructive, with some visible improvements including greater disclosure and transparency, the appointment of independent directors, improved terms for incentive plans and the abolition of termination benefits for non-executive directors.

Non-executive director (NED) remuneration

In the first six months of 2010, eight companies sought approval for an increase in the maximum aggregate level of fees that could be paid to the company's NEDs. This number continues to be relatively low – most likely a response to the global financial crisis.

AMP Capital voted in support of all the increases sought as they were considered reasonable after taking into account various factors including the size of the company, its complexity, performance, board composition (including the number of directors and the balance of independent directors), whether options or retirement benefits are paid to directors and the factors put forward by the company to explain the need for the increase being sought.

In line with generally accepted principles of good governance, AMP Capital is not in favour of option grants being made to non-executive directors. It is preferred that non-executive directors be aligned with the shareholders they represent rather than potentially being influenced by incentive structures that may not reflect the experience of the shareholders who hold listed securities. Preferably, non-executive directors should be encouraged to invest their own capital in the company or to acquire shares from the allocation of a portion of their fees.

AMP Capital Investors proxy voting statistics 2010:	2010 First half (6 months)	2009 First half (6 months)	2008 First half (6 months)	2007 First half (6 months)	2006 First half (6 months)	2008 Full year (12 months)
Number of company meetings where votes were submitted:	83	97	109	122	94	418
Number of resolutions voted on:	365	473	561	556	449	2154
% of meetings where all resolutions were supported by AMP Capital:	71%	62%	71%	59%	63%	59%
% of meetings where incentive issues were considered:	63% (52)	60% (58)	66% (72)	54% (66)	71% (67)	82% (341)
% of meetings where incentive issues were not supported by AMP Capital:	25% (13)	34% (20)	35% (25)	34% (23)	42% (28)	43% (148/341)

Share and option incentive plans

To date this year AMP Capital has submitted votes on 61 incentive-related resolutions (not including votes on NED fees and remuneration reports).

AMP Capital voted against resolutions at the following companies:

Ampella Mining Ltd	Extract Resources Ltd
Australand Property Group	Gold One Intl Ltd
Berkeley Resources Ltd	Northern Iron Ltd
Bow Energy Ltd	

AMP Capital also specifically abstained from voting on incentive schemes at an additional three companies.

We specifically abstain from voting where schemes contain minor flaws, or where it may be the first time we have raised the concern with the company. We find this 'abstention and communication' mechanism more constructive than simply voting for a slightly flawed resolution as it allows us to send clear signals to companies, which can often lead to useful dialogue. In almost all cases we endeavoured to make contact with the company (usually via a letter to the chairman) to provide reasons for our position.

As investors, we seek to invest in companies that will provide the best relative share market performance over the long-term and as such we prefer a significant portion of the CEO's remuneration is aligned with that goal.

The underlying reasons for not supporting incentive-related resolutions include:

- Poor disclosure of the terms of the incentive plans
- Plans are shorter than the desired three-year minimum
- Plans had no performance hurdles or hurdles that lacked sufficient alignment with the interests of shareholders
- Proposed plan amendments would increase the value to employees, without any corresponding benefit to shareholders
- Participation of NEDs in executive schemes, and
- Plans showed no improvement, despite the company having received comments/input and the matter being not supported previously.

AMP Capital continues to consider how incentive grants should respond upon a change of control at the company. In 2007 we became interested in this feature after seeing instances where company executives and directors engaged in behaviour that could potentially destroy shareholder value while they themselves were reaping significant personal gains.

Remuneration reports

Since the introduction of the non-binding votes on remuneration reports in 2005, Australian investors now have a mechanism by which to review and comment on the approach to remuneration used by the companies in which they invest.

When reviewing the appropriateness of remuneration reports, AMP Capital generally considers a wide range of factors.

Remuneration reports should be concise and provide a clear understanding of the company's remuneration policy, along with evidence the policy is both fair and reasonable and is aligned with shareholder interests.

We particularly look for criteria such as the clarity of disclosure, satisfactory short and long-term incentive and termination arrangements and also appropriate non-executive director remuneration.

Over the first half of 2010, AMP Capital submitted votes on 39 remuneration reports, supporting 32 (82%) of them. The remuneration reports AMP Capital voted against (as opposed to either supporting or abstaining) over this period include:

Australand Property Group	Austar United Communications Ltd
Aristocrat Leisure Limited	

AMP Capital voted against remuneration reports which exhibited; poor disclosure, poor alignment with shareholder interests, inclusion of non-executive directors in executive incentive plans, excessive quantum and poorly structured performance hurdles (eg. absolute rather than relative, not sufficiently challenging, too short-term, purely accounting-based, allow too many opportunities for re-testing etc).

Another feature of concern has been the excessive termination payments (both actual and potential) that were made to some departing senior executives – particularly as actual payments often bore little resemblance to previously agreed limits.

AMP Capital also specifically abstained from voting on four other remuneration reports, adopting the 'abstention and communication' mechanism mentioned earlier.

Board composition

Board composition continues to be one of the most important corporate governance issues for shareholders. Despite its significance, it is often difficult for shareholders to determine whether they have the right boards governing their companies. The short biographies available in annual reports provide little detail and, without being present in the boardroom, shareholders can not observe the dynamics of the board, nor its overall effectiveness.

In any proxy season, most company meetings are Annual General Meetings which require shareholders to vote on the election or re-election of directors. AMP Capital supported the majority of directors seeking re-election. Instances where AMP Capital voted against a director election in the last six months include only the nominations of directors at:

APN News & Media Ltd

More often than not, a vote against a director relates to the company board having too few independent directors.

In addition, AMP Capital specifically abstained from re-electing directors at a further four companies. In these cases there may have been a better representation of independent directors, albeit still a minority, and/or this was the first time the issue of board composition had been raised with the particular company. In almost all cases we endeavoured to communicate our specific concerns to the company involved.

In addition, there were companies where, after weighing up the merits of the nomination, AMP Capital rejected the election of self-nominated, non board-endorsed candidates.

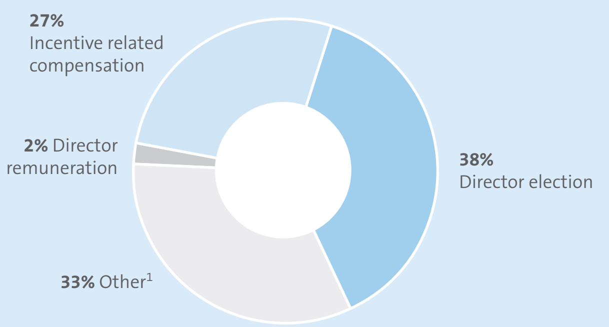
Other

Each year shareholders are asked to vote on 're-organisations, mergers and capitalisation changes'. These resolutions seek approval for acquisitions, asset sales, loans and/or merger agreements, and various share issues (including those made in connection with acquisitions).

During the last six months all these resolutions were supported (except where AMP Capital was excluded from voting as a result of having participated in the particular capital raising).

Resolutions relating to re-organisations, mergers and capitalisation changes require analysis against both governance and investment criteria. This analysis establishes whether transactions are conducted appropriately, in the best interests of shareholders and with full and clear disclosure.

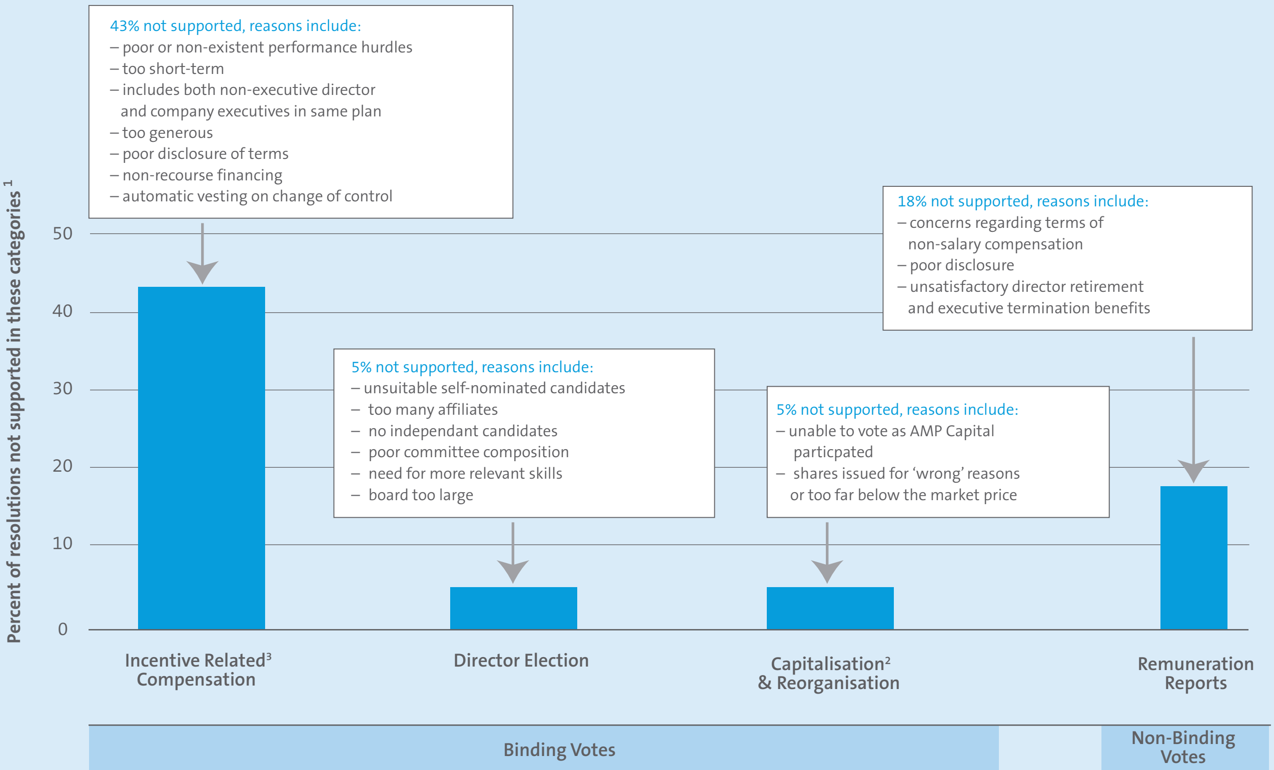
Categories of resolutions considered



Categories of resolutions considered (Australian companies):
January-June 2010
as a percentage of all resolutions put forward by companies

(Source: AMP Capital estimates)
1. "Other" includes: ratification of shares issues/capital raising, constitutional updates, restructure proposals, asset sales, buy-backs, change of domicile, name changes etc

Resolutions not supported by AMP Capital Investors: January 2010 – June 2010



1. Includes where AMP Capital either voted against or specifically abstained from voting.
2. Approval and ratification for DRP, share issues, placements, re-organisations and mergers.
3. Statistics this period were heavily infuenced by the number of resolutions not supported at Gold One and Harvey Norman (later withdrawn by company)

Source: AMP Capital Investors estimates (based on number of resolutions)

Snippets

Government responds to the Productivity Commission Report on Executive Remuneration

In April the Government responded to the Productivity Commission's (PC's) final report on Australia's director and executive remuneration framework. The media release states the following:

> The Government supports nearly all of the PC's recommendations, including the "two strikes" proposal, and has decided to further strengthen several of the recommendations by expanding their scope and enforceability.
>
> The Government will also consider an additional proposal, not identified by the PC, to clawback bonuses paid to directors and executives in the event of a material misstatement in the company's financial statements.
>
> The Government will introduce legislation to implement many of the PC's recommendations, including the "two strikes" proposal, which will strengthen the non-binding vote on remuneration and set out consequences where companies do not adequately respond to shareholder concerns on remuneration issues.
>
> Legislation giving effect to the reforms will be introduced this year, following public consultation on an exposure draft.
>
> The Government will also undertake consultation on the proposal to clawback bonuses paid to directors and executives in the event of a material misstatement of a company's financial statements.
>
> This proposal is aimed at ensuring that, to the extent that pay packets are inflated by incorrect information, that money is returned to shareholders. A discussion paper will be released in coming months.
>
> These are important reforms that will improve Australia's remuneration framework by encouraging shareholder engagement, tackling conflicts of interests, improving disclosure requirements and improving the design of remuneration policies. These reforms will also ensure that Australia's regulation of director and executive remuneration remains at the forefront of international best practice.

After the Government released this response, the Australian Institute of Company Directors issued a statement[26] expressing concerns that the measures announced by the Federal Government in response to the Productivity Commission's executive remuneration inquiry will add more unnecessary regulation and have unintended consequences which could disrupt companies.

Australian Institute of Company Directors (AICD) Chief Executive, John Colvin, said that "the Government should not be rushing into introducing legislative changes arising from the Commission's inquiry."

"In several instances it has gone well beyond what the Productivity Commission recommended, rejecting a 'comply or explain' approach implemented through ASX Corporate Governance Council guidelines and opting instead for further new black letter law."

"This is going too far. It adds yet more law and regulation which is disproportionate to the problem and is inconsistent with Australia's very high international reputation on corporate governance."

Timing of taxation on equity-based payments

The Productivity Commission's (PC) report into executive remuneration stated that currently, income tax on equity-based payments is generally payable at termination of employment, irrespective of whether performance conditions or holding requirements still apply. Two of the key points listed under 'Taxation Issues', in the Commission's full report states:

- From an executive's perspective, this creates a disincentive to deferring equity over the longer term and thus could work counter to approaches that seek to improve managerial alignment with shareholder interests.
- While there may be some costs to revenue from extending tax deferral beyond termination of employment, the broader economic costs of not changing this policy are judged to be more important. Any adverse implications for tax system integrity and compliance from such a change appear surmountable.

The PC report recommended removing cessation of employment as the taxation point for deferred equity subject to risk of forfeiture. The specific targeted benefits of this recommendation were to:

- Remove barriers to deferred remuneration
- Consistent with longer-term alignment
- Removes need for special tax rulings.

Ideally the scope to defer taxation of long-term equity incentives (those at risk of forfeiture) beyond departure could facilitate deferment of remuneration. This could promote better alignment of incentives in the latter years of an executive's term, as well as giving the board scope to 'claw back' payments made to executives in the event of unacceptable post-departure outcomes.

The PC recommended that (Recommendation 13):

> The Australian Government should make legislative changes to remove the cessation of employment trigger for taxation of equity or rights that qualify for tax deferral and are subject to risk of forfeiture. These equity-based payments should be taxed at the earliest of: the point at which ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.

The Government however did not support the recommendation stating that:

> ... cessation of employment as a deferred employee share scheme taxing point has been a feature of the law since 1995. The taxing point was introduced as one of a number of changes designed to counter tax avoidance arrangements involving employee share schemes.
>
> In setting tax policy the Government must consider the implications on the wider community, as the employee share scheme tax arrangements affect a diverse class of taxpayers from executives of prudentially regulated entities to non-executive employees of large corporates to employees of small business. Removing the cessation of employment taxing point would increase the concessionality of employee share schemes, providing a disproportionately large benefit to higher-income employees who are the major users of the deferred tax concession. The Government does not consider this additional concessionality a policy priority.
>
> Further, it is very difficult for the Tax Office to monitor employee share scheme tax liabilities after the employment relationship has ended.
>
> Finally, removing the cessation of employment taxing point would have a significant cost to revenue. The Government believes that the current taxation of employee share schemes strikes the right balance between providing concessions in support of employee share schemes, and tightly targeting expenditure to reflect key government priorities.

The Government's decision not to support this particular recommendation has had a negative response. Mr Colvin, the AICD's Chief Executive stated that:

> "We are also extremely disappointed that the Government has rejected the Commission's recommendation to remove the current taxation impediment to deferred equity incentive pay, to allow deferral of equity incentives beyond the point where an executive ceases employment," Mr Colvin said.
>
> "This widely supported change would have removed this barrier to deferred remuneration and so would encourage longer term alignment of shareholder and executive interests.
>
> "The decision by the Government is, frankly, baffling. Its reasons for failing to act on this very positive recommendation in the Productivity Commission report are far from convincing."

More details on the Productivity Commission and the Government's views can be found in their full reports[27].

International Corporate Governance Network annual conference (Toronto 2010) – Shareholders too powerful

At this year's ICGN in Toronto, veteran corporate director, Peter Dey delivered a blunt message for Canada's large shareholders: stay off directors' turf. Mr Dey, who created Canada's first corporate governance guidelines for boards, says he has become convinced the balance of power has shifted too far to shareholders on key issues and is eroding the power of directors.

"There is a trend for shareholders to try to involve themselves in issues which, under our corporate model, should be within the purview of the board," he says.

One key example, he says, is 'say on pay,' where shareholders are demanding the right to a non-binding advisory vote on companies' compensation practices.

"Is say on pay the beginning of a trend?" he asks. "Will shareholders want to vote on a company's environmental policy, on its health and safety policy, and so on?"

In an interview, he said his governance views have been shaped in recent years by his work on boards of companies like Goldcorp Inc., which faced calls from shareholders in 2006 to hold a vote on a dilutive takeover bid. A court supported the board's position that a vote was not required, but the TSX later changed its rules to require votes on similar deals in the future.

Since then, Mr Dey said he has watched shareholders get more involved in decisions that should be left to directors, who are closer to the company and have more information.

"To perform that job properly, you really have to understand the corporate strategy, and then you have to understand what incentives you should include in your compensation system to make sure that strategy is achieved," he said. "For a shareholder, that's an impossible thing to do."

Mr Dey said he supports shareholder activism by advocacy groups like the Canadian Coalition for Good Governance (CCGG), but said their best tool is the use of private conversations with a board, not 'public confrontations.'

"Where you can be most effective is identifying good directors, getting them on the slate and electing them, and, if necessary, removing ineffective directors," he said. "But to try to jump in and make judgments where the board should be making judgments, I think is just the wrong direction."

The rewards of virtue: Does good corporate governance pay? Studies give contradictory answers[28]

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Once again, corporate governance reform is back on the legislative agenda, not least in the United States. In 2002, after the scandalous collapses of Enron and WorldCom, Congress voted in the Sarbanes-Oxley act, which was intended among other things to beef up corporate risk-management. Now, the financial reforms being considered in Washington include several proposals intended to correct flaws in the oversight of firms that were revealed in the aftermath of the financial crisis. The reforms likeliest to become law include an advisory 'say on pay' vote for shareholders on the remuneration of top executives, and measures to make it easier for shareholders to nominate candidates for election to company boards.

As always, these efforts to improve corporate governance have plenty of opponents. They argue that, contrary to the claims of the reformers, the changes would harm corporate performance by wrapping managers up in red tape. In the case of Sarbanes-Oxley, which was rushed into law with too little discussion of the details, the critics of reform had a point. The case for the latest proposals seems more straightforward, however, and has been debated for many years.

The controversy over corporate governance has been fuelled by a surprising lack of conclusive evidence that improving it actually pays in the form of higher returns to shareholders. The study most cited by the reformers is "*Corporate Governance and Equity Prices*", published in 2003 by three economists, Paul Gompers, Joy Ishii and Andrew Metrick. This found that in 1991-99, investors going long on well-governed firms, as defined by an index combining 24 different aspects of corporate governance, while shorting poorly-governed ones, would have enjoyed an unusually high annual return of 8.5%.

Similarly strong returns were found for a trading strategy based on a narrower list of what reformers consider the six core elements of good corporate governance, such as making the company's whole board face re-election each year, and not having any 'poison pill' defences against takeovers.

Critics of reform were never convinced. A new study co-written by Lucian Bebchuk, a Harvard professor who is also an activist for corporate-governance reform, gives rise to further doubts—at least at first glance. "*Learning and the Disappearing Association Between Governance and Returns*," by Mr Bebchuk, Alma Cohen and Charles Wang, repeats the study by Mr Gompers and his colleagues for 2000-08.

It finds that, in contrast with the 1990s, neither the 24-factor index nor the six-factor one would have helped investors beat the market.

Mr Bebchuk and his colleagues argue that the disappearance of the good-governance premium during the past decade is actually a sign that investors have woken up to the importance of governance. This, they think, was due to a huge increase in discussion of the issue in the media in 2001-02, following the Enron and WorldCom scandals and the publication of the Gompers study. As a result, they argue, early in the decade differences in the quality of governance between different firms were fully incorporated in their share prices. Since this adjustment was a one-off, well-governed firms' shares have not subsequently outperformed the market.

Not all reformers are convinced that the market has wised up, however. On April 22nd the Corporate Library, a governance-research organisation, published a study that *found significantly higher returns in 2003-10* when it excluded from its portfolio firms that according to its governance ratings system were of high or very high risk. The crucial difference between this ratings system and the 24- and six-factor indices used by the other studies is that the Corporate Library says it researches firms for specific evidence of governance problems, whereas the indices rely on a box-ticking exercise.

Reformers hope that the latest study will put an end to the debate over whether good corporate governance is a virtue that pays. Doubters will surely try to dig up something in Corporate Library's methodology to undermine its conclusions. It is a debate that will run and run—which is, at least, better than brushing the issue under the carpet.

"...the disappearance of the good-governance premium during the past decade is actually a sign that investors have woken up to the importance of governance."

End Notes

1 The second meeting of the G-20 heads of state in discussion of financial markets and the world economy. Held in London on 2 April 2009.

2 The Financial Stability Board was established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. The Principles for Sound Compensation Practices: Implementation Standards. 25 September 2009.

3 The Corporations Amendment (Improving Accountability on Termination Payments) Act 2009 (Cth) (Amendment Act), came into operation on 24 November 2009; addressed concerns about director and executive termination benefits.

4 The revised APRA governance standards came into effect on 1 April 2010, they require the boards of authorised deposit taking institutions to have a Remuneration Policy and to establish a Board Remuneration Committee comprised entirely of independent directors

5 Joy, Carter, Wagner and Narayanan, Catalyst. The Bottom Line: Corporate Performance and Women's Representation on Boards October 2007 http://www.catalyst.org/publication/200/the-bottom-line-corporate-performance-and-womens-representation-on-boards

6 6 ABS, Cat. 6202.0, Labour Force, Australia, April 2010 Source: Table 02, Labour Force Status by Sex – Seasonally Adjusted http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6202.0Apr%20 2010?OpenDocument

7 EOWA, EOWA 2008 Australian Census of Women in Leadership, 2008.

8 Ibid.

9 Ibid.

10 EOWA, Pay Power and Position: Beyond the 2008 EOWA Australian Census of Women inLeadership, 2009. Average statistics.

11 Based on salary earned upon entering the workforce. Source: Graduate Careers Australia, Gradstats 2009, 2009.

12 ABS, Cat. 6302, Average Weekly Earnings, Seasonally Adjusted, Table 02, Average Weekly Earnings – Seasonally Adjusted, February 2010. http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6302.0Nov%20 2009?OpenDocument

13 Source
Equal Opportunity for Women in the Workplace Agency: Gender workplace statics at a glance: http://www.eowa.gov.au/Information_Centres/Resource_Centre/EOWA_Publications/Gender_stats_at_a_glance.pdf

14 Rachel Soares, Nancy M. Carter, Ph.D., and Jan Combopiano 2009 Catalyst Census: Fortune 500 Women Board Directors. Dec 2009

15 McKinsey & Company (2007): Women Matter: Gender diversity, a corporate performance driver. Exhibit 3 – pg 7. http://www.mckinsey.com/locations/swiss/news_publications/pdf/women_matter_english.pdf

16 McKinsey & Company (2007): Women Matter: Gender diversity, a corporate performance driver. pg 7.

17 Corporations and Markets Advisory Committee (CAMAC) Diversity on Boards of Directors March 2009 Pg 19

18 McKinsey & Company (2007): Women Matter: Gender diversity, a corporate performance driver. pg 10.

19 Return on equity (ROE): ratio of after-tax net profit to stockholders' equity. Return on sales (ROS): pre-tax net profit divided by revenue. Return on invested capital (ROIC): ratio of after-tax net operating profit to invested capital. (Based upon the four-year average for ROE, ROS, and ROIC for 2001, 2002, 2003, and 2004, and women board director (WBD) data for 2001 and 2003. Financial data for the companies examined were obtained from the Standard & Poor's Compustat database. Because of movement into and out of the Fortune 500 each year, there are 520 companies in this analysis; the top quartile comprises the 132 companies with the highest average percentage of women board directors while the bottom quartile comprises the 129 companies with the lowest average percentage of women board directors. WBD data was obtained from the 2003 Catalyst Census of Women Board Directors and the 2001 Catalyst Census of Women Board Directors. Financial performance measures vary by industry. To account for this variability, standardized financial performance measures were used to make comparisons within the overall sample.)

20 Dr Jeremy Galbreath, a research fellow at Curtain University's Graduate School of Business (GSB), who is exploring the relationship between corporate governance and sustainability – which combines economic, environmental and social aspects. Galbreath's interest has come from a trend that has called for business firms to move beyond narrow financial self-interest, and to respond to stakeholder demands for environmental quality and social responsiveness.

21 Committee for Economic Development of Australia (CEDA) Women in Leadership Series: Women on boards – promoting gender diversity (Luncheon - 30 June 2010)

22 ASX Governance Council Proposed Amendments to the ASX Corporate Governance Principles and Recommendations: Exposure Draft 22 April 2010.

23 Australian Institute of Company Directors (AICD) Directors take the lead in helping put women on boards Press Release (22 April 2010)

24 Australian Government: Opportunity for Women in the Workplace Agency: Agender in the boardroom Egon Zehnder International 2008

25 Australian Government: Opportunity for Women in the Workplace Agency: Agender in the boardroom Egon Zehnder International 2008 pg. 13

26 Australian Institute of Company Directors (AICD) Government has gone too far with pay legislation say directors Press Release (16 April 2010)

27 Australian Government Response To the Productivity Commission's Inquiry on Executive Remuneration in Australia April 2010 http://mfsscl.treasurer.gov.au/Ministers/ceba/Content/pressreleases/2010/attachments/033/033.pdf Productivity Commission's Inquiry Report – Section 10 "Taxation Issues" http://www.pc.gov.au/__data/assets/pdf_file/0003/93603/13-chapter10.pdf

28 The Economist (2010) The rewards of virtue: does good governance pay? Studies give contradictory answers. Viewed at http://www.thecgo.org/docs/Does_good_governance_pay.pdf

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