

Corporate Governance Year-end Report

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Remuneration: the big issue of 2009

When the Global Financial Crisis began to take hold in 2008, shareholders were for the first time able to observe how incentive schemes behaved in a downturn.

In some cases shareholders, who for years had been happy for executives to receive a share of boom-time profits, discovered that in reality 'pay and performance' at many companies had only been 'aligned' on the upside – and 'at risk' pay had never really been 'at risk' at all.

More votes against

After years of generally voting in support of remuneration reports, there is now evidence that an increasing number of shareholders have begun to question the appropriateness of pay structures. Between 2007 and the onset of the GFC in 2008 there was a 38% increase in the number of Remuneration Reports that received a significant 'against' vote (i.e. greater than 20%)¹ and preliminary statistics for the 2009 AGM season show this protest vote appears to have remained at high levels.

Since their introduction in 2005, AMP Capital has voted against many Remuneration Reports (see tables on page 3 and 5). It has been our long held view that where remuneration is concerned, alignment between the interests of shareholders and management is key. As such, it is vital appropriate performance hurdles be set. Incentives should ideally be designed to reward future superior performance with a clear link to appropriate relative benchmarks which are challenging and the achievement of which genuinely reflects an improved competitiveness of the company.

Inquiry into executive remuneration

With remuneration making headlines for all the wrong reasons, the Australian Government launched a public inquiry into executive remuneration². In early October, after months of gathering data, the Productivity Commission released its draft discussion paper confirming executive pay had been growing strongly and while there was no evidence of a system-wide failure, there had been episodes of poor practice and excess, pointing to weakness in governance that warranted action.

The 'two-strikes' rule

The Productivity Commission proposal that generated the most interest has been the 'two-strikes rule'. This rule suggests entire company boards should be spilled whenever companies receive more than 25% votes 'against' their Remuneration Report in two consecutive years. The introduction of such a proposal would undoubtedly lead to increased scrutiny of remuneration practices. It would force all directors on a board to take notice and one would expect companies would be more inclined to engage directly with their shareholders on remuneration matters - especially when significant 'against' votes had been received. In addition, the threat of a board spill would place greater pressure on shareholders themselves to carefully consider how their votes would be cast.

While this increased scrutiny of remuneration would be positive, a few issues need to be considered before the 'two-strikes' proposal could be implemented. For example: Do the benefits outweigh the costs? Not only would it be expensive to hold an extraordinary general meeting to facilitate the 'spill', but the removal of directors would undoubtedly be costly in terms of disruption and the loss of continuity.

In addition, there is the technical consideration as to who should be entitled to vote. Given the increased stakes, potential 'conflicts of interest' need to be addressed. For example, when considering the adoption of the remuneration report at Ramsay Health Care's AGM, should major shareholder Paul Ramsay be allowed to vote his 73 million shares? While Mr Ramsay is no longer an executive director, as a non-executive director (NED) he is beneficiary of the company's NED retirement benefit scheme. At the recent Ramsay Health Care AGM, Mr Ramsay's vote had a significant impact; 93.4 million votes were cast 'for' the remuneration report (apparently including Mr Ramsay's 73 million shares) and 44.4 million were cast 'against'.

Big “no” votes on remuneration in 2009

Given the widespread interest in remuneration, it is useful to examine the factors of greatest concern to shareholders – noting that remuneration reports will become even more important if, in future, the Productivity Commission’s ‘two-strikes’ proposal takes effect.

In the 2009 proxy season, four Top 300 companies received ‘a greater than 50%’ vote against the adoption of their remuneration reports³. The significant protest votes at Downer EDI, Energy Developments, NRW Holdings and St Barbara Mines reflect dissatisfaction with regard to various factors, including:

1. Lack of alignment: demonstrated by significant increases in fixed pay and the payment of large termination payments, bonuses and/or retention grants – at a time when company profits and/or share prices fell. Incentive structures appeared to reward average (or under) performance by being subject to performance hurdles that have been set too low or require only continued service.
2. ‘At risk’ pay not being truly ‘at risk’: demonstrated by companies re-setting (lowering) performance hurdles or allowing re-testing against previously unattained hurdles.
3. Poor disclosure: demonstrated by a lack of clarity around both short-term and long-term performance hurdles– thus making it difficult for shareholders to determine whether they are sufficiently challenging or aligned.
4. In addition, there has been the ‘surprise’ factor. This year, more than ever before, shareholders have been subjected to a range of ‘nasty’ surprises. Company remuneration reports have revealed a range of unexpected substantial and unexplained pay rises, exceedingly generous termination payments and/or ‘retention’ grants. Many of these bore little resemblance to previously reported (and previously approved) incentive and termination structures.

Bottom line

Since the onset of the financial crisis, shareholders have become more inclined to vote against poor remuneration structures. Of particular concern to shareholders this year has been evidence some ‘at risk’ pay had never really been ‘at risk’, as well as the number of other unpleasant surprises lurking in some remuneration reports.

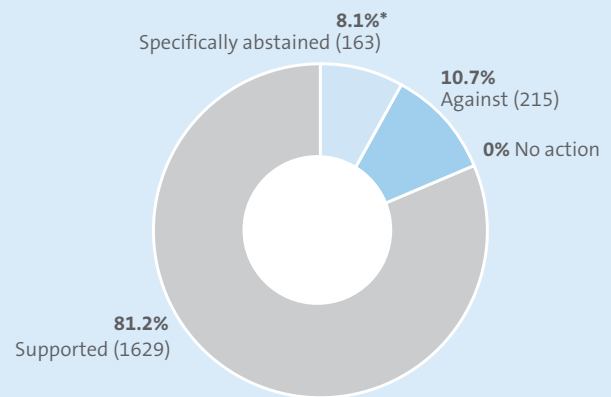
Given the importance of remuneration structures, shareholders will continue to focus on the appropriateness and the alignment they provide. Should the Productivity Commission’s ‘two-strikes’ proposal be introduced, shareholder dissatisfaction with remuneration reports will have even greater potential consequences.

Proxy voting report

In 2009, AMP Capital voted on 2007 resolutions at 406 company meetings. The bulk of resolutions related to the re-election of directors and non-salary remuneration. AMP Capital supported all resolutions at 224 (55%) meetings.

Voting 2009

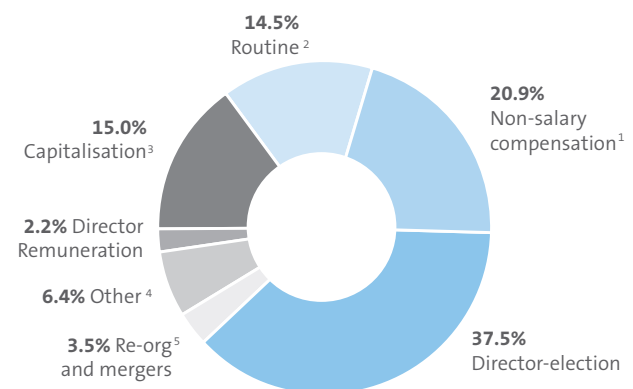
AMP Capital voted on 2007 resolutions at 406 company meetings



* Includes resolutions where AMP Capital was excluded from voting eg. participated in share issues

Categories of resolutions considered in 2009

as a percentage of all votes cast



Source: Riskmetrics – Votex Report

1. Relates to remuneration reports, employees stock and option plans, various long-term Incentive plans, retirement plans etc.
2. Accepting financial statements, general amendments to constitution, appointing auditors, change company name, etc.
3. Approval and ratification for DRP, share issues, placements, etc.
4. Shareholder resolutions (self-nominated directors), board related, anti-takeover provisions etc
5. Acquisitions, mergers, asset sales etc.

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. 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 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 2009, AMP Capital submitted votes on 288 remuneration reports, supporting 180 (63%) of them. The remuneration reports AMP Capital voted against (as opposed to either "supporting" or "abstaining") over this period include:

Abacus Property Group	Hillgrove Resources Ltd
AJ Lucas Group Ltd	Industrea Ltd
Austereo Group Ltd	Kingsgate Consolidated
Avoca Resources Ltd	Leighton Holdings Ltd
AWB Ltd	Lend Lease Corporation Ltd
Babcock & Brown Infrastructure Group	Lynas Corporation Ltd
Bannerman Resources Ltd	Mcmillan Shakespeare Ltd
Boart Longyear Group	Nexus Energy Ltd
Cabcharge Australia Ltd	NRW Holdings Ltd
Cape Lambert Iron Ore Ltd	Oceania Capital Partners Ltd
Cockatoo Coal Ltd	OZ Minerals Ltd
Coffey International Ltd	Perseus Mining Ltd
Crane Group Ltd	Photon Group Ltd
Cudeco Ltd	QRxPharma Ltd
Dominion Mining Ltd	Ramsay Health Care Ltd
Domino's Pizza Enterprises Ltd	Sims Metal Management Ltd
Downer EDI Ltd	Sino Gold Mining Ltd
Eastern Corporation Ltd	St Barbara Ltd
Eastern Star Gas Ltd	Straits Resources Ltd
Energy Resources of Australia Ltd	Technology One Ltd
Felix Resources Ltd	Transurban Group
Gindalbie Metals Ltd	United Group Ltd
Gryphon Minerals Ltd	Western Areas
Gunns Ltd	Whitehaven Coal Ltd
HFA Holdings Ltd	

AMP Capital voted against remuneration reports which exhibited the following criteria; 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.

While the remuneration reports of some companies have improved, others did not show sufficient improvement, and so reappear on the list. In addition to those companies named above, AMP Capital also specifically abstained from voting on 47 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. As such, we continue to note with interest the various self-assessments and peer-reviews commissioned by boards, as well as studies conducted by academics and other interested parties.

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 included the nominations of directors to the following boards:

Austereo Group Ltd	Harvey Norman Holdings Ltd.
Dominion Mining Ltd.	OZ Minerals Ltd
Energy World Corp	SP AusNet
Gindalbie Metals Ltd	Western Areas
GWA International Ltd.	

In most cases these boards had too few independent directors, or planned to appoint additional executives, or otherwise affiliated directors, to boards that already had a majority of affiliated directors. In addition, AMP Capital specifically abstained from re-electing directors at a further 25 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.

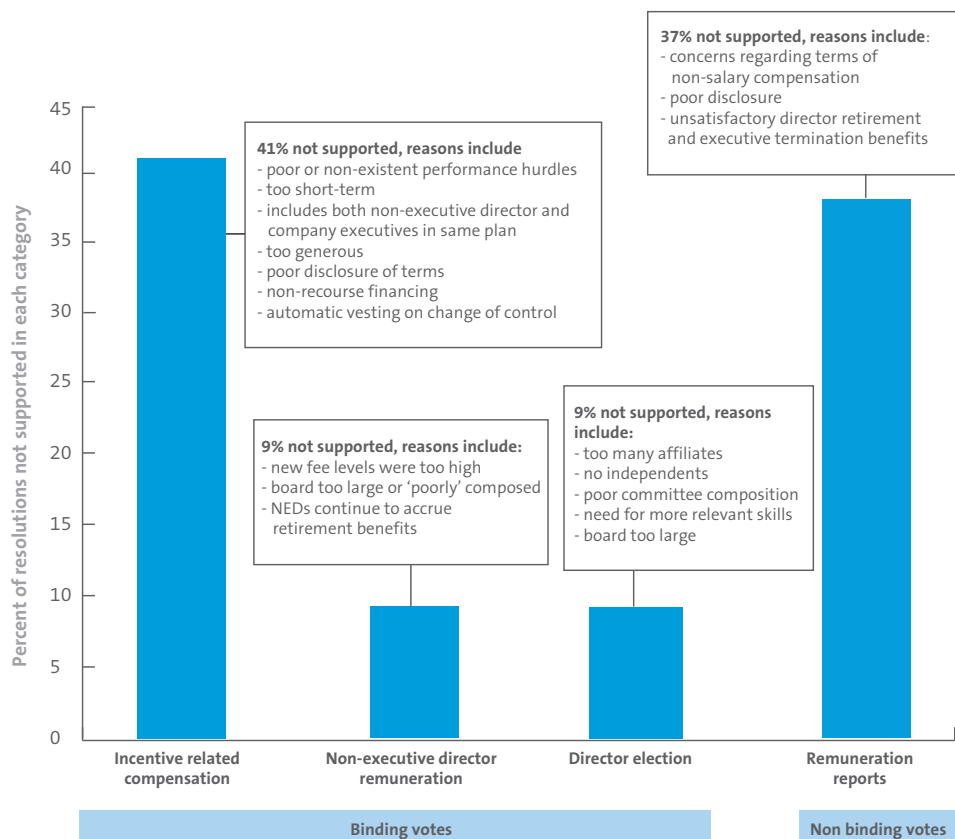
Re-organisations, mergers and capitalisation changes

Each year shareholders are asked to vote on 're-organisations, mergers and capitalisation changes'. These resolutions seek approval for, inter alia, acquisitions, asset sales, loans and/or merger agreements, and various share issues (including those made in connection with acquisitions). Generally, the number of such resolutions put to shareholders in any particular period is not significant, typically representing less than 3% of the total number of resolutions under consideration. In 2007 the environment for corporate activity became more favourable and the number of such resolutions increased substantially – generally relating to the issue of shares in connection with acquisitions.

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.

In 2009, the number of these resolutions was back at the 4% level, most seeking shareholder ratification of capital raisings used to replenish balance sheets impacted by the GFC. Interestingly, Australian businesses raised a record \$119.9 billion through equity issues between July 2008 and September 2009 - allowing companies to repay debt and restore balance sheets.

Resolutions not supported by AMP Capital Investors in 2009



Source: AMP Capital voting statistics

Governance snippets

Government inquiries and reviews in a nutshell:

The global financial crisis (GFC) turned a spotlight on the workings of financial markets, prompting the Government to initiate a series of reviews - each with the potential to impact the way in which business is done in Australia.

The four reviews having the greatest impact on financial markets and governance are as follows:

Ripoll: Inquiry into financial products and services in Australia

- **Main premise:** Given the GFC and the collapse of high profile companies such as Storm Financial and Opes Prime, the Government considered it important both the regulatory regime and regulators were adequately equipped and ensure Australian investors have confidence in financial products and services.

Key recommendations included⁴:

- The Corporations Act be amended to explicitly state that advisers hold a fiduciary duty to put the interests of their clients first.
- The Government consult with the industry on the best way to cease payments from product manufacturers to financial advisers, such as commissions and volume bonuses.
- ASIC and the industry work together to form a professional standards board where anyone wanting to call themselves a financial adviser would be required to join. This body would establish, monitor and enforce nomenclature, competency and conduct standards.
- The Government consider making the cost of financial advice tax deductible for consumers.
- ASIC be appropriately resourced to perform effective risk-based surveillance of the advice provided under an Australian Financial Services Licence.

- ASIC be given extended powers to remove individuals and licensees from providing financial services.
- The Government investigate different options for a last resort compensation scheme.

- **Timing:** Report was tabled on November 23, 2009. The findings will be considered along with those of the Cooper review (below).
- **Governance focus:** Useful lessons can be learned from how poor fee structures can adversely impact behaviour and also how and why conflicts of interest can be eradicated.

Cooper: A review into the governance, efficiency, structure and operation of Australia's superannuation system

- **Main premise:** To determine whether the current superannuation system in Australia is as good as it could be in serving the long-term interests of members and whether it will continue to do so for the next 20 years.
- **Timing:** Preliminary report due early December 2009; Final report due 30 June 2010.
- **Governance focus:** As super funds potentially grow and consolidate – will they be adequately equipped to handle the commensurate increase in governance responsibilities? How engaged should share-owners, i.e. trustees and investment managers be?

Henry: Australia's future tax system

- **Main premise:** A 'root and branch' approach has been taken to examine Australian and State government taxes and interactions with the transfer system. This has been done in order to make recommendations that will position Australia to deal with the demographic, social, economic and environmental challenges that lie ahead.
- **Timing:** Final report due December 2009.
- **Governance focus:** As taxation has a significant impact on the way in which companies will structure their remuneration – there is currently clear evidence many companies are awaiting clarity around future tax rules before implementing or changing their incentive schemes.

Productivity Commission (Gary Banks): Public Inquiry into Executive Remuneration

- **Main premise:** The Productivity Commission has been asked to undertake a public inquiry into the regulatory framework around remuneration of directors and executives of companies regulated under the Corporations Act.
- **Timing:** Discussion draft released September 30, 2009; Final report due December 2009.
- **Governance focus:** As this inquiry is focused on executive remuneration it is expected to have the greatest impact on the corporate governance of Australian companies. Remuneration not only impacts what a CEO will focus on but is also a window into the relationship between a board of directors and company management. (Some recommendations made by the Productivity Commission have been discussed elsewhere in this report and others will be covered in future editions of this report.)

APRA's prudential requirements on remuneration

- **Main premise:** APRA participated in the Financial Stability Board's⁵ initiative on executive remuneration and has since released its prudential requirements on remuneration for authorised deposit taking institutions (ADIs) and general and life insurance companies.

APRA's governance standards set out the minimum remuneration requirements that a regulated institution must satisfy in the interests of promoting effective governance, emphasising that remuneration needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements.

The relevant industry governance standards (APS 510, GPS 510 and LPS 510) and an associated prudential practice guide (PPG 511) have now been published.

Where APRA judges that the remuneration arrangements of a regulated institution are likely to encourage excessive risk taking, APRA has several supervisory options, including the power to impose additional capital requirements on that institution.

The Prudential Practice Guide on Remuneration (PPG 511) assists boards to comply with the new governance standard and covers issues such as:

- the use of deferred remuneration;
- guidance on the links between incentive and risk and on the use of equity in incentive arrangements;
- the need to link incentive remuneration to both forward and backward-looking risk measures; and
- the balance between fixed and variable components.

- **Timing:** The revised governance standards will come into effect on 1 April 2010. By this date, APRA requires that the Board Remuneration Committee, with appropriate composition and charter, will be established and a suitable Remuneration Policy will be in place.
- **Governance focus:** It has been recognised that poorly structured remuneration practices may result in excessive risk-taking by individuals and can undermine the risk management systems of prudentially regulated institutions.

GMI Ratings:

Australia maintains fourth place global governance rating:

Each year GovernanceMetrics International®, an independent corporate governance research and rating agency, publishes global ratings⁶. The most recent global ranking, as at September 22, 2009, show Australia has maintained its fourth place ranking⁷.

According to GMI President and CEO Howard Sherman, "Many of the country rankings come as no surprise, as GMI research and ratings place a great deal of emphasis on transparency and accountability. But a low ranking today also spells opportunity.

"As emerging markets in particular compete for global capital and develop a cross-border shareholder base, it seems inevitable they will face pressure to become more transparent and less insular. South Africa serves as good example here. Its average rating of 6.49 was the highest among all of the emerging markets we cover and higher than many developed markets. We think that translates into a competitive advantage for the South African economy."

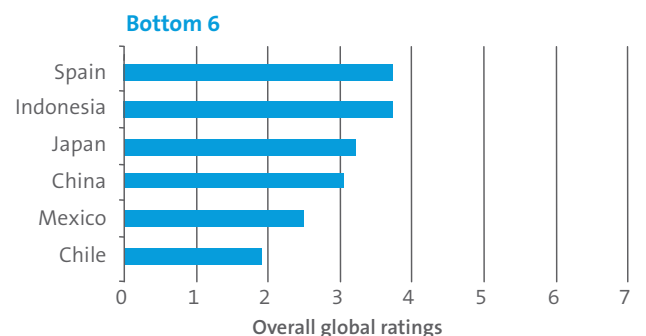
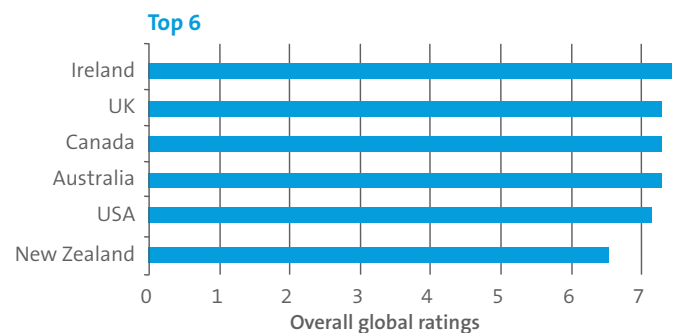
"Still, country rankings are only a guide," Sherman added. "Within each country there are companies with relatively strong or improving governance and those with relatively weak profiles. That is where we and our clients concentrate our research efforts and where the real investment opportunity, or risk, is usually found."

The lowest ranked countries worldwide included China (3.01), Mexico (2.48) and Chile (1.96). China's ranking was particularly striking in light of its rapid growth in recent years and is largely due to 82% of companies covered by GMI having a non-independent board, 60% having an executive chairman with none of the 40% non-executive chairmen classified as independent by GMI, and disclosure levels that are still well below standard.

Other notable results included Japan, the world's second largest economy but with a low average rating of 3.32. Reasons for this include the fact that 96% of Japanese companies rated by GMI have a majority of non-independent directors on their boards, 45% have no independent directors at all and 30% comprise executive directors only. GMI also found some remaining problems with cross-shareholdings (5%) and a sizable proportion of companies with poison pills (30%).

The following extract highlights countries rated by GMI in the 'Top 6' and 'Bottom 6' respectively.

GMI country rankings as at 22 September, 2009: overall rating by country



Source: GovernanceMetrics International www.gmiratings.com

Governance snippets (continued)

Lost votes:

Progress being made

Since January 2006, when AMP Capital first highlighted concerns over the issue of lost votes in Australia, many positive discussions have been held – firstly, to verify the problem and then to work toward a solution. While on the surface it appeared progress had slowed, much work has continued behind the scenes.

Riskmetrics recently disclosed they had worked together with Computershare to implement a system for electronic vote lodgement and confirmation. The system has initially been set-up for all Australian-based issuer clients.

It is significant step forward that vote lodgement can be based on key-strokes rather than faxes. Riskmetrics Australia's director, Dean Paatsch, has said that while further development will be required before the process is entirely automated, progress made means clients of Riskmetrics' voting platforms will have access to auditable, bankable vote confirmations which provide Riskmetrics with the ability to identify potential over-votes before they occur and work with the client to resolve any issues.

ENDNOTES:

- 1 Analysis of voting on Remuneration Reports at the Top300 Australian companies: 2007 – 54 companies received greater than 10 percent against; 24 greater than 20 percent; In 2008 – 68 greater than 10 percent against, 33 greater than 20 percent. (Source: Riskmetrics)
- 2 Australian Government - Productivity Commission: Executive Remuneration. (Chaired by Gary Banks).
- 3 As at December 14, 2009
- 4 Media Release: Parliamentary Joint Committee on Corporations and Financial Services (November 23, 2009). Inquiry into financial products and services in Australia. The committee's report is available on the committee's website at: http://www.aph.gov.au/Senate/committee/corporations_ctte/index.htm
- 5 As announced in the G20 Leaders Summit of April 2009, the expanded Financial Stability Forum was re-established as the Financial Stability Board (FSB) with a broadened mandate to promote financial stability.
- 6 Source: GovernanceMetrics International <http://www.gmiratings.com>
- 7 GMI rating criteria are based on securities regulations, stock exchange listing requirements and various corporate governance codes and principles. Among the latter are principles promulgated by the OECD, the Commonwealth Association for Corporate Governance, the International Corporate Governance Network and the Business Roundtable. In addition, GMI have sought the views of various corporate governance and legal advisors, institutional investors, corporate officers and company directors, and utilized the combined experience of the founding partners.

Contact us

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