

# Corporate Governance 2011 midyear report

SEPTEMBER 2011

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## Two-strikes and you're out Will boards really be spilled over remuneration practices?

The controversial 'two-strikes' rule has now been passed by both houses of Federal Parliament. So what does it all mean? Can shareholders really 'spill' boards when dissatisfied with a company's remuneration practices? Here AMP Capital Investors examines how the 'two-strike rule' will work and considers the likelihood of entire company boards being 'spilled' over what some shareholders consider to be poor remuneration practices.

Regular readers of our Corporate Governance Report will know that AMP Capital is a keen advocate of strong and independent board composition and fair remuneration practices. For many years, we have 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. We have voted against many remuneration reports and engaged with companies to communicate concerns.

In theory, remuneration for publicly listed companies should be simple: to provide a level of pay that fairly rewards the contribution toward meeting business targets, and to align this with the interests of shareholders. In reality, finding a balance between reward, motivation, retention and alignment is far from simple. A particular challenge for companies has been structuring equity incentives in such a way that encourages employees to act like owners, without being unnecessarily generous.

Since the introduction of the non-binding vote on the adoption of remuneration reports in 2005 almost one-third of all reports have not been supported by AMP Capital. Reasons for voting against remuneration reports include poor disclosure,

poorly structured incentives and overly generous base pay or termination payments.<sup>1</sup> Interestingly, such concern over the remuneration practices at many Australian companies does not appear to be widespread; in 2010 only 32 of the ASX300 companies had more than 25 per cent of shareholders vote against their remuneration report.

## How the 'two-strikes' rule works

Until recently there were no set consequences for a company board receiving a significant vote against its remuneration policies. Given the importance of this issue, and the fact shareholders are actually the owners of the company, the Government decided shareholders who take on the risk of investing their capital for a share of the company's profits and losses deserved more say over how the pay of company executives is set.<sup>2</sup>

Now, under the newly passed 'two-strikes' rule, shareholders will have the ability to vote on whether to 'spill' the board of directors (that is, remove the directors) over remuneration concerns. The diagram on page 2 however shows that before shareholders reach this point, several criteria must first be met.

Before a 'spill' meeting is called, a board will need to have received:

- an 'against vote' of at least 25 per cent in year one, **and**
- a second against vote of at least 25 per cent in year two, **and**
- 50 per cent of all eligible votes<sup>3</sup> being cast in support of a 'board spill meeting'.<sup>4</sup>

Only then:

- will a 'board spill' meeting be required. Such a meeting must be held within 90 days. All directors who held office at the time of the 'year two' meeting (other than the Managing Director) must stand for re-election. Under normal election rules – those who are re-elected remain, those who are not are removed. Any new directors elected at the "spill" meeting automatically hold office at the end of the meeting.

To ensure the required minimum of three directors remain after the spill meeting, any remaining positions (after the managing director and any newly appointed directors) will be filled by those with the highest percentages of votes favouring their appointment.<sup>5</sup>

The government has stated that the separation of the 'second strike' and the 'spill resolution' is intended to ensure shareholders who fear the removal of certain board members are not discouraged from voting against the remuneration report in year two. The separation ensures shareholders are free to express their concerns on the remuneration report, and is intended to provide a clearer signal of shareholders' views on the remuneration report.

## What does this mean?

With the stakes now higher, AMP Capital has seen a noticeable increase in the number of companies focusing on remuneration. Not only are boards seeking shareholder views on this issue but also a clearer understanding of the process by which institutional shareholders decide how proxy votes are cast.

Over the last six-months, more and more companies have sought to engage with AMP Capital in relation to remuneration and voting. Interestingly, it has not only been those companies that have received significant 'against' votes in the past seeking to discuss their remuneration with us, but also many that have received consistent support for their remuneration practices.

Given the importance of this issue, AMP Capital is pleased to see an increased focus on remuneration quantum, structures and disclosure. However, it is our opinion that the threshold of 25 per cent (of all votes cast) may have been set too low and may lead to unnecessary angst and work for boards of directors.

In addition it will be interesting to see how boards make contingency plans for a 'second strike'. Once they receive a 25 per cent 'against' on a remuneration report, the notice of meeting for the AGM in year two will need to anticipate the potential for a spill resolution.

AMP Capital acknowledges it will be burdensome for companies to convene a spill meeting within 90 days of the 'year two' meeting and be in a position to replace the entire Board with a new harmonious team of appropriately-qualified nominee directors. AMP Capital hopes this exercise will not have a destabilising effect. We are very aware that remuneration is not the only issue boards have to deal with and we will watch with interest to see how boards prioritise their many responsibilities.

AMP Capital would prefer to see shareholders' remuneration concerns addressed and therefore no 'spill meetings' required. For many years we have encouraged companies to focus on producing concise remuneration reports that facilitate a

clear understanding of their remuneration policy, providing evidence that it is fair and reasonable and, most importantly, aligned with shareholder interests. To this end, we encourage companies to focus on good disclosure in particular, and to engage with shareholders well before the main proxy season (October and November) each year.

In the last two years, only six major Australian companies' remuneration reports have received two consecutive negative votes (that is, greater than 25 per cent against). These were Astar United Communication, Cabcharge, Challenger Financial Services Group, Downer EDI, Rio Tinto and Transurban.

Several companies that had previously received two consecutive negative votes, received shareholder endorsement last year after engaging with shareholders and making improvements to their remuneration structures. Two such companies were Qantas and UGL, who turned around the negative votes via a combination of improved disclosure, freezing of base-pay levels, the use of board discretion to reduce excessive bonus entitlements and the introduction of new long-term incentive structures subject to more challenging performance hurdles and longer vesting periods.

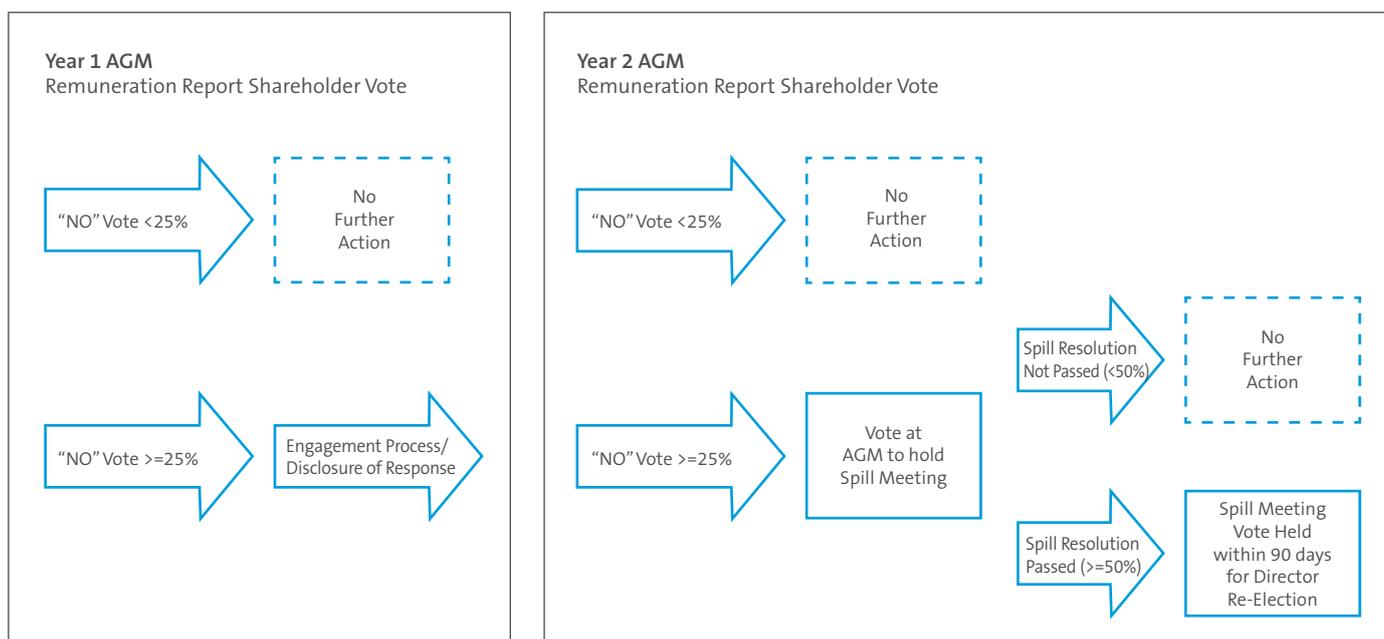
## Will boards actually be spilled?

AMP Capital considers it unlikely that entire boards will be spilled over shareholders' remuneration concerns. Yet we value the increased focus on this important issue.

Companies who do the right thing, work to understand shareholders and improve their remuneration reports should have nothing to fear. Australian shareholders do not have a tendency to vote out directors who are generally considered to be doing a good job.

AMP Capital has always taken voting on remuneration reports seriously, viewing this voting as a means of communicating our preferred remuneration structures. Despite the potential impact of the 'two-strikes' rule, this approach is not expected to change.

## How shareholders can axe a board



Source: Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011, Australian Parliament

## Putting a price on carbon – how will it drive structural reform?

Over the last decade, scientists have increasingly focused on global warming and the potential environmental and economic damage from high levels of carbon pollution.

On 10 July, 2011, the Australian government announced a comprehensive plan to move to a clean energy future. Central to its Clean Energy Future Plan (CEFP) is the introduction of a carbon price where the country's biggest polluters will be required to pay for their pollution.

The intention in pricing each tonne of carbon pollution released into the atmosphere is to create a financial incentive to reduce carbon emissions and drive investment in new clean energy sources such as solar, gas and wind.

Initially, approximately 500 companies with the highest carbon output will pay \$23 for each tonne of carbon dioxide equivalent (CO<sub>2</sub>-e)<sup>6</sup> they emit. The carbon price will then increase by 2.5 per cent real per annum for the first three years, after which the carbon price will move to market determined price, i.e. an emissions trading scheme. The scheme which initially covers approximately 66 per cent of Australia's emissions will cover up to a further 10 per cent once changes to fuel excise arrangements for some parts of the transport sector have been agreed.

To offset the costs incurred by some companies in their move to cleaner technologies the government has committed to a program of transition assistance for the most emissions-intensive trade-exposed (EITE) industries, such as aluminum smelting, steel and glass manufacturing and pulp and paper production. EITEs will initially receive assistance of approximately 94.5 per cent of their emissions based on the industry average baseline emission intensities and company specific production rates and moderate emitters will receive 66 per cent. By basing the assistance against the industry average baseline, efficient companies will receive relatively more free permits. Over time the industry assistance provided will decrease 1.3 per cent per annum.

Despite the industry assistance, it is expected most companies will incur excess costs which will be passed on to consumers – this in turn, leading to a general rise in the cost of living in Australia. Treasury forecasts the increase in CPI is expected to be relatively modest (the 0.7 per cent increase in CPI in the first year is less than the increase with the introduction of the GST).

To offset increased costs to households, the government has also announced various measures to support families. Over half the money raised from the carbon price will be used to assist households. Nine in 10 households will receive a combination of tax cuts and payments to help with the additional costs associated with the introduction of the carbon price.

### How does the Clean Energy Future Plan compare to the previous schemes?

Over past years, governments have discussed various methods of solving the issue of carbon pollution.

Most recently the Rudd government had proposed the Carbon Pollution Reduction Scheme (CPRS). The CPRS was to meet Australia's emissions reduction targets via a cap and trade system which limited greenhouse gas pollution, while giving individuals and businesses incentives to reduce their emissions.



Setting a limit means that the right to emit greenhouse gases becomes scarce and tradeable. The implementation of the CPRS however stalled due to major concerns surrounding the emissions targets, the granting of rights to pollute and the provision of free permits to major polluters. The Clean Energy Future Plan has many core elements of the previously proposed CPRS – the main differences relate to the specifics of scheme coverage<sup>7</sup>, household assistance<sup>8</sup>, the governance<sup>9</sup> and the more comprehensive range of specific assistance packages for industry.<sup>10</sup>

### Outlook

The carbon tax proposed under the CEFP, and subsequent move to an emissions trading scheme in 2015, provides some much needed certainty for investors. While AMP Capital considers the implementation of an emissions trading scheme from year one as preferable, as it will lead to the lowest cost abatement from inception, the Clean Energy Future Plan has a relatively short fixed price period of three years and does enable liable parties to prepare for an emission trading regime.

It is important the scheme covers as many industry sectors as possible, so the market can distribute the costs efficiently through the economy and allow maximum opportunity to identify lowest cost abatement. The decision to exclude transport from the scheme but apply changes in excises equivalent to the carbon price, makes the scheme administratively easier for some companies who have to pass the cost on and also reflects the difficult political environment that existed to get agreement between the government, minor parties and independents. Proposed changes to the on-road fuel excise in 2014 are supported as the expected inflationary impact is minimal.

AMP Capital supports the provision of assistance to emission intensive trade exposed (EITE) companies as the transitional assistance should provide the necessary support for the short-to-medium term until additional action is taken internationally. It also provides these industries an incentive to reduce emissions.

Pricing carbon is seen as a necessary step to support the structural change required in the Australian economy as it faces a carbon constrained world. Other countries have already commenced similar initiatives. Beginning this process now would enable smooth change to our economy and support Australian investments.

In summary, companies likely to be most affected by the introduction of a price on carbon are those unable to pass costs on to their consumers. AMP Capital is of the opinion that most companies will not be impacted significantly by a carbon price in the short-term.

### Next steps

In broad terms, the Clean Energy Future Plan (CEFP) maintains many core elements of the previously proposed Carbon Pollution Reduction Scheme (CPRS) with a few notable changes in terms of household and industry assistance. In the absence of conflicting information, AMP Capital expects the CEFP to be presented to Parliament as outlined in the announcement on 10 July, 2011.

As an investor, AMP Capital is examining how the carbon tax will impact companies. The four main drivers being considered are:

1. the level at which the carbon price is set,
2. the ability a company has to pass the carbon price on to customers,
3. any abatement opportunities a company may have and
4. the number of free permits a company may be allocated.

Initial analysis indicates most companies would not be significantly impacted by the carbon price in the short term. However some uncertainties remain - particularly after 2015 – due to political factors, the future Productivity Commission reviews and the final allocation of industry assistance. More clarity is expected in the coming months as the package is refined.

### AMP Capital's involvement:

AMP Capital has been involved in the climate change debate for many years.

- In 2004 AMP Capital helped launch the Carbon Disclosure Project (CDP) with the aim of facilitating the effective communication to investors by companies on how they manage the risks and opportunities associated with climate change. Now, the CDP is supported by 534 financial institutions with assets of over US\$64 trillion and asks over 3000 companies about their climate change risks. In Australia and NZ, the CDP is supported by 43 institutional investors, covering most of the major asset managers and asset owners. This information is made available for use by a wide audience and, most importantly, helps companies manage risks and make performance improvements.

The Carbon Disclosure Project is now the largest database of primary corporate climate change information in the world.

- AMP Capital also helped establish the Investor Group on Climate Change Australia/New Zealand (IGCC) which represents institutional investors, with total funds under management of approximately \$600 billion, and others in the investment community interested in the impact of climate change on investments.

The IGCC aims to encourage government policies and investment practices that address the risks and opportunities of climate change, for the ultimate benefit of superannuants and unit holders. This is done by raising awareness of the potential impacts of climate change and assisting the investment industry to understand and incorporate climate risks into investment decision making.

- For many years AMP Capital has also provided contribution to public policy discussions in this sphere including active involvement in the design of the Emission Trading Scheme.
- Since 2004, AMP Capital has also published a significant number of research papers on topics such as the Emissions Trading Scheme, sustainability and climate change.<sup>11</sup>



# AMP Capital Investors proxy voting statistics: 1 January to 30 June 2011

## AMP Capital's shareholder activism

AMP Capital continues to be actively committed to encouraging good corporate governance at the companies owned in the portfolios we manage.

Whilst our lodgement of proxy votes has an impact on governance we believe communication, either via letters or our meetings with company directors, to be a more constructive and effective form of shareholder activism.

Each year many governance-related letters are written to company chairmen. We continue to be pleased with the companies' 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.

It is expected an increased number of companies will seek to engage with shareholders post the recent passing of the 'two-strikes' rule. (See page 1 for more details).

## Non-executive director (NED) remuneration

Over these six months 11 companies sought approval for an increase in the maximum aggregate level of fees that could be paid to the company's NEDs.

Most increases sought were considered reasonable after taking into account various factors including the size of the company, the company's 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.

## Share and option incentive plans

In the first half of 2011 AMP Capital submitted votes on 62 incentive-related resolutions (not including votes on NED fees and remuneration reports).

Over the period, AMP Capital voted against at least one incentive-related resolution at the following companies:

Alacer Gold Corp	Integra Mining Ltd
Aurora Oil & Gas Ltd	Ivanhoe Australia Ltd
Ausdrill Ltd	Oceanagold Corp
Bathurst Resources Ltd	OM Holdings Ltd
Coalspur Mines Ltd	Tower Australia Group Ltd

AMP Capital also specifically abstained from voting on incentive schemes in several other companies.

We will 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.
- 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. We became interested in this feature several years ago after seeing instances where company executives and directors engaged in behaviour that could potentially destroy shareholder value while themselves 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 facilitate a clear understanding of the company's remuneration policy, providing evidence that 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 period AMP Capital submitted votes on 44 remuneration reports, supporting 33 (75%) of them. The remuneration reports AMP Capital voted against (as opposed to either "supporting" or "abstaining") over this period include:

Energy Res Australia Ltd	Ivanhoe Australia Ltd
Austar United Communications Limited	Hillgrove Resources Ltd

AMP Capital voted against remuneration reports which exhibited one or more of the following criteria; 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, allowing 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 other remuneration reports, adopting the 'abstention and communication' mechanism mentioned earlier.

## AMP Capital Investors Proxy Voting Statistics (2006 to 2011)

	2011 First half (6 months)	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)
Number of company meetings where votes were submitted:	96	83	97	109	122	94
Number of resolutions voted on:	473	365	473	561	556	449
% of meetings where all resolutions were supported by AMP Capital*:	67%	71%	62%	71%	59%	63%
% of meetings where incentive issues were considered:	56% (52)	63% (54)	60% (58)	66% (72)	54% (66)	71% (67)
% of meetings where incentive issues were not supported by AMP Capital:	40% (21)	25% (13)	34% (20)	35% (25)	34% (23)	42% (28)

\* Includes meetings where AMPCI was excluded from voting due to conflicts of interest eg. participation in share issues.

## Board composition

Board composition continues to be one of the most important corporate governance issues for shareholders. Despite its significance, we acknowledge 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 cannot 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. Votes against directors would generally reflect concerns including poor board attendance, an insufficient number of independent directors to represent public shareholders and issues related to poor governance.

In the first half of 2011, AMP Capital supported the majority of directors seeking re-election; those not supported were predominantly self-nominated, non board-endorsed candidates who we considered not to be ideal candidates.

In addition, AMP Capital specifically abstained from re-electing directors at several other 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.

## Termination Payments

Recent amendments to the Corporations Act 2001 (Cth) have tightened restrictions on termination payments that can be made to executives without shareholder approval.

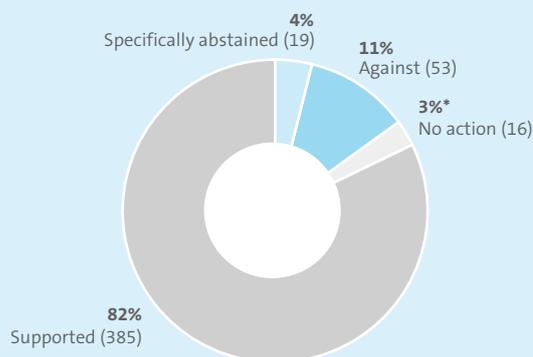
The amendments now mean any employment contracts entered into (or varied) on or after 24 November 2009 will require shareholder approval for termination benefits (paid to directors or certain executives) in excess of one year's base salary. Previously, termination benefits could reach up to seven times a recipient's total annual remuneration before shareholder approval was required.

These changes were first announced in March 2009 as part of the Federal Government's focus on excessive retirement payments following significant negative media surrounding this issue.

In the peak 2010 proxy season, it was interesting to observe how different companies responded to these amendments.

Some companies viewed an increase in base pay as an 'amendment to their employment contract' and therefore chose voluntarily to seek shareholder approval for the termination payments, while it appeared others were more opportunistic – seeking to lock in generous and long-term termination arrangements by issuing new employment contracts just prior to the 24 November 2010 deadline. AMP Capital is monitoring these developments with interest.

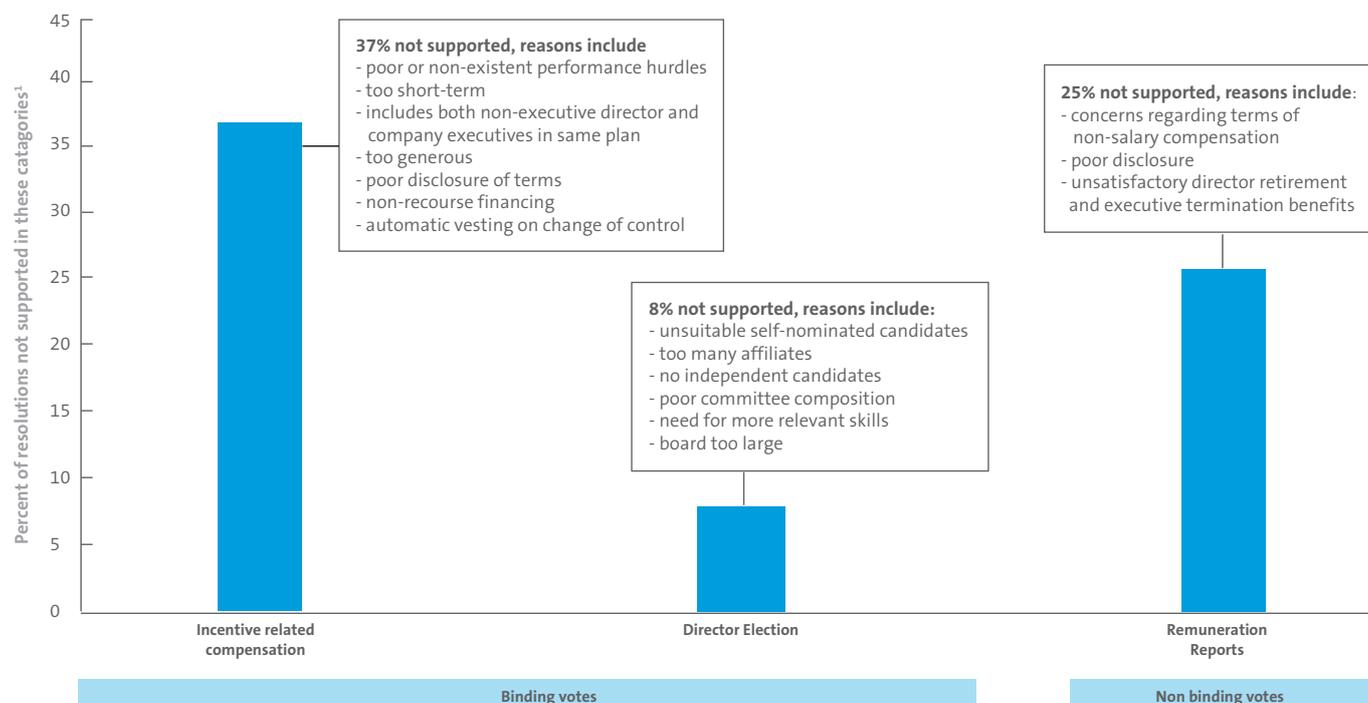
### Voting: January-June 2011



**Voting: January-June 2011**  
AMP Capital Investors voted on 473 resolutions at 96 company meetings

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

### Resolutions not supported by AMP Capital Investors in 2011 (1 January to 30 June)



Source: AMP Capital voting statistics

1. Includes where AMP Capital either voted against or specifically abstained from voting.

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**End notes:**

1. For further detail on voting statistics and the reasons why AMP Capital may not support the adoption of a Remuneration report please see previous editions of the report or the "Proxy Voting Statistics" section of this report.
2. Bradbury, David MP (23 February, 2011) Speech to the House of Representatives: Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011.
3. Under the new law, key management personnel and their closely related parties will be prohibited from participating in the non-binding shareholder vote on remuneration and on the spill resolution.
4. Note: Where a company receives a negative vote in year one, a board-spill resolution, contingent on the company receiving a second negative vote of at least 25 per cent in year two, will need to be put to shareholders at the year-two meeting. If this contingent 'board-spill' resolution is passed, such a meeting must be held within 90 days.
5. Explanatory Memorandum: Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011. Pages 7 - 8.
6. Four greenhouse gases will be covered by the scheme: carbon dioxide, methane, nitrous oxide and perfluorocarbons. Different greenhouse gases have different greenhouse potential, which is expressed as carbon dioxide equivalent.
7. The scheme excludes transport and only covers four of the six greenhouse gases (See footnote 6).
8. For example, the overhaul of the personal income tax regime including a significant increase to the tax-free threshold.
9. A Climate Change Authority will act as an independent adviser to the Government.
10. For example, the Government has proposed an additional assistance package of \$300m to the steel industry and the coal industry will receive \$1.2 billion in extra assistance. Moreover, the Clean Energy Finance Corporation is intended to be a \$10 billion government funded investor in low-emissions technologies and renewable energy.
11. AMP Capital Investors' Research Papers are available on the AMP Capital Investor website: <http://www.ampcapital.com.au/research-centre/sustainability-research/sustainability-papers.asp>

## Contact us

If you would like to know more about how AMP Capital can help you, please visit [ampcapital.com.au](http://ampcapital.com.au), or contact one of the following:

### Financial Planners

AMP Capital's Investment Representative on 1300 139 267

### Personal Investors

Your Financial Adviser or call us on 1800 188 013

### Wholesale Investors

AMP Capital's Client Service Team on 1800 658 404

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