

## Shareholder's tighten grip on the purse strings – new rules on executive remuneration commence

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In the wake of the Global Financial Crisis, there have been renewed calls for tightening of corporate governance policies (and purse strings). In response, the Government recently passed the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011*, which took effect 1 July 2011.

### Summary

The new rules are aimed at addressing shareholder discontent over the divergence between company performance and executive remuneration, and ensuring that 'best practice' governance principles are delivered as common practice. The rules:

- introduce a 'two-strikes' rule for the non-binding vote on the remuneration report;
- target potential conflicts of interest associated with directors, executives and their related parties voting on the remuneration report;
- establish rules around the selection and use of remuneration consultants to increase accountability;
- require shareholder approval for declarations of 'no vacancy' by the board where they have failed to appoint the maximum number of directors as set in the constitution;
- ban key management personnel from hedging 'at risk' remuneration; and
- ensure proxy holders are not able to 'cherry pick' proxy votes by requiring that any directed proxies that are not voted on, pass to the chair.

We focus on the first three of the above changes, outlining the practical measures that the boards of listed companies will need to consider in respect to the vote on the remuneration report.

### 'Two-strikes' rule

Since the inception of the non-binding advisory vote on the remuneration report at AGMs, there have been no *immediate* consequences for boards that chose to ignore the outcome of the vote. With the introduction of the 'two-strikes' rule, boards will now be faced with more than just noise around shareholder discontent over the remuneration report.

Listed companies that receive 25 per cent or more 'no' votes on the resolution for the adoption of the remuneration report in two consecutive years, must put to shareholders a *board spill resolution* at the AGM where the second 'strike' is received.

The *board spill resolution*, if passed by 50 per cent or more of the total votes cast, compels a company to convene another general meeting (*spill meeting*) within 90 days. At this *spill meeting*, all the incumbent

directors (with the exception of the managing director) cease to hold office and must stand for re-election along with any other person proposed by resolution. For listed companies, the threat of a *board spill resolution* may arise as early as the second half of 2012.

### **Ban on interested voting**

Changes have been introduced that restrict key management personnel and a 'closely related party' of the key management personnel, from voting on the remuneration report for AGMs held on or after 1 August 2011.

Key management personnel include those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, and are not limited to directors. The concept of a 'closely related party' is introduced into the *Corporations Act* for the first time and includes, relevantly:

- a spouse or child of that key management personnel; or
- a child of that key management personnel's spouse; or
- a dependant of that key management personnel or of that key management personnel's spouse; or
- anyone else who is one of the key management personnel's family and may be expected to influence or be influenced by the key management personnel, in their dealings with the entity; or
- a company the key management personnel controls; or
- any other person prescribed by the regulations.

### **New rules on remuneration consultants**

Remuneration consultants are widely engaged by companies to advise boards or board sub-committees on matters relating to appropriate levels of remuneration, pay structures and associated performance hurdles. Previously, there were no controls relating to the use of remuneration consultants. As such, boards were subject to criticism for deferring responsibility to a remuneration consultant and subsequently ignoring the findings of that consultant.

For financial years commencing 1 July 2011, boards will be required to sign off on the appointment of a remuneration consultant and in the report, provide:

- a statement of the recommendations made by the consultant;
- information on whether the consultant provided any other advice;
- details of the consideration payable for the remuneration recommendation; and

- a statement about whether the board is satisfied the remuneration recommendation is free from undue influence by the members or members of key management personnel;

In the short-term, these changes are likely to increase compliance costs for companies who will be forced to review their existing arrangements. However, making the process more transparent may put shareholders in a more informed and rational position when voting on the remuneration report and, as such, may counteract the bluntness of the 'two-strikes' rule.

### **Changes to the remuneration report**

The new rules also make changes to the content of remuneration reports. These changes will take effect for the financial years starting 1 July 2011, applying to reports presented at AGMs from 2012.

The key changes for listed companies, include:

- removing the requirement to report on the five highest paid executives, instead simplifying the focus to key management personnel only;
- requiring companies to include a response, outlining any action or reasons for inaction, if a 'first strike' was received on the previous years remuneration report; and
- ensuring that full particulars are provided over the use of remuneration consultants, including, details of the remuneration recommendations and a statement by the board as to the independence of the remuneration consultant.

### **What should listed companies do?**

We anticipate that as a result of the changes there will be renewed interest by shareholders in voting on the remuneration report. This increased shareholder participation, coupled with the wide net cast over which interested parties are precluded from voting on the resolution, has the potential to cause a significant shift in voting outcomes and boards may see vastly different responses to previous years.

The requirement for a full re-election of the board may be a costly and de-stabilising process. As such, the boards of listed companies will need to take practical measures to ensure they address the changes.

We recommend that listed companies:

- review the results from the previous AGM on the advisory vote on the remuneration report;
- identify what steps were taken to deal with shareholder concerns (if any) on the remuneration report, to ensure the company does not receive a 'first strike' at the 2011 AGM;
- ensure that the notice of meeting and explanatory memorandum outline how the 'two-strikes' rule operates, the possible impacts on the company of a *board spill resolution* and an appropriate proxy form in the case that the second 'no' vote is received;
- ask key management personnel to provide details of their 'closely related parties' on the share registry;

- clearly define the voting exclusions for interested parties;
- update the company *remuneration policy*;
- carefully consider how existing remuneration consultants are engaged by the company in light of the increased disclosures on transparency and independence; and
- ensure that the board is appropriately monitoring compliance with the changes brought about by the new rules.

### **Conclusion**

Approaching the 2011 reporting season, the new rules will need to be addressed immediately. If shareholder concerns over the remuneration report are not managed effectively, a company may suffer strategic and reputational damage leading to a loss of value for shareholders.

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